PRESENT LAW AND PROPOSALS RELATING TO ESTATE AND GIFT TAXATION AND EXPENSING BY SMALL BUSINESSES

Scheduled for a Hearing

Before the

SENATE COMMITTEE ON FINANCE

on June 7, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on June 7, 1995, on issues relating to small business tax incentives. Specifically, the hearing will examine estate and gift taxation and expensing of equipment for small businesses under section 179 of the Internal Revenue Code of 1986 and will analyze proposed changes to these present-law provisions. The proposed changes to the estate and gift taxes are contained in section 351 of H.R. 1215 (the "Tax Fairness and Deficit Reduction Act of 1995") as passed by the House of Representatives on April 5, 1995; S. 105; S. 161 (the "American Family Business Preservation Act"); S. 628 (the "Family Heritage Preservation Act"); S. 692 (the "Family Forestland Preservation Tax Act of 1995"); and S. 867 (the "National Family; Enterprise Preservation Act of 1995"). The proposed change to section 179 is contained in section 352 of H.R. 1215. This document,[1] prepared by the staff of the Joint Committee on Taxation, describes the present-law estate and gift tax and section 179 and the applicable provisions of proposed legislation that would amend present law.

Part I of the document is an overview of present-law estate and gift taxation and equipment expensing and the legislative proposals that would amend these present-law rules. Part II is a description of estate and gift tax provisions of present law, H.R. 1215 as passed by the House, and Senate bills. Part III is a description of expensing provisions of present law and H.R. 1215.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Proposals Relating to Estate and Gift Taxation and Expensing by Small Businesses (JCX-23-95), June 6, 1995.

I. OVERVIEW

Estate and gift taxation

A gift tax is imposed on any transfer of property by gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $10,000 or less per donor per donee generally are not subject to tax.

An estate tax also is imposed on the "taxable estate" of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death. The taxable estate generally equals the worldwide "gross estate" less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to an individual's cumulative taxable gifts and bequests. Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. A unified credit of $192,800 is available with respect to taxable transfers by gift and at death, which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased out by a 5-percent surtax imposed upon cumulative taxable transfers over $10 million and not exceeding $21,040,000.

A separate transfer tax is imposed on generation-skipping transfers to a beneficiary of a generation more than one generation below that of the transferor. The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million.

Section 351 of H.R. 1215, as passed by the House, would increase the present-law unified credit of $192,800 (i.e., the amount that effectively exempts $600,000 in taxable transfers from the estate and gift tax) to $248,300 (i.e., the amount that would effectively exempt $750,000 in taxable transfers from the estate and gift tax) over a three-year period beginning in 1996. After 1998, the unified credit amount would be indexed for inflation. The bill would also index the following amounts for inflation beginning after 1998: (1) the $10,000 annual exclusion for gifts; (2) the $750,000 ceiling amount on special use valuation under Code section 2032A; (3) the $1,000,000 generation-skipping transfer tax exemption; and (4) the value of a closely-held business (i.e., $1,000,000) eligible for the special 4-percent interest rate on deferred payments of estate tax liability under Code section 6601(j).

S. 105 would provide that the cash lease of specially valued real property by a qualified heir to certain family members would not cause the qualified use of such property to cease for purposes of

imposing the additional estate tax under Code section 2032A(c). S. 628 would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax. S. 692 would provide special estate tax treatment for qualified conservation easements, and special estate tax valuation for qualified forest lands. S. 161 and S. 867 would make certain changes to the estate and gift tax treatment of certain family-owned businesses.

Equipment expensing for small businesses

Taxpayers generally recover the cost of tangible property placed in service in a trade or business over time through annual depreciation deductions. Under present-law section 179, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $17,500 of the cost of tangible personal property (i.e., generally, machinery and equipment) placed in service for the taxable year. The $17,500 amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

Section 352 of H.R. 1215 would increase the amount allowed to be expensed under section 179 to $35,000 for taxable years beginning after 1998. The increase to $35,000 would be gradually phased in from 1996 to 1999.

II. ESTATE AND GIFT TAXATION

A. Present-Law Rules

Application of the estate and gift tax

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. Since 1976, the gift tax and the estate tax have been unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.[2] Under this rate schedule, the unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)).

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. Since 1987, the unified credit amount has been $192,800 (sec. 2010), which effectively exempts a total of $600,000 in cumulative taxable transfers from the estate and gift tax. The benefits of the unified credit (and the graduated estate and gift tax rates) are phased-out by a 5-percent surtax imposed upon cumulative taxable transfers between $10 million and $21,040,000 (sec. 2001(c)(2)).[3]

The unified credit originally was enacted in the Tax Reform Act of 1976. As enacted, the credit was phased in over five years to a level that effectively exempted $175,625 of taxable transfers from the estate and gift tax in 1981 (i.e., a unified credit of $47,000). The Economic Recovery Tax Act of 1981 increased the amount of the unified credit each year between 1982 and 1987, from an

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[2] Prior to 1976, separate tax rate schedules applied to the gift tax and the estate tax.

[3] Thus, if a taxpayer has made cumulative taxable transfers exceeding $21,040,000, his or her average transfer tax rate will be 55 percent under present law.

effective exemption of $225,000 in 1982 to an effective exemption of $600,000 in 1987. The unified credit has not been increased since 1987.

Annual exclusion for gifts

A taxpayer may exclude $10,000 of gifts made to any one donee during a calendar year (sec. 2503). This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Prior to 1982, the annual exclusion was $3,000.

Valuation

Generally, for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Fair market value is determined as of either (1) the time of the decedent's death, or (2) the "alternate" valuation date of six months after the decedent's death (sec. 2032).

Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Currently, the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at the time of death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property) is at least 50 percent of the decedent's gross estate (reduced by mortgages and other secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[4] (4) the real property qualifying for current use valuation must pass to a qualified heir;[5] (5) such real property must have been owned by the decedent or a member of the decedent's family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely held business by the decedent or a member of the decedent's family in 5 years out of the 8 years immediately preceding the decedent's death (Code sec. 2032A (a) and (b)).[6]

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[4] For purposes of the 50-percent and 25-percent tests, the value of the property is determined without regard to its current use value.

[5] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[6] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or

If, after an election is made to specially value property at its current use value, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation. Some courts have held that the cash rental of specially valued property after the death of the decedent is not a qualified use and, therefore, results in the imposition of the additional estate tax under section 2032A(c). Martin v. Commissioner, 783 F.2d 81 (7th Cir. 1986) (cash lease to unrelated party); Williamson v. Commissioner, 93 T.C. 242 (1989) (cash lease to family member).

Contributions for conservation purposes

A deduction is allowed for estate and gift tax purposes for a contribution of a qualified real property interest to a charity (or other qualified organization) exclusively for conservation purposes (secs. 2055(f), 2522(d)). Qualifying conservation purposes are: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit, and is either for the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy; or (4) the preservation of an historically important land area or certified historic structure (sec. 170(h)(4)). For this purpose, a qualified real property interest means the entire interest of the transferor in real property (other than certain mineral interests), a remainder interest in real property, or a perpetual restriction on the use of real property (sec. 170(h)). Also, a contribution will be treated as "exclusively for conservation purposes" only if the conservation purpose is protected in perpetuity.

Generation-skipping transfer tax

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct

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other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

skips, taxable terminations and taxable distributions.[7] The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million.

Installment payment of estate tax

Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate.

If an election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under Code section 6621 (i.e., the Federal short term rate plus three percentage points). Under Code section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. The maximum amount that may be subject to the 4-percent rate is the lower of (1) $345,800 (i.e., the amount of estate tax on the first $1,000,000), less the amount of allowable unified credit, or (2) the amount of estate tax attributable to the closely-held business that is being paid in installments pursuant to Code section 6166.

B. Description of Provision in H.R. 1215

Description of Provision

Increase in unified credit

Section 351 of H.R. 1215, as passed by the House, would increase the present-law unified credit of $192,800 to $248,300 over a three-year period beginning in 1996. For decedents dying and gifts made in 1996, the unified credit would be $229,800 (i.e., the amount that would effectively exempt $700,000 in taxable transfers from the estate and gift tax). For decedents dying and gifts made in 1997, the unified credit would be $239,050 (i.e., the amount that would effectively exempt $725,000 in taxable transfers from the estate and gift tax). For decedents dying and gifts made after 1997, the unified credit would be $248,300 (i.e., the amount that would effectively exempt $750,000 in taxable transfers from the estate and gift tax). After 1998, the unified credit would be indexed for

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[7] For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a gift from grandparent to grandchild). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

inflation each year by multiplying the applicable exclusion amount of $750,000 by a cost of living adjustment. The indexed exclusion amount would be rounded to the nearest $10,000.

To reflect the increase in the unified credit, the provision also would make conforming amendments to (1) the 5-percent surtax in order to permit the proper phase out of the increased unified credit, (2) the general filing requirements for estate and gift tax returns under Code section 6018(a), and (3) the amount of the unified credit allowed under Code section 2102(c)(3) with respect to nonresident aliens with U.S. situs property who are residents of certain treaty countries.

Indexing of certain provisions

In addition to increasing and indexing the unified credit, the H.R. 1215 would index the following amounts for inflation beginning after 1998: (1) the $10,000 annual exclusion for gifts; (2) the $750,000 ceiling amount on special use valuation under Code section 2032A; (3) the $1,000,000 generation-skipping transfer tax exemption; and (4) the value of a closely-held business (i.e., $1,000,000) eligible for the special 4-percent interest rate under Code section 6601(j). Indexing of the annual exclusion would be rounded to the nearest $1,000 and indexing of the other amounts would be rounded to the nearest $10,000.

Effective Date

The provisions relating to the increase in the unified credit would apply to the estates of decedents dying, and gifts made, after December 31, 1995. The indexing of the other provisions would apply after December 31, 1998.

C. Descriptions of Other Bills

1. S. 105 (Senators Daschle, Conrad, Dorgan, Kassebaum, and Baucus)

Description of the Bill

The bill would provide that the cash lease of specially valued real property by a qualified heir to a "member of the family" (who continues to operate the farm or closely held business) does not cause the qualified use of such property to cease for purposes of imposing the additional estate tax under Code section 2032A(c).

Effective Date

The bill would apply to rentals occurring after December 31, 1976.

2. S. 628 (Senators Kyl and Helms)

Description of the Bill

The bill would repeal the Federal estate and gift tax and the Federal generation-skipping transfer tax.

Effective Date

The bill would apply to decedents dying, gifts made, and generation-skipping transfers occurring the date of enactment.

3. S. 867 (Senator Cochran)

Description of the Bill

The bill would provide three special rules applicable to "family enterprise property." For purposes of the bill, family enterprise property generally would mean any interest in real or personal property devoted to use as a farm or use for farming purposes or that is used in a trade or business, if at least 80 percent of the ownership of the farm or trade or business is held by five or fewer individuals or by members of the same family.

First, in addition to the unified credit of $192,800 allowed under present law, the bill would grant an additional unified credit amount of up to $121,800 with respect to gifts and bequests of "family enterprise property." Thus, the bill would increase the amount of property that can be transferred free of estate and gift tax as a result of the unified credit from $600,000 to $1 million, provided that at least $400,000 of such transfers were gifts and bequests of family enterprise property.[8]

Second, the bill would allow an exclusion for annual gifts of up to $10,000 of family enterprise property per donee, in addition to the $10,000 annual exclusion for gifts allowed under present law.

Third, under the bill, a decedent's gross estate would be reduced by 50 percent of the value of any family enterprise property included in the gross estate. The maximum reduction under this provision would be $1 million. Any reduction in value would be subject to recapture of estate tax if the family member(s) cease active management of the property or dispose of the property within ten years after the decedent's death. The amount of recapture would depend upon when the recapture

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[8] As presently drafted, the bill literally only requires $121,800 of family enterprise property to qualify for the maximum additional credit of $400,000. The Joint Committee on Taxation staff understands that the intent, however, is that the additional credit apply only to family enterprise property and not be available to offset the tax attributable to other property.

occurs during the ten-year period. For this purpose, the term active management means the making of the management decisions of a business other than the daily operating decisions.

In addition to the special rules applicable to family enterprise property, the bill would increase the $750,000 ceiling amount on special use valuation under Code section 2032A to $1 million.

Effective Date

The bill would apply to the estates of decedents dying, and gifts made, after December 31, 1995.

4. S. 161 (Senator Murray)

Description of the Bill

The bill would make several changes to the estate and gift tax applicable to qualified "family-owned business interests." For purposes of the bill, a qualified family-owned business interest would mean any interest in a sole proprietorship, a partnership carrying on a trade or business with 15 partners or less, and a corporation with 35 shareholders or less.

First, in certain cases, the bill generally would reduce the estate tax rate on qualified family-owned business interests to either 15 or 20 percent. To qualify for this reduction and tax rates, the value of the qualified family-owned business interest must exceed 50 percent of the value of the adjusted gross estate. In addition, during five of the eight years preceding the decedent's death the qualified family-owned business interest must have been owned by the decedent or a member of her family and the decedent or a member of her family must have materially participated in the business. Any reduction in tax rate would be subject to recapture if certain disposition events occurred or the heirs ceased to materially participate with respect to the qualified family-owned business interest within ten years following the decedent's death.

Second, if the estate tax is deferred under section 6166, the special 4-percent interest rate available under section 6601(j) generally would apply to the tax imposed on the value of the qualified family-owned business interest without regard to the $1 million limitation.

Third, the bill would allow an alternate valuation date of 40 months after the decedent's death (rather than six months after the decedent's death as provided under present-law sec. 2032) to be used with respect to estates that qualify for the reduced tax rates.

In addition to the special rules applicable to family-owned businesses, the bill would change the annual exclusion for gifts such that the annual exclusion cannot be less than 15 percent of the donor's earned income during the calendar year. Finally, the bill would index the applicable unified credit for inflation and would make conforming amendments to the unified credit to reflect the other changes made by the bill.

Effective Date

The bill would be effective with respect to the estates of decedents dying, and gifts made, after December 31, 1995.

5. S. 692 (Senator Gregg)

Description of the Bill

a. Special treatment for conservation easements (sec. 101 of the bill)

The bill would provide that an executor may irrevocably elect to exclude from a decedent's gross estate the value of any land subject to a qualified conservation easement. The amount excluded would be the value of any qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) made by the decedent or a member of the decedent's family. A qualifying conservation purpose would be any of the purposes defined in present-law section 170(h)(4), except that the preservation of a historically important land area or a certified historic structure would not be a qualifying conservation purpose under the bill. The basis of such land acquired at death would be a carryover basis (i.e., the basis would not be stepped-up to its fair market value at death). A member of the decedent's family would include his or her ancestors, his or her spouse, a lineal descendant of the decedent, the decedent's spouse or the decedent's parents, and the spouses of any of the foregoing lineal descendants (sec. 2032A(e)(2)).

Effective Date

The provision would apply to the estates of decedents dying after December 31, 1995, with respect to qualified conservation easements granted after December 31, 1995.

b. Special estate tax valuation of certain forest land (sec. 102 of the bill)

In general, the value of certain forestland (called "qualified forestland") for Federal estate taxes purposes would be its value for use as a timber operation. "Qualified forestland" would be real property which either (1) qualifies for a State differential use value assessment plan or (2) is forestland with a minimum size of 10 acres that is subject to a forest management plan. The proposal is similar to the special valuation rules of present-law section 2032A with the following major differences:

(1) In order to qualify for the new valuation rules, the value of the forestland must be more than 25 percent of the adjusted value of the gross estate (i.e., there also is not a 50 percent test as with present law special valuation rules)

(2) Heirs would be required to perform "active management" with respect the property (instead of "material participation");

(3) The estate tax value of forestland would the lowest of: (a) its State assessed value; (b) the sales value of comparable rural forestland; (c) the capitalized value of expected income from timber operations; or (d) any other factor which fairly values the timber value of the property;

(4) There would be no limit on the amount that the value of the forestland could be reduced by the provision (i.e., there would be no $750,000 limit);

(5) Continued forestland use would be required for 25 years (instead of the 10 years provided by the sec. 2032A special valuation rules);

(6) A qualified heir can dispose of the forestland to any other person before 25 years without recapture tax if the transferee agrees to continue use of the property as qualified forest use;

(7) In addition to cessation of forestland use, recapture would occur if any depreciable improvements are made to the property (other than those relating to qualified forestland use);

(8) A qualified heir can make a contribution of a conservation easement without recapture tax; and,

(9) Recapture from involuntary conversion or exchanges would be avoided to the extent conversion proceeds or replacement property are invested in property to be used for qualified forest use.

Effective Date

The provision would apply to the estates of decedents dying after December 31, 1995.

III. EXPENSING BY SMALL BUSINESSES

Present Law

Taxpayers generally recover the cost of tangible property placed in service in a trade or business over time through annual depreciation deductions. In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to expense and deduct up to $17,500 of the cost of qualifying property placed in service for the taxable year (sec. 179).[9] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $17,500 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. In addition, the amount eligible to be expensed for a taxable year may not exceed the taxable income of the taxpayer for the year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). The $17,500 and $200,000 amounts are not indexed for inflation.[10]

Description of Provision

Section 352 of H.R. 1215, as passed by the House, would increase the $17,500 amount allowed to be expensed under Code section 179 to $35,000. The increase would be phased in as follows:

Taxable year beginning in--	Maximum expensing
1996	$22,500
1997	$27,500
1998	$32,500
1999 and thereafter	$35,000

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[9] The amount permitted to be expensed under Code section 179 is increased by up to an additional $20,000 for certain property placed in service by a business located in an empowerment zone (sec. 1397A).

[10] The Omnibus Budget Reconciliation Act of 1993 increased the amount allowed to be expensed under section 179 from $10,000 to $17,500. The $10,000 amount had been provided by the Tax Reform Act of 1986 ("1986 Act"). Prior to the 1986 Act, taxpayers were allowed to expense up to $5,000 of the cost of qualifying personal property. The $5,000 limit had been scheduled to rise to $7,500 for taxable years beginning in 1988 and 1989, and $10,000 thereafter. The 1986 Act also instituted the present-law $200,000 phaseout and taxable income limitation.

Effective Date

The provision would be effective for property placed in service in taxable years beginning after December 31, 1995, subject to the phase-in schedule set forth above.