# DESCRIPTION OF CHAIRMAN ARCHER'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO "THE DEATH TAX ELIMINATION ACT OF 2000'' (H.R. 8)

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# INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the modifications to H.R. 3081, the "Death Tax Elimination Act of 2000," contained in an amendment in the nature of a substitute proposed by Chairman Bill Archer. The House Committee on Ways and Means is scheduled to mark up the bill on May 25, 2000.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman Archer's Amendment in the Nature of a Substitute to "The Death Tax Elimination Act of 2000" (H.R. 8)* (JCX-52-00) May 23, 2000.

## DESCRIPTION OF CHAIRMAN ARCHER'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO "THE DEATH TAX ELIMINATION ACT OF 2000" (H.R. 8)

Under Chairman Archer's amendment in the nature of a substitute to "The Death Tax Elimination Act of 2000" (H.R. 8), the bill would be modified as follows:

### I. PHASE IN REPEAL OF ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

Prior to repeal of the estate, gift, and generation-skipping transfer taxes in 2010, the estate and gift tax rates would be reduced as follows. Beginning in 2001, the top estate and gift tax rates above 53 percent and the 5-percent surtax, which phases out the benefit of the graduated rates, would be repealed. Beginning in 2002, the rates in excess of 50 percent would be repealed. In 2003 through 2006, each of the estate and gift tax rates would be reduced by 1 percentage point, per year. In 2007, each of the estate and gift tax rates would be reduced by 1.5 percentage points. In 2008 and 2009, each of the estate and gift tax rates would be reduced by 2 percentage points. No estate and gift tax rate would be reduced below the lowest individual income tax rate for unmarried individuals (other than surviving spouses and heads of households), and the highest estate and gift tax rate would not be reduced below the highest individual income tax rate for unmarried individuals (other than surviving spouses and heads of households). The highest estate and gift tax rate in effect for a given year would be the generation-skipping transfer tax rate for that year. From 2003 through 2009, the State death tax credit rates would be reduced in proportion to the reduction in the estate and gift tax rates.

Beginning in 2001, the unified credit would be replaced with a unified exemption amount. The unified exemption amount would be determined for the following calendar years: in 2001, $675,000; in 2002 and 2003, $700,000; in 2004, $850,000; in 2005, $950,000; and in 2006 and thereafter, $1,000,000. For decedents who are not residents and not citizens of the United States, the exemption would be the greater of (1) $60,000 or (2) the portion of $175,000 which the value of the decedent's U.S.-situs property bears to the value of the decedent's worldwide gross estate.

After repeal of the estate, gift, and generation-skipping transfer taxes in 2010, the basis of assets received from a decedent generally would be the basis of the decedent (i.e., carryover basis). However, $1.3 million of transfers from decedents to any beneficiaries would receive a step up in basis. An additional $3 million of transfers from decedents to surviving spouses also would receive a step up in basis. For these purposes, the executor would elect which assets receive a step up in basis. The $1.3 million and $3 million amounts would be adjusted annually for inflation incurring after December 31, 2010.

Effective date.–The unified credit would be replaced with a unified exemption, the 5-percent surtax would be repealed, and the rates in excess of 53 percent would be repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31,

2000.

Reduction of the estate and gift tax rates and phaseout of the State tax credit would occur in 2003 through 2009.

The estate, gift, and generation-skipping transfer taxes would be repealed and the carryover basis regime would take effect for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2009.

The following provisions would be added to H.R. 8:

## II. MODIFY GENERATION-SKIPPING TRANSFER TAX RULES

### A. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips

#### Present Law

A generation-skipping transfer 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 generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

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 direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55 percent under present law) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust. The allocation of generation-skipping transfer tax exemption reduces the 55-percent tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual may elect out of the automatic allocation for lifetime direct skips.

For lifetime transfers made to a trust that are not direct skips, the transferor must allocate generation-skipping transfer tax exemption--the allocation is not automatic. If generation-skipping transfer tax exemption is allocated on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time of the transfer. If, however, the allocation is not made on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time the allocation of generation-skipping transfer tax exemption was made.

Treas. Reg. sec. 26.2632-1(d) further provides that any unused generation-skipping transfer tax exemption, which has not been allocated to transfers made during an individual's life, is automatically allocated on the due date for filing the decedent's estate tax return. Unused generation-skipping transfer tax exemption is allocated pro rata on the basis of the value of the property as finally determined for estate tax purposes, first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused generation-skipping transfer tax exemption is allocated pro rata, on the basis of the estate tax value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made.

## Description of Proposal

The proposal would provide for the automatic allocation of generation-skipping transfer exemption to transfers made during life that are "indirect skips." An indirect skip means any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

A generation-skipping transfer trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless:

- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before 1 or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46;

- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;

- the trust instrument provides that, if 1 or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of 1 or more of such individuals or is subject to a general power of appointment exercisable by 1 or more of such individuals;

- the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;

- the trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or

- the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual may elect not to have the automatic allocation rules apply to an indirect skip, and such elections will be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual may elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and may elect to treat any trust as a generation-skipping transfer trust with respect to any or all transfers made by the individual to such trust, and such election may be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

### Effective Date

The proposal would apply to transfers subject to estate or gift tax after December 31, 1999, and to estate tax inclusion periods ending after December 31, 1999.

## B. Retroactive Allocation of the Generation-Skipping Transfer Tax Exemption

### Present Law

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 direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable termination or taxable distribution, generation-skipping transfer tax may be avoided.

A transferor will likely not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and generation-skipping transfer tax exemption had not been allocated to the trust, then generation-skipping transfer tax would be due even if the transferor had unused generation-skipping transfer tax exemption.

## Description of Proposal

The proposal would allow the retroactive allocation of generation-skipping transfer exemption when there is an unnatural order of death. Under the provision, if a lineal descendant of the transferor predeceases the transferor, then the transferor may allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The proposal would permit a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption would be allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined at the value on the date that the relevant property was transferred to trust.

## Effective Date

The proposal would apply to deaths of non-skip persons occurring after December 31, 1999.

## C. Severing of Trusts Holding Property Having an Inclusion Ratio of Greater than Zero

## Present Law

A generation-skipping transfer 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 generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to

transferred property.

If the value of transferred property exceeds the amount of the generation-skipping transfer exemption allocated to that property, then the generation-skipping transfer tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is currently 55 percent) by the "inclusion ratio" and the value of the taxable property at the time of the taxable event. The "inclusion ratio" is the number one minus the "applicable fraction." The applicable fraction is a fraction calculated by dividing the amount of the generation-skipping transfer exemption allocated to the property by the value of the property.

Under Treas. Reg. 26.2654-1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee's discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under current Treasury regulations, however, a trustee cannot establish inclusion ratios of zero and one by severing a trust that is subject to the GST tax after the trust has been created.

### Description of Proposal

The proposal would allow a trust to be severed in a "qualified severance." A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the proposal, a trustee could elect to sever a trust in a qualified severance at any time.

### Effective Date

The proposal would be effective for severances of trusts occurring after December 31, 1999.

## D. Modification of Certain Valuation Rules

### Present Law

Under present law, the inclusion ratio is determined using gift tax values for allocations of generation-skipping transfer tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of generation-

skipping transfer tax exemption made to transfers at death. Treas. Reg. 26.2642-5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

### Description of Proposal

The proposal would provide that, in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

### Effective Date

The provision would apply to transfers subject to estate of gift tax made after December 31, 1999.

## E. Relief from Late Elections

### Present Law

Under present law, an election to allocate generation-skipping transfer tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to trust is used for determining generation-skipping transfer tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate generation-skipping transfer tax exemption.

### Description of Proposal

The proposal would authorize and direct the Treasury Secretary to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement. If such relief were granted, then the value on the date of transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary would be directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems

relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) would be treated as if not expressly prescribed by statute.

**Effective Date**

The proposal to provide relief from late elections would apply to requests pending on, or filed after, December 31, 1999. No implication is intended with respect to the availability of relief from late elections prior to the effective date of the provision.

## F. Substantial Compliance

**Present Law**

Under present law, there is no statutory rule which provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.

**Description of Proposal**

The proposal would provide that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption would suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates an intent to have an inclusion ratio of zero with respect to a particular transfer or trust, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces, when possible, a zero inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances would be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

**Effective Date**

The substantial compliance provisions would apply to transfers subject to estate or gift tax made after December 31, 1999. No implication is intended with respect to the availability of a rule of substantial compliance prior to the effective date of the provision.

## III. EXPAND THE ESTATE TAX RULE FOR CONSERVATION EASEMENTS

### Present Law

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a 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)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property. The exclusion from estate taxes does not extent to the value of any development rights retained by the decedent or donor.

### Description of Proposal

The proposal would expand the availability of qualified conservation easements by modifying the distance requirements. Under the proposal, the distance from which the land must be situated from a metropolitan area, national park, or wilderness area would be increased from 25 to 50 miles, and the distance from which the land must be situated from an Urban National Forest would be increased from 10 to 25 miles. The proposal also would clarify that the date for determining easement compliance would be the date on which the donation was made.

### Effective Date

The proposal to clarify the date for determining easement compliance would be effective for estates of decedents dying after December 31, 1997. The proposal that modifies the distance rules would be effective for estates of decedents dying after December 31, 2000.