

[JOINT COMMITTEE PRINT]

**BACKGROUND  
AND DESCRIPTION OF BILLS  
(S. 395, S. 404, S. 574, AND S. 858)**

**RELATING TO  
ESTATE AND GIFT TAXES**  
SCHEDULED FOR A HEARING  
BEFORE THE  
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION  
OF THE  
COMMITTEE ON FINANCE  
ON MAY 1, 1981

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PREPARED FOR THE USE OF THE  
COMMITTEE ON FINANCE  
BY THE STAFF OF THE  
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### INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on May 1, 1981, regarding the purposes and effects of the Federal estate and gift taxes in general and particularly as they affect farms and other small businesses.

This pamphlet, prepared in connection with the hearing, contains five parts. The first part is a summary of present law and the bills described in the pamphlet. The second part provides a brief description of the present estate and gift tax laws. The third part provides background information, including a short history of the estate and gift tax laws, and data on the number and size of estates subject to tax and the burdens of the tax. The fourth part provides a discussion of the issues involved in considering modifications to the Federal estate and gift tax laws, including a discussion of the arguments for and against various modifications to the estate and gift tax laws. Part five provides a description of four bills, S. 404, S. 858, S. 395, and S. 574, that would modify the Federal estate and gift tax laws in some manner.



## I. SUMMARY

### Present Law

Under present law, there is imposed a gift tax on lifetime transfers and an estate tax on deathtime transfers. In addition, a generation-skipping tax is imposed on certain transfers which benefit more than one generation but would not be subject to estate or gift tax upon the termination of the interests of the older generation.

Under the Tax Reform Act of 1976, the estate and gift taxes were unified so that a single progressive rate schedule is applied to cumulative lifetime and deathtime transfers. Under the unified rate schedule, the rates range from 18 percent on the first \$10,000 of taxable transfers to 70 percent on taxable transfers in excess of \$5 million. A unified credit of \$47,000 is allowed against an individual's estate and gift tax liabilities. With a unified credit of \$47,000 and the existing rate schedule, there is no estate or gift tax on transfers of up to \$175,625. In addition, a limited credit is allowed, for estate tax purposes, for State death taxes.

Present law allows an annual exclusion, for gift tax purposes, of \$3,000 per donee. In addition, in the case of a qualified disclaimer by a donee or heir, the donee or heir is not deemed to have made a gift. A qualified disclaimer can arise only where the disclaimer is effective under applicable State law.

A limited deduction is allowed in computing the estate and gift taxes for certain transfers to spouses (i.e., the marital deduction). An unlimited deduction is allowed for estate and gift tax purposes for certain transfers for charitable, etc., purposes (i.e., the charitable deduction). In addition, deductions are allowed for estate tax purposes for certain transfers to orphans.

The estate tax provisions also allow certain real property used in the trade or business of farming or in other closely held trades or businesses to be valued at its current use value rather than its highest and best use value. The maximum reduction in the value of the real property by reason of the special valuation provision is \$500,000. The estate tax benefits of the special valuation provision are recaptured in whole or in part if the heir ceases using the land as a farm or in the closely held business within 15 years of the decedent's death.

Present law contains two provisions allowing the installment payment of estate taxes attributable to closely held businesses. Under the more limited provision (Code sec. 6166), payments can be made over a 15-year period and there is a special 4-percent interest rate on the estate tax attributable to the first \$1 million of interests in closely held businesses. Under the broader provision (Code sec. 6166A), payments can be made over a 10-year period and no special interest rate applies.

### Summary of Bills

#### 1. S. 404—Senator Symms

The bill would repeal the estate, gift, and generation-skipping taxes as of December 31, 1981.

#### 2. S. 858—Senator Durenberger

The bill would increase the unified credit for estate tax purposes to \$192,800, beginning in 1982.

The bill also would increase gradually the unified credit for gift tax purposes beginning in 1981 until 1985 when it would be \$192,800. With a unified credit of \$192,800 and the existing rate schedule, there would be no estate or gift tax on transfers aggregating \$600,000.

The bill would also repeal the \$500,000 limitation of present law which restricts the maximum reduction in value from the current use valuation rule. The bill would reduce the recapture period from 15 to 10 years. The bill also would make several changes which broaden eligibility for current use valuation and reduce the instances where recapture occurs.

The bill would also allow a reduced interest rate, not to exceed 6 percent, on the installment payment of estate tax attributable to interests in closely held businesses.

These changes would be effective generally after December 31, 1981.

#### 3. S. 395—Senators Wallop, Boren, Byrd (Va.), and others

The bill would reduce the estate and gift tax rates so that they would range from 10 percent on the first \$25,000 of taxable transfers to 60 percent of taxable transfers in excess of \$5 million effective after December 31, 1980. The bill also would increase the unified credit gradually beginning in 1981 until 1985 when the unified credit would be \$124,750. With a unified credit of \$124,750 and the revised rate schedule, there would be no estate or gift tax on transfers aggregating \$600,000.

The bill would also allow an unlimited marital deduction for both estate and gift tax purposes and would increase the annual gift tax exclusion from \$3,000 to \$10,000 effective after December 31, 1981.

The bill would repeal the \$500,000 limitation of present law which restricts the maximum reduction in value from the current use valuation rule. The bill would reduce the recapture period from 15 years to 10 years. The bill also would make several changes which broaden the eligibility for current use valuation and reduce the instance where recapture occurs. These changes would be effective after December 31, 1981.

The bill would make several other changes to the estate and gift tax laws. The bill would provide that the value of gifts made within 3 years of the decedent's death are to be included in the gross estate at their value at the time of gift instead of the estate tax valuation date. The bill would allow a donor to elect to use only a portion of his unified credit against his gift tax liability in order to permit beginning the running of the statute of limitations on the gift's value. The bill would combine the two provisions of present law (Code secs. 6166 and 6166A) allowing the installment payment of estate tax attributable

to interests in closely held businesses. Lastly, the bill would provide that a disclaimer would be considered as qualified (and, therefore, not result in a taxable gift) where the disclaimer does not transfer an interest under applicable local law and the disclaiming party timely transfers the interest to the person to whom the property would have passed if the disclaiming party had predeceased the holder of legal title of the interest. These changes would be effective after December 31, 1980.

**4. S. 574—Senator Kassebaum**

The bill would allow a limited deduction of \$750,000 for certain property used in the trade or business of farming or other closely held trade or business which passes to the decedent's spouse or a qualified heir of the decedent. There would be recapture of the estate tax benefit from the deduction if the property ceases being used by the spouse or heir as a farm or in the closely held business. The deduction would be effective after December 31, 1980.

## II. PRESENT LAW

Under present law, there is imposed a gift tax on lifetime transfers and an estate tax on death-time transfers. Under the Tax Reform Act of 1976, the estate and gift taxes were unified so that a single progressive rate schedule is applied to cumulative lifetime and death-time transfers.

### 1. Rates, unified credit, and computation of tax

Under the unified estate and gift tax rate schedule, rates range from 18 percent on the first \$10,000 in taxable transfers to 70 percent on taxable transfers in excess of \$5 million.<sup>1</sup>

The amount of gift tax payable (for any calendar quarter or year, as the case may be) is determined by applying the unified rate schedule to cumulative lifetime taxable transfers and then subtracting the taxes payable on the lifetime transfers made for past taxable periods. This amount then is reduced by any available unified credit (and certain other credits) to determine the amount of gift tax liability for that period.

The amount of estate tax generally is determined by applying the unified rate schedule to the aggregate cumulative post-1976 lifetime and death-time transfers and then subtracting the post-1976 gift taxes payable on the lifetime transfers. (In essence, death-time transfers are treated as the last taxable gift by the decedent.) This amount then is reduced by any remaining unified credit and by certain other credits (discussed below) in determining the amount of estate tax liability.

The unified credit presently is \$47,000.<sup>2</sup> With a unified credit of \$47,000 and the existing rate schedule, there is no estate or gift tax on transfers of up to \$175,625.<sup>3</sup>

<sup>1</sup> Prior to the Tax Reform Act of 1976, there were separate rate schedules for the estate and gift taxes. The gift tax rates were approximately  $\frac{3}{4}$ ths of the estate tax rates. The Tax Reform Act of 1976 combined the separate rate schedules into a unified transfer rate schedule.

<sup>2</sup> Prior to the Tax Reform Act of 1976, there was a \$30,000 lifetime exemption for gift tax purposes and a \$60,000 exemption for estate tax purposes. The Tax Reform Act of 1976 converted the estate and gift tax exemptions into a unified credit. With a unified credit, the gift or estate tax first is computed without any exemption and then the unified credit is subtracted to determine the gift or estate tax liability. The \$47,000 unified credit established by the Tax Reform Act of 1976 was phased in over a five-year period as follows: \$30,000 for 1977, \$34,000 for 1978, \$38,000 for 1979, \$42,500 for 1980, and \$47,000 for 1981 and thereafter.

<sup>3</sup> Note that the effect of the unified credit is, in essence, to reduce the rates of tax on the first \$175,625 of transfers to zero and to subject transfers in excess of that amount to tax at the rates based upon cumulative transfers including that amount. Thus, the lowest rate at which tax liability is actually incurred under the estate and gift tax is 32 percent.

## 2. Transfers subject to tax: taxable gifts and the gross estate

### *Gift tax*

The gift tax is imposed on any transfer of property by gift whether made directly or indirectly and whether made in trust or otherwise. The amount of the taxable gift is determined by the fair market value of the property on the date of gift. In addition, the exercise or the failure to exercise certain powers of appointment are also subject to the gift tax.

Present law provides an annual exclusion of \$3,000 (\$6,000 where the nondonor spouse consents to split the gift) of transfers of present interests in property for each donee. In addition, certain transfers of interests in qualified pension plans are excluded from the tax. In the case of the creation of a tenancy by the entirety (including a joint tenancy) in real property by spouses, present law postpones any taxable gift until the termination of the tenancy unless the spouses elect to treat the creation as a gift.

### *Estate tax*

Under present law, all property included in the "gross estate" of the decedent is subject to tax. The gross estate generally includes the value of all property in which a decedent has an interest at his death (Code sec. 2031).<sup>4</sup> The amount included in the gross estate is generally the fair market value of the property at the date of the decedent's death, unless the executor elects to value all property in the gross estate at the alternate valuation date (which is six months after the date of the decedent's death) (Code sec. 2032).<sup>5</sup>

In addition, the gross estate includes the value of certain properties not owned by the decedent at the time of his death if certain circumstances are met. These include, generally, transfers for less than adequate and full consideration if (1) the decedent retained the beneficial enjoyment of the property during his life (Code sec. 2036) or the power to alter, amend, revoke, or terminate a previous lifetime transfer (Code sec. 2038), (2) the property was transferred within three years of death (Code sec. 2035), (3) the property was previously transferred during the decedent's lifetime but the transfer takes effect at the death of the decedent (Code sec. 2037), and (4) interests in certain annuities (other than certain interests in qualified retirement plans) (Code sec. 2039). In addition, the gross estate includes the value of property subject to certain general powers of appointment possessed by the decedent (Code sec. 2041). Lastly, the gross estate includes the proceeds of life insurance on the decedent if the insurance proceeds are receivable by the executor of the decedent's estate or the decedent possessed an incident of ownership in the policy (Code sec. 2042).

<sup>4</sup> Special rules (discussed below in Part II.3.) are provided for jointly held property.

<sup>5</sup> See below (Part II.4.) for a discussion of the special method permitted for the valuation of real estate used in certain farms and other closely-held businesses under Code section 2032A.

### 3. Jointly held property

The present estate tax provisions contain several special rules governing the treatment of jointly held property for estate tax purposes. These rules apply to forms of ownership where there is a right of survivorship upon the death of one of the joint tenants. They do not apply to community property or property owned as tenants in common.

In general, under these rules, the gross estate includes the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship, except that portion of the property that was acquired by the other joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party. The decedent's estate has the burden of proving that the other joint owner, or owners, acquired their interests for consideration, or by bequest or gift. Consideration furnished by the surviving joint owner, or owners, does not include money or property shown to have been acquired from the decedent for less than a full and adequate consideration in money or money's worth.

The Tax Reform Act of 1976 provided special rules for certain qualified joint interests held in joint tenancy by the decedent and his spouse. If a decedent owns a qualified joint interest, one-half of the value of such interest is included in the gross estate of the decedent at the date of the decedent's death (or alternate valuation date), regardless of which joint tenant furnished the consideration. An interest is a qualified joint interest only if the following requirements are satisfied: (1) the interest must have been created by the decedent or his spouse, or both; (2) in the case of personal property, the creation of the joint interest must have been a completed gift for purposes of the gift tax provisions; (3) in the case of real property, the donor must have elected to treat the creation of the joint tenancy as a taxable event at that time (even though no gift tax is actually paid because of the annual exclusion, marital deduction, or use of the unified credit); and (4) the joint tenants cannot be persons other than the decedent and his spouse.

The Revenue Act of 1978 provided a special rule in cases where both spouses owning jointly held property used in a farm or other trade or business materially participate in the operation of the farm or other trade or business. Under the law prior to the 1978 Act, the husband generally was considered to provide all of the consideration for the acquisition of the jointly held property used on a farm or in other trades or businesses even though the wife materially participated in the operation of the farm or other trade or business. The 1978 Act provided a special rule for excluding a portion of the value of certain jointly owned property by a husband and wife that is used in a farm or other business. The amount excludable is determined by multiplying a percentage rate of 2 percent for each year the surviving spouse materially participated in the business (not to exceed 50 percent) to the excess of the value of the joint interest over the amount attributable to the original consideration furnished. In addition, the amount attributable to the original consideration furnished by the

surviving spouse would be excludable. For this purpose, the amount attributable to the original consideration would consist of the amount of that consideration plus assumed appreciation at the rate of 6 percent simple interest for the period of investment of the consideration. However, the maximum amount by which the value of a joint interest may be reduced under this rule is \$500,000.

#### 4. Current use valuation

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value, rather than full fair market value, provided that the gross estate may not be reduced more than \$500,000 (Code sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his 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 debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;<sup>6</sup> (4) the real property qualifying for current use valuation must pass to a qualified heir;<sup>7</sup> (5) such real property must have been owned by the decedent or a member of his 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 his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2032A (a) and (b)).<sup>8</sup>

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained from the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

#### 5. Allowable deductions

##### *Charitable deduction*

Present law allows a deduction for certain amounts transferred for charitable, etc., purposes in computing both the amount of taxable

<sup>6</sup> For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

<sup>7</sup> 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.

<sup>8</sup> 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 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.

gifts and the taxable estate. The deduction is allowed for amounts transferred to the United States or any State or local government, to certain organizations organized and operated exclusively for charitable, etc., purposes, and to certain organizations of war veterans. Where the charitable transfer is an interest that is less than the entire interest in property (*e.g.*, a remainder interest), present law requires that the gift take certain specified forms in order to be deductible.

#### **Marital deduction**

Both the gift tax and the estate tax allow a limited deduction for certain amounts transferred from one spouse to another spouse. The original purpose of the marital deduction<sup>9</sup> was generally to equate the tax treatment of property ownership in common law states with the tax treatment in community law states. In a community law state, one-half of all community property generally is owned for tax purposes by each spouse even though only one spouse generated the income to acquire the property. In a common law state, the property is considered owned for tax purposes by the spouse who generated the income to acquire the property. Because a progressive rate structure taxes one large accumulation of wealth more heavily than two smaller accumulations, residents in community property states were taxed less heavily than residents in common law states prior to the adoption of the marital deduction.

Under the marital deduction as first adopted in 1948, a donor was allowed a marital deduction for gift tax purposes equal to one-half of the property transferred to his spouse. For estate tax purposes, the estate was allowed a deduction for property transferred to the spouse of the decedent up to one-half of the adjusted gross estate.<sup>10</sup> The adoption of the marital deduction allowed one spouse to transfer one-half of his wealth to the other spouse free of estate or gift taxes and, thus, residents of common law states can achieve roughly the same tax treatment as residents of community law states.

The Tax Reform Act of 1976 modified the marital deduction for both estate and gift tax purposes to allow a 100-percent deduction for limited amounts of property passing between spouses. Under these new rules, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal transfers in excess of \$200,000. For estate tax purposes, the marital deduction was modified to allow a deduction for amounts passing to a surviving spouse equal to the greater of \$250,000 or one-half of the decedent's adjusted gross estate. This amount is adjusted by the excess of the amount of the unlimited marital gift tax deduction over one-half of lifetime gifts to the surviving spouse.

<sup>9</sup> The marital deduction was first adopted by the Revenue Act of 1948.

<sup>10</sup> Under both the gift and estate tax marital deduction, deductions are not allowed for so-called "terminable interest". Terminable interests generally are created where an interest in property passes to the spouse and another interest in the same property passes from the donor or decedent to some other person for less than full and adequate consideration. For example, an income interest to the spouse would not qualify for the marital deduction where the remainder interest is transferred to a third party. In general, the adjusted gross estate is the gross estate less deductions other than the marital and charitable deductions.

***Expenses, indebtedness, taxes, and losses***

In addition to the charitable and marital deductions, deductions are allowed, for estate tax purposes, for certain administrative expenses of the estate, certain indebtedness of the decedent, and certain taxes other than estate, succession, legacy, or inheritance taxes (Code sec. 2053). A deduction also is allowed for casualty losses incurred by the decedent's estate (Code sec. 2054).

***Orphans' deduction***

Present law also allows a limited estate tax deduction for amounts passing to an orphan child of the decedent. The deduction is limited to \$5,000 for each year that the orphan child is under age 21 on the date of the decedent's death.

**6. Credits against tax**

In addition to the unified credit, there are several credits allowed which directly reduce the amount of the state tax. Two of the most important are the credit for tax on prior transfers and the credit for State death taxes.

***Credit for tax on prior transfers***

Where property includible in the decedent's gross estate has recently been subject to a previous Federal estate tax, a credit is allowed for all or a portion of that previous Federal estate tax. The amount of the credit is reduced the longer the period of time between the previous Federal estate tax and the death of the decedent. After 10 years, there is no credit (Code sec. 2013).

***State death tax credit***

A limited credit is allowed against the Federal estate tax for the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia on account of any property included in the gross estate (Code sec. 2011). The amount of the credit varies with the size of the taxable estate and ranges from zero percent on small estates to 16 percent on estates exceeding approximately \$10 million.<sup>11</sup>

**7. Generation-skipping tax**

Under the Federal estate tax law, the gross estate generally includes only interests in property owned by the decedent at his death. Where an individual was given only an income interest in property for life, the gross estate of the individual does not include the value of the property generating the income because the income interest terminates at his death and, consequently, the decedent did not own any interest in such property at his death. Moreover, the rules requiring inclusion of

<sup>11</sup> The maximum limitation on the amount of the State death tax credit is essentially a percentage of the rates of Federal estate tax that existed after World War I. After that war, there was pressure to repeal the estate tax. Instead of repealing the tax, Congress adopted the State death tax credit. The effect of the credit is to provide additional revenues to the States. Indeed, most States impose an additional tax commonly referred to as a "pick up" or "make up" tax, equal to the difference between the maximum State death tax credit and any inheritance or other succession taxes the State imposes. The effect of the "pick up tax" is to insure maximum revenues for the State without otherwise increasing the total death taxes paid by the decedent's estate and his heirs.

property where the decedent retained a life estate in previously transferred property do not apply in such a case because the income beneficiary did not create the income interest in himself. Consequently, it is possible under the Federal estate tax law to transfer the beneficial enjoyment from one generation to another without estate tax (i.e., to skip a generation) by simply providing the intermediate generation with an income interest.

In order to prevent the avoidance of the Federal gift or estate taxes through the use of generation-skipping arrangements, Congress enacted the generation-skipping tax provisions as part of the Tax Reform Act of 1976. Under that Act, a new generation-skipping tax was added to the Internal Revenue Code. The tax is imposed on generation-skipping transfers under a trust or similar arrangement<sup>12</sup> upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations which are younger than the generation of the grantor of the trust. The generation-skipping tax is not imposed in the case of outright transfers. In addition, the tax is not imposed if the grandchild has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation. For example, where a trust is created for the benefit of the grantor's grandchild, with remainder to the great-grandchild, then, upon the death of the grandchild, the tax is computed by adding the grandchild's portion of the trust assets to the grandchild's estate and taxable gifts and computing the tax at the grandchild's marginal transfer tax rate. In other words, for purposes of determining the amount of the tax, the grandchild is treated as a "deemed transferor" of the trust property.

The grandchild's marginal estate tax is used as a measuring rod for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate is not liable for the payment of the tax. Instead, the tax must generally be paid out of the proceeds of the trust property. However, the trust is entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the charitable deduction (if part of the trust property is left to charity), the credit for State death taxes, and a deduction for certain administrative expenses. In addition, the value of the grandchild's gross estate is increased by the generation-skipping transfer for marital deduction purposes.

<sup>12</sup> For purposes of these rules, trust equivalents include life estates, estates for years, certain insurance and annuity contracts, and other arrangements where there is a splitting of the beneficial enjoyment of assets between generations.

**8. Taxation of nonresident aliens*****Gift tax***

The Federal gift tax is imposed on nonresident aliens with respect to tangible real and personal property located within the United States. The regular gift tax rates apply. The rules are essentially the same as for citizens, except that the charitable deduction generally is allowed only for transfers to domestic charities and no marital deduction is allowed.

***Estate tax***

Present law imposes a separate estate tax on nonresident aliens (Code secs. 2101 to 2108). The tax is imposed only on the part of the gross estate that is situated in the United States. Deductions for expenses, indebtedness, taxes, and losses are allowed only for the proportion of the gross estate located within the United States. As in the case of the gift tax, the charitable deduction is allowed only for transfers to domestic charities and no marital deduction is allowed. There is a separate rate schedule which ranges from 6 percent on the first \$100,000 in taxable estate to 30 percent on taxable estates of over \$20 million. The unified credit is \$3,600. Present law also imposes a special tax if a decedent loses his United States citizenship within 10 years of his death and one of the principal purposes of changing his citizenship was to avoid Federal estate, gift, or income taxes.

### III. BACKGROUND AND LEGISLATIVE HISTORY

#### 1. History of the Estate and Gift Taxes<sup>1</sup>

##### 1797 to 1915

The first Federal involvement with an estate tax began in 1797 when Congress enacted a stamp tax on legacies, probates of wills and letters of administration. The stamp tax lasted until 1802 when it was repealed.

As a method of raising revenue to finance the Civil War, Congress enacted an inheritance tax<sup>2</sup> in 1862. Rates ranged up to 5 percent. The tax was repealed in 1870.

The next Federal estate tax<sup>3</sup> was imposed by the War Revenue Act of 1898. Rates ranged to 15 percent and there was an exemption of \$10,000. The tax was repealed in 1902.

##### 1916 to present

###### 1916-1942

The Revenue Act of 1916 imposed an estate tax that has remained in force until the present, although it has been modified in numerous ways since then. The 1916 estate tax rates ranged from one percent on small estates to ten percent on estates over \$5 million. An exemption of \$50,000 was allowed.

Between 1916 and 1942, the estate tax rates were raised or lowered on several occasions. The estate tax rates were raised twice in 1917. After these changes, the rates ranged from 2 percent on small estates to 25 percent on estates over \$10 million. The Revenue Act of 1918 modified the estate tax by exempting estates of less than \$1 million from the tax.

The Revenue Act of 1924 made several changes to the estate tax laws. It raised the top estate tax rate to 40 percent on estates over \$10 million. It allowed a limited credit for State death taxes. The Revenue Act of 1924 also imposed a gift tax for the first time.

The Revenue Act of 1926 reduced the estate tax rates and repealed the gift tax. The maximum rate was reduced to 20 percent for estates

<sup>1</sup> For a more detailed history of the Federal estate and gift taxes, see Howard Zaritsky, "Federal Estate, Gift and Generation-Skipping Taxes: A Legislative History and a Description of Current Law", CRS Report No. 80-76A (April 10, 1980).

<sup>2</sup> An inheritance tax is a tax imposed upon an individual's privilege of inheriting property from a decedent. Typically, the rates of an inheritance tax vary with the closeness of the familial relationship between the decedent and the heir. The rate schedule is applied separately to each heir. In contrast, an estate tax is a tax imposed on the decedent upon the privilege of leaving property to his heirs. The rate schedule is applied once to all property passing (or deemed to pass) at the decedent's death, regardless of the number of heirs or their familial relationship to the decedent.

<sup>3</sup> The Income Tax Act of 1894 treated gifts and inheritances as income and, thus, the tax was technically not an estate tax. The 1894 Income Tax Act was held unconstitutional in 1895.

over \$10 million. The estate tax exemption was increased from \$50,000 to \$100,000, and the maximum credit for State death taxes was increased to 80 percent of the Federal estate tax.

The Revenue Act of 1932 increased the estate tax rates, reduced the exemption to \$50,000, and reenacted the gift tax. The top marginal rate under the 1932 Act was 45 percent on estates over \$10 million. The gift tax rates were established at three-fourths of the estate tax rates, and there was an annual exclusion of \$5,000 and a lifetime exemption of \$50,000.

The Revenue Act of 1934 increased the top marginal estate tax rate to 60 percent on estates over \$10 million. The Revenue Act of 1935 increased the top marginal rate to 70 percent on estates over \$10 million and reduced the estate and gift tax exemptions to \$40,000.

The Revenue Act of 1941 increased the estate and gift tax rates from 3 percent on small estates to 77 percent on estates over \$10 million. The Revenue Act of 1942 modified the estate and gift exemptions and exclusions. Under the 1942 Act, the estate tax exemption was set at \$60,000 and the gift tax exemption was set at \$30,000. The annual gift tax exclusion was reduced from \$5,000 to \$3,000.

#### *1943 to present*

The rates and exemptions established by the Revenue Act of 1941 and 1942 remained in effect until the Tax Reform Act of 1976. The only other major change to the estate and gift taxes during this period was the introduction of the marital deduction by the Revenue Act of 1948. The purpose of the marital deduction was generally to equate the tax treatment in common law states with the tax treatment in community law states.

The Tax Reform Act of 1976 modified the estate and gift tax laws in a number of ways. The most significant are as follows:<sup>4</sup>

- (1) it unified the estate and gift tax laws into a single cumulative transfer tax system based on combined lifetime and deathtime transfers;<sup>5</sup>
- (2) the rates were changed so that they began at 18 percent on small estates and increased to 70 percent on estates of over \$5 million;
- (3) the gift tax and estate tax exemptions were combined and changed into a unified credit of \$47,000, which allowed combined lifetime and deathtime transfers of \$175,625 to be free from estate or gift taxes;
- (4) the marital deduction was increased to 100 percent of the first \$100,000 of gifts and the first \$250,000 of legacies and bequests to the spouse;
- (5) special valuation methods were provided for the valuation of certain real estate used in farming or in other closely held businesses; and
- (6) a generation-skipping tax was imposed.

<sup>4</sup> The Tax Reform Act of 1976 also revised the income tax treatment of inherited property by providing that the basis of inherited property in the hands of the heir was the same as the basis of the property in the hands of the decedent with certain adjustments (i.e., a "carryover basis"). Under prior law, the basis of inherited property was its fair market value on the date of the decedent's death (or alternate valuation date, if elected). The carryover basis rules of the 1976 Act were repealed retroactively by the Crude Oil Windfall Profits Tax Act of 1980.

<sup>5</sup> Prior to the Tax Reform Act of 1976, the amount of lifetime transfers generally did not affect the amount of estate tax because there were separate rate schedules for both the gift tax and the estate tax. Under the unified system of the Tax Reform Act of 1976, deathtime transfers, in essence, are treated as the last gift of the decedent under a single rate schedule.

## 2. Estate and Gift Tax as a Source of Revenue

### Federal revenues

Prior to 1916, estate taxes were used primarily to raise revenue. Since 1916, the estate and gift taxes have been used to raise revenues and for other purposes. (See the discussion in Part IV, below.) Table 1 compares the revenue from the estate tax as a percent of all Federal revenues from the period 1925 to the present. As indicated, estate taxes have accounted for less than 2 percent of Federal revenues since World War II. Table 2 provides estimates of the revenues from estate and gift taxes from 1981 to 1985 based upon existing rates and credits.

TABLE 1.—ESTATE TAX REVENUES AS A PERCENT OF TOTAL FEDERAL REVENUE, SELECTED YEARS—1925 TO PRESENT

[Dollar amounts are in millions]

| Year             | Net estate tax <sup>1</sup> | Total Federal revenue <sup>2</sup> | Percent of revenues attributable to estate tax |
|------------------|-----------------------------|------------------------------------|--|
| 1925-----        | \$86                        | \$3,641                            | 2.4  |
| 1930-----        | 39                          | 4,058                              | 1.0  |
| 1935-----        | 154                         | 3,706                              | 4.2  |
| 1940-----        | 250                         | 6,879                              | 3.6  |
| 1945-----        | 531                         | 50,162                             | 1.1  |
| 1950-----        | 484                         | 40,940                             | 1.2  |
| 1955-----        | 778                         | 65,469                             | 1.2  |
| 1961-----        | 1,619                       | 94,389                             | 1.7  |
| 1963-----        | 1,841                       | 106,560                            | 1.7  |
| 1966-----        | 2,414                       | 130,856                            | 1.8  |
| 1970-----        | 3,000                       | 193,743                            | 1.5  |
| 1977-----        | 4,979                       | 357,762                            | 1.4  |
| 1981 (est.)----- | 7,263                       | 608,840                            | 1.2  |

<sup>1</sup> Calendar year receipts (Note: calendar year receipts of estate tax generally are received in the next subsequent fiscal year.)

<sup>2</sup> Fiscal year receipts.

TABLE 2.—ESTIMATES OF FEDERAL ESTATE AND GIFT TAX REVENUES,  
FISCAL YEARS 1981-1985

[Millions of dollars]

|                 | 1981  | 1982  | 1983  | 1984  | 1985   |
|-----------------|-------|-------|-------|-------|--------|
| Estate tax..... | 6,667 | 7,263 | 8,149 | 9,056 | 9,924  |
| Gift tax.....   | 242   | 281   | 331   | 387   | 446    |
| Total.....      | 6,909 | 7,544 | 8,480 | 9,443 | 10,370 |

**State revenues**

As indicated above (see part II), present law allows a limited credit against Federal estate tax for death taxes paid to a State. Typically, most States impose an inheritance tax and, in addition, impose an estate tax, commonly called a "pick up" or "make up" tax, equal to the difference between the maximum State death tax credit and any inheritance taxes imposed on property passing from the decedent. Table 3 sets forth the aggregate amount of the State death tax credit for the period 1925 to the present. This can be considered an additional burden of the Federal estate tax, although the revenue goes to the State governments, not the Federal government.

TABLE 3.—CREDIT FOR STATE INHERITANCE TAXES PAID, SELECTED  
YEARS—1925 TO PRESENT

[Millions]

| Year:            | Amount |
|------------------|--------|
| 1925 .....       | \$11   |
| 1930 .....       | 113    |
| 1935 .....       | 44     |
| 1940 .....       | 45     |
| 1945 .....       | 65     |
| 1950 .....       | 49     |
| 1955 .....       | 86     |
| 1961 .....       | 196    |
| 1963 .....       | 208    |
| 1966 .....       | 280    |
| 1970 .....       | 333    |
| 1977 .....       | 552    |
| 1981 (est.)..... | 896    |

### 3. Historical Distribution of the Estate Tax

Table 4 provides a comparison from 1925 until the present of (1) the number of estate tax returns filed; (2) the number of estates paying estate tax, expressed as an absolute number and as a percentage of all decedents dying in that year; (3) the aggregate dollar amount of gross estate of all estate tax returns filed for that year; (4) the aggregate dollar amount of taxable estate of all estates paying tax for that year; (5) the aggregate dollar amount of estate tax paid for that year; and (6) the average estate tax rate of estates paying tax during that year.

TABLE 4.—SELECTED FEDERAL ESTATE TAX DATA, SELECTED YEARS—1925 TO PRESENT

[Dollar amounts are in millions]

| Year           | Taxable returns   |          | Percent of all decedents | Gross estate | Taxable estate | Net estate tax | Average tax rate |
|----------------|-------------------|----------|--------------------------|--------------|----------------|----------------|------------------|
|                | Number of returns | Number   |                          |              |                |                |                  |
| 1925 .....     | 14, 013           | 10, 642  | 0. 8                     | \$2, 958     | \$1, 621       | \$86           | 5. 3             |
| 1930 .....     | 8, 798            | 7, 028   | 0. 5                     | 4, 109       | 2, 377         | 39             | 1. 6             |
| 1935 .....     | 11, 110           | 8, 655   | 0. 6                     | 2, 435       | 1, 317         | 154            | 11. 7            |
| 1940 .....     | 15, 435           | 12, 907  | 0. 9                     | 2, 633       | 1, 479         | 250            | 16. 9            |
| 1945 .....     | 15, 898           | 13, 869  | 1. 0                     | 3, 437       | 1, 900         | 531            | 27. 9            |
| 1950 .....     | 25, 858           | 17, 411  | 1. 2                     | 4, 918       | 1, 917         | 484            | 25. 2            |
| 1955 .....     | 36, 595           | 25, 143  | 1. 6                     | 7, 467       | 2, 991         | 778            | 26. 0            |
| 1961 .....     | 64, 538           | 45, 439  | 2. 7                     | 14, 622      | 6, 014         | 1, 019         | 26. 9            |
| 1963 .....     | 75, 393           | 55, 207  | 3. 0                     | 17, 007      | 7, 071         | 1, 841         | 26. 0            |
| 1968 .....     | 97, 339           | 67, 404  | 3. 6                     | 21, 936      | 9, 160         | 2, 414         | 26. 4            |
| 1970 .....     | 133, 944          | 93, 424  | 4. 9                     | 29, 671      | 11, 662        | 3, 000         | 25. 7            |
| 1977 .....     | 200, 747          | 139, 115 | 7. 3                     | 48, 202      | 20, 904        | 4, 979         | 23. 8            |
| 1981 (est.)... | 111, 733          | 55, 672  | 2. 8                     | 53, 542      | 39, 357        | 7, 263         | 18. 5            |

#### IV. DISCUSSION OF ISSUES

##### 1. Summary of Purposes of Estate and Gift Taxes

One of the issues to be discussed at the hearing is whether there should be modifications to the present estate and gift tax structure. An understanding of the purposes of the estate and gift taxes should be helpful in determining whether the present structure should be modified.

##### **Estate and gift taxes as a revenue source**

Prior to 1916, the estate taxes were used principally to raise revenue, most often in times of war. While other purposes for the taxes also have existed since 1916, the amount of revenue raised by estate and gift taxes has been significant in absolute dollar amounts. See Tables 1 and 2 above. For 1981, the amount of revenue raised by the estate and gift taxes is roughly equal to the amount of revenues raised by excise taxes for the highway trust fund. Moreover, the relative amount of revenue raised by estate and gift taxes has been relatively uniform for over three decades. However, the amount of revenue raised by estate and gift taxes is a relatively small portion of total revenues (estimated to be slightly over one percent in 1981).

In addition, through the operation of the State death tax credit, the Federal estate and gift taxes provide revenues to the States. (See Table 3.) However, it is not possible to determine the amount of State revenue resulting from the Federal imposition of estate and gift taxes because it is impossible to determine the amount of death taxes that States would impose on their citizens if the Federal estate tax were repealed or reduced.

##### **Estate and gift taxes to implement certain social goals**

Since 1916, estate and gift taxes also have been used as a method of implementing certain social goals. The most important goal is increasing social and economic mobility by reducing large accumulations of wealth. Many people believe that the opportunities available to one generation should not be determined, beyond a certain point, by the social and economic position of their ancestors. Taxing large transfers of wealth is one way of increasing social and economic mobility. In response, it can be argued that wealth transfers are only one of many ways by which ancestors can improve the social and economic positions of their descendants and that it is unfair to impose a tax on only one source of unequal opportunity.

Proponents of estate and gift taxes also argue that persons with large accumulations of wealth can use that wealth to have a disproportionate input into the processes of government.<sup>1</sup>

<sup>1</sup> It would appear that this argument is more likely to be true in the case of nondiversified accumulations of wealth.

**Role in overall tax system**

Under present law, there are three major types of taxes imposed directly on individuals: the income tax, social security taxes, and estate and gift taxes. Social security taxes are imposed only on limited amounts of earned income and, therefore, can be characterized as a regressive tax (i.e., the average rate of tax decreases as income increases). On the other hand, the income tax rates are progressive (i.e., average rates increase with increases in income). However, the fact that many of the provisions of the income tax laws that provide incentives for particular kinds of investment or activity are more extensively used by individuals with higher incomes offsets some of the progressivity of the income tax rates. Table 5 sets forth the average combined social security and income tax rates by expanded income class.

TABLE 5.—EFFECTIVE TAX RATES BY EXPANDED INCOME CLASS, 1981  
INCOME LEVELS

| Expanded income            | Number of returns (thousands) | Expanded income (millions) | Income tax liability (millions) | Social security tax (millions) | Average effective tax rate (percent) |
|----------------------------|-------------------------------|----------------------------|---------------------------------|--------------------------------|--------------------------------------|
| Below \$5,000.....         | 18,144                        | \$38,782                   | -\$157                          | \$2,804                        | 6.8                                  |
| \$5,000-\$10,000.....      | 16,128                        | 120,233                    | 6,381                           | 6,518                          | 10.7                                 |
| \$10,000-\$15,000.....     | 13,413                        | 166,112                    | 16,317                          | 9,141                          | 15.3                                 |
| \$15,000-\$20,000.....     | 10,875                        | 189,741                    | 22,987                          | 10,900                         | 17.9                                 |
| \$20,000-\$30,000.....     | 16,977                        | 419,530                    | 58,558                          | 24,238                         | 19.7                                 |
| \$30,000-\$50,000.....     | 13,650                        | 511,729                    | 85,706                          | 26,538                         | 21.9                                 |
| \$50,000-\$100,000.....    | 3,609                         | 232,033                    | 51,631                          | 7,595                          | 25.5                                 |
| \$100,000-\$200,000.....   | 637                           | 84,489                     | 24,125                          | 1,335                          | 30.1                                 |
| \$200,000-\$500,000.....   | 141                           | 39,585                     | 12,468                          | 291                            | 32.2                                 |
| \$500,000-\$1,000,000..... | 18                            | 11,694                     | 3,607                           | 34                             | 31.1                                 |
| Over \$1,000,000.....      | 7                             | 16,786                     | 5,035                           | 13                             | 30.1                                 |
| Total.....                 | 93,599                        | 1,830,722                  | 286,659                         | 89,407                         | 20.5                                 |

Note: Details may not add to totals due to rounding.

Proponents of estate and gift taxes argue that these taxes are necessary to achieve an appropriate amount of progressivity for the overall tax system. To the extent that combined social security and income taxes are less progressive, individuals are more likely to accumulate larger amounts of wealth which would be subject to the estate and gift taxes.

Another argument for the estate and gift taxes involves the basis to an heir in assets acquired from a decedent. Under present law, the basis to an heir in assets acquired from a decedent is "stepped up" to its fair market value at the decedent's death or alternative valuation date if elected (Code sec. 1014). As a result, any appreciation that occurs while the asset was held by the decedent is not subject to the income tax. Proponents of this rule argue that this result is appropriate because the assets are subject to the estate tax and, consequently, there would be double taxation if the appreciation were also subject to the income tax.

## 2. Proposals for Repeal of Estate and Gift Taxes

The issue of whether Federal estate and gift taxes should be repealed involves a weighing of competing objectives. The arguments for and against repeal may be summarized as follows:

### Arguments for repeal

Proponents for repeal of the estate and gift taxes argue that estate and gift taxes operate as a large disincentive to work and to save. This is said to be especially true in higher income classes where the desire to benefit one's heirs may be the most important motivation to earn income and to save. Proponents of repeal argue that the amount of revenues derived from estate and gift taxes is relatively small. (See Table 1.) This is especially relevant in light of the undesirable effects of the taxes. First, proponents of repeal argue that death is a very inopportune time to impose a tax because the needs for cash are typically high at that time, especially since death generally is not a planned event. Second, the tax often results in the forced sale of family heirlooms, farms, or closely held businesses. This forced sale often results in more concentration of ownership of these assets. Third, proponents of repeal argue that large overhead costs arise from the tax because of the efforts of individuals to arrange their affairs to minimize their estate tax and because of the high costs of valuing assets. Lastly, proponents of repeal either reject the purposes of the taxes (see Part IV.A, above) or believe that the arguments for repeal outweigh these purposes.

### Arguments against repeal

Opponents of repeal argue that the purposes for which the estate and gift taxes originally were imposed (see Part IV.A.) are just as valid today as when the taxes originally were enacted. They argue that repeal of the estate and gift taxes would aid only the richest persons in the country. (See Table 1, above.) They point out that, while the revenue from estate and gift taxes is not large compared with other sources of revenue (see Table 1), the absolute dollar amount of revenues derived from the taxes is substantial (see table 2). Opponents argue that repeal of the Federal estate and gift tax would result in revenue loss to the States from the State "pick up" estate tax. Opponents of repeal also note that the estate and gift taxes affect the amount of repeal further argue that repeal would significantly reduce charitable bequests.<sup>3</sup>

<sup>3</sup> Present law allows an unlimited deduction for gifts and bequests to charitable organizations (Code secs. 2055 and 2522). It is not possible to determine how much of an effect that this has on amounts transferred to charities. However, in 1976, the total charitable deductions taken on estate tax returns was \$2,993 million.

### 3. General Reductions in Estate and Gift Taxes

The issue of whether to reduce estate and gift taxes generally also depends upon a weighing of competing objectives. In addition, the manner in which any reduction is to be achieved (e.g., rate reductions versus increases in the unified credit) depends upon a balancing of objectives. On the one hand, because of the nature of the transfer tax base,<sup>4</sup> increases in the unified credit would involve a relatively large loss of revenue but would not substantially affect the other purposes of the taxes. On the other hand, decreases in the top marginal tax rates would have less relative revenue effect but would substantially affect the ability of the tax to fulfill its other objectives. Tables 6 through 11 set forth the distribution of the estate tax by wealth class under present law (with an exemption equivalent of \$175,625) and with unified credits with exemption equivalents of \$250,000, \$500,000, \$600,000, \$750,000, and \$800,000, respectively.

The arguments regarding general reductions in the estate and gift taxes can be summarized as follows:

#### Arguments for reduction

Proponents of general reductions in estate and gift taxes argue that inflation has increased the dollar value of individuals' wealth, but not their real value. As a result, the estate and gift taxes have become progressively higher and affect larger and larger segments of society. The effect of inflation on the estate and gift tax structure is said to have been particularly severe on farms and closely held businesses, which often must be sold to pay the tax. Moreover, proponents of reduction in the form of a higher unified credit argue that increases in the unified credit will not substantially undermine the social purposes of the tax.

#### Arguments against reduction

Opponents of general reductions argue that reductions in the present estate and gift tax structure would be regressive because only the top three percent of all individuals pay the tax. (See Table 1.) Moreover, opponents argue that, since the present level of unified credit became applicable in 1981, the amount of the present unified credit has not been substantially undermined by the effects of inflation.

<sup>4</sup>A diagram of the transfer tax base would show a wide, relatively short pyramid.

TABLE 6.—ESTIMATED ESTATE TAX RETURNS, TAXABLE RETURNS, AND ESTATE TAX LIABILITY OF RESIDENT DECEDENTS, BY SIZE OF GROSS ESTATE, CALENDAR YEAR 1981

[Dollar amounts in millions]

| Size of gross estate  | Number of returns | Taxable returns | Taxable returns as a percent of resident decedents | Tax liability | Tax as percent of total |
|-----------------------|-------------------|-----------------|--|---------------|-------------------------|
| \$175,000-\$500,000   | 87,174            | 37,417          | 1.9  | \$1,301       | 17.9                    |
| \$500,000-\$1,000,000 | 15,819            | 13,288          | .7   | 1,625         | 22.4                    |
| \$1-\$2,000,000       | 5,709             | 3,290           | .2   | 1,377         | 19.0                    |
| \$2-\$3,000,000       | 1,451             | 802             | ( <sup>1</sup> )                                   | 705           | 9.7                     |
| \$3-\$5,000,000       | 902               | 502             | ( <sup>1</sup> )                                   | 711           | 9.8                     |
| \$5-\$10,000,000      | 488               | 272             | ( <sup>1</sup> )                                   | 782           | 10.8                    |
| Over \$10,000,000     | 190               | 101             | ( <sup>1</sup> )                                   | 762           | 10.5                    |
| Total                 | 111,733           | 55,672          | 2.8  | 7,263         | 100.0                   |

<sup>1</sup> Less than one-tenth of 1 percent.

TABLE 7.—ESTIMATED ESTATE TAX RETURNS, TAXABLE RETURNS, AND ESTATE TAX LIABILITY OF RESIDENT DECEDENTS UNDER PROPOSED \$250,000 EXEMPTION EQUIVALENT CREDIT, BY SIZE OF GROSS ESTATE, CALENDAR YEAR 1981

[Dollar amounts in millions]

| Size of gross estate       | Number of returns | Taxable returns | Taxable returns as a percent of resident decedents | Tax liability | Tax as percent of total | Revenue loss |
|----------------------------|-------------------|-----------------|--|---------------|-------------------------|--------------|
| \$175,000-\$500,000.....   | 42,414            | 14,663          | 0.7  | \$491         | 8.3                     | \$810        |
| \$500,000-\$1,000,000..... | 11,362            | 8,825           | .4   | 1,236         | 21.0                    | 389          |
| \$1-\$2,000,000.....       | 5,709             | 3,141           | .2   | 1,266         | 21.5                    | 111          |
| \$2-\$3,000,000.....       | 1,451             | 780             | ( <sup>1</sup> )                                   | 678           | 11.5                    | 27           |
| \$3-\$5,000,000.....       | 902               | 482             | ( <sup>1</sup> )                                   | 695           | 11.8                    | 16           |
| \$5-\$10,000,000.....      | 488               | 265             | ( <sup>1</sup> )                                   | 774           | 13.1                    | 8            |
| Over \$10,000,000.....     | 190               | 102             | ( <sup>1</sup> )                                   | 759           | 12.9                    | 3            |
| Total.....                 | 62,516            | 28,258          | 1.4  | 5,899         | 100.0                   | 1,364        |

<sup>1</sup> Less than one-tenth of 1 percent.

TABLE 8.—ESTIMATED ESTATE TAX RETURNS, TAXABLE RETURNS, AND ESTATE TAX LIABILITY OF RESIDENT DECEDENTS UNDER PROPOSED \$500,000 EXEMPTION EQUIVALENT CREDIT, BY SIZE OF GROSS ESTATE, CALENDAR YEAR 1981.

[Dollar amounts in millions]

| Size of gross estate     | Number of returns | Taxable returns | Taxable returns as a percent of resident decedents | Tax liability | Tax as percent of total | Revenue loss |
|--------------------------|-------------------|-----------------|--|---------------|-------------------------|--------------|
| \$175,000-\$500,000..... |                   |                 |  |               |                         | \$1,301      |
| \$500,000-1,000,000..... | 15,820            | 4,891           | 0.2  | \$332         | 8.4                     | 1,293        |
| \$1-\$2,000,000.....     | 5,709             | 2,866           | .1   | 900           | 22.8                    | 477          |
| \$2-\$3,000,000.....     | 1,451             | 750             | ( <sup>1</sup> )                                   | 585           | 14.8                    | 120          |
| \$3-\$5,000,000.....     | 902               | 454             | ( <sup>1</sup> )                                   | 638           | 16.2                    | 73           |
| \$5-\$10,000,000.....    | 488               | 252             | ( <sup>1</sup> )                                   | 742           | 18.8                    | 40           |
| Over \$10,000,000.....   | 190               | 93              | ( <sup>1</sup> )                                   | 746           | 18.9                    | 16           |
| Total.....               | 24,560            | 9,306           | .5   | 3,944         | 100.0                   | 3,319        |

<sup>1</sup> Less than one-tenth of 1 percent.

TABLE 9.—ESTIMATED ESTATE TAX RETURNS, TAXABLE RETURNS, AND ESTATE TAX LIABILITY OF RESIDENT DECEDENTS UNDER PROPOSED \$600,000 EXEMPTION EQUIVALENT CREDIT BY SIZE OF GROSS ESTATE, CALENDAR YEAR 1981

[Dollar amounts in millions]

| Size of gross estate       | Number of returns | Taxable returns | Taxable returns as a percent of resident decedents | Tax liability | Tax as percent of total | Revenue loss |
|----------------------------|-------------------|-----------------|--|---------------|-------------------------|--------------|
| \$175,000-\$500,000.....   |                   |                 |  |               |                         | \$1,301      |
| \$500,000-\$1,000,000..... | 11,362            | 2,285           | 0.1  | \$139         | 3.9                     | 1,486        |
| \$1-\$2,000,000.....       | 5,709             | 2,777           | .1   | 749           | 21.3                    | 629          |
| \$2-\$3,000,000.....       | 1,451             | 745             | ( <sup>1</sup> )                                   | 546           | 15.5                    | 159          |
| \$3-\$5,000,000.....       | 902               | 443             | ( <sup>1</sup> )                                   | 614           | 17.5                    | 97           |
| \$5-\$10,000,000.....      | 488               | 250             | ( <sup>1</sup> )                                   | 729           | 20.7                    | 53           |
| Over \$10,000,000.....     | 190               | 91              | ( <sup>1</sup> )                                   | 741           | 21.1                    | 21           |
| Total.....                 | 20,102            | 6,591           | .3   | 3,518         | 100.0                   | 3,745        |

<sup>1</sup> Less than one-tenth of 1 percent.

TABLE 10.—ESTIMATED ESTATE TAX RETURNS, TAXABLE RETURNS, AND ESTATE TAX LIABILITY OF RESIDENT DECEDENTS UNDER PROPOSED \$750,000 EXEMPTION EQUIVALENT CREDIT, BY SIZE OF GROSS ESTATE, CALENDAR YEAR 1981

[Dollar amounts in millions]

| Size of gross estate   | Number of returns | Taxable returns | Taxable returns as a percent of resident decedents | Tax liability | Tax as percent of total | Revenue loss |
|------------------------|-------------------|-----------------|--|---------------|-------------------------|--------------|
| \$175,000-\$500,000    |                   |                 |  |               |                         | \$1,301      |
| \$500,000-\$10,000,000 | 4,675             | 658             | ( <sup>1</sup> )                                   | \$21          | 0.7                     | 1,604        |
| \$1-\$2,000,000        | 5,709             | 2,566           | 0.1  | 534           | 17.4                    | 843          |
| \$2-\$3,000,000        | 1,451             | 730             | ( <sup>1</sup> )                                   | 486           | 15.9                    | 219          |
| \$3-\$5,000,000        | 902               | 437             | ( <sup>1</sup> )                                   | 579           | 18.9                    | 132          |
| \$5-\$10,000,000       | 488               | 248             | ( <sup>1</sup> )                                   | 709           | 23.1                    | 73           |
| Over \$10,000,000      | 190               | 88              | ( <sup>1</sup> )                                   | 735           | 24.0                    | 27           |
| Total                  | 13,415            | 4,727           | .2   | 3,064         | 100.0                   | 4,199        |

<sup>1</sup> Less than one-tenth of 1 percent.

TABLE 11.—ESTIMATED ESTATE TAX RETURNS, TAXABLE RETURNS, AND ESTATE TAX LIABILITY OF RESIDENT DECEDENTS UNDER PROPOSED \$800,000 EXEMPTION EQUIVALENT CREDIT BY SIZE OF GROSS ESTATE, CALENDAR YEAR 1981

[Dollar amounts in millions]

| Size of gross estate  | Number of returns | Taxable returns | Taxable returns as a percent of resident decedents | Tax liability | Tax as percent of total | Revenue loss |
|-----------------------|-------------------|-----------------|--|---------------|-------------------------|--------------|
| \$175,000-\$500,000   |                   |                 |  |               |                         | \$1,301      |
| \$500,000-\$1,000,000 | 3,740             | 280             | ( <sup>1</sup> )                                   | \$6           | 0.2                     | 1,619        |
| \$1-\$2,000,000       | 5,709             | 2,446           | 0.1  | 464           | 15.8                    | 913          |
| \$2-\$3,000,000       | 1,451             | 726             | ( <sup>1</sup> )                                   | 466           | 15.9                    | 239          |
| \$3-\$5,000,000       | 902               | 437             | ( <sup>1</sup> )                                   | 567           | 19.3                    | 144          |
| \$5-\$10,000,000      | 488               | 246             | ( <sup>1</sup> )                                   | 702           | 23.9                    | 80           |
| Over \$10,000,000     | 190               | 86              | ( <sup>1</sup> )                                   | 732           | 24.9                    | 30           |
| Total                 | 12,480            | 4,221           | .2   | 2,937         | 100.0                   | 4,326        |

<sup>1</sup> Less than one-tenth of 1 percent.

#### 4. Reductions in Estate and Gift Taxes Targeted Toward Particular Types of Property

Present law provides special methods for valuing certain real property used for farming purposes or in other closely held trades or businesses (Code sec. 2032A). The issue of whether this provision should be expanded or other reductions targeted toward particular types of assets be adopted also depends upon a balancing of competing objectives. In addition, provisions targeted at particular types of assets raise issues of equity among taxpayers.

The arguments for and against reductions in estate and gift taxes targeted towards particular types of assets may be summarized as follows:

##### Arguments for targeted reductions

Proponents for targeted estate and gift tax reductions argue that the advantages of maintaining family ownership of particular types of assets, such as farm and closely held businesses, outweigh any advantages from the estate and gift tax structure. Moreover, changes in values and the sizes of economically viable farms and closely held businesses have increased the impact of the estate and gift tax on these businesses. Proponents argue that the relatively low cash flow of this type of assets justifies allowing the asset more favorable treatment. Without such treatment, the low cash producing capacity of the asset often would require its sale to pay the tax. This is said to be true particularly in the case of closely held businesses where the productivity of the business is often dependent upon the personal efforts of the decedent, who can no longer be involved in the business.

##### Arguments against targeted reductions

Opponents of targeted estate and gift tax reductions argue that special treatment for certain types of assets creates serious inequities between taxpayers. It permits the heirs of one decedent to be better treated than heirs of other decedents simply because of the nature of the decedent's wealth. Moreover, opponents argue that, in many cases such as farm land, there has been true appreciation that exceeds the general rate of inflation. The problem with farms and closely held businesses is often a liquidity problem and it is argued that liquidity problems do not justify reductions in the estate tax.<sup>5</sup>

<sup>5</sup> The following summary of this argument was presented by Professor Michael Graetz of the University of Virginia School of Law in hearings before the Committee on Ways and Means on March 23, 1976:

" . . . In recent years, the value of farmland has risen at a rate faster than the rate of increase of prices generally. While the wealth of large segments of the American people has been eroded by inflation, the wealth of farmers generally—in constant dollars—has increased.

\* \* \* \* \*  
"It is a fact that the increase in farm real estate values has resulted in more farmers being subject to estate tax. And in many cases this produces genuine hardship. Funds are often simply not available to pay estate taxes. But this "liquidity" problem does not justify general estate tax relief. And one should be careful to distinguish a genuine liquidity problem from an heir's desire to continue to speculate on further price increases of land rather than selling at the current market value."

Another argument against selective reductions is that they encourage wealthy individuals to buy the favored assets for estate tax purposes which could drive up the price of the asset. For example, special estate tax treatment of farmland could drive up its price and make it difficult for farmers to buy farmland.

### **5. Increases in Marital Deduction**

Present law provides a limited marital deduction for estate and gift tax purposes for amounts passing between spouses. One of the issues to be raised at the hearing will be whether the existing limitations on the marital deduction should be increased or removed entirely.

The arguments for and against increases in the marital deduction can be summarized as follows:

#### **Arguments for increased marital deductions**

Proponents of increased marital deductions argue that there should be no tax imposed on transfers between spouses since a husband and wife should be treated as a single economic unit for estate and gift tax purposes, as they generally are for income tax purposes. Moreover, since the adoption of the generation-skipping tax, the objectives of the estate and gift tax are considered met if the tax is imposed once each generation. An increased marital deduction would not allow generation skipping. Finally, proponents argue that an increased marital deduction would simplify significantly the taxation of jointly held property of a husband and wife.

#### **Arguments against increased marital deduction**

Opponents of an increased marital deduction argue that the purpose of the marital deduction was to equate generally the tax treatment of property in common law states with community law states, and that increasing the marital deduction would not further that purpose. In addition, opponents argue that increasing the marital deduction may result in one spouse giving all his or her property to the other spouse which, under a progressive tax structure, may actually increase the total estate and gift taxes paid by the couple.

## 6. Increases in the Annual Gift Tax Exclusion

Present law allows an annual \$3,000 per donee exclusion from the gift tax. In addition, spouses can consent to split their gifts so that a couple can give up to \$6,000 per donee per year without gift tax. Another of the issues to be raised at the hearing are proposals to increase the annual gift tax inclusion.

The arguments for and against increasing the exclusion may be summarized as follows:

### Arguments for increased gift tax exclusion

Proponents of increasing the annual gift tax exclusion argue that inflation has substantially eroded the real value of the exemption since its value was last established in 1942. As a result, proponents argue that it is not possible to give a child an automobile or a college education without exceeding the annual exclusion.

### Arguments against increased gift tax exclusion

Opponents of an increase in the gift tax exclusion argue that this provision is used as a method of significantly reducing overall estate and gift taxes. They note that the intent of the exclusion was to exempt relatively small gifts, such as weddings, Christmas and birthday gifts from tax, but that practice has been to exclude these types of gifts in addition to the annual \$3,000 amount. Any increase in the size of the exemption would allow substantial reduction in estate and gift tax liabilities because of the typical large number of family members as donees.<sup>9</sup> Moreover, if there is a general agreement that gifts of items such as automobiles and college educations should not be subject to tax, then an increased exclusion for consummable items would allow this result without allowing substantial avoidance of estate and gift taxes generally.

<sup>9</sup> For example, assume that an elderly couple has three children, each of whom is married and each of whom has three children. In such a case, there would be 15 potential donees. If the annual exclusion were increased to \$10,000 (\$20,000 per couple), it would be possible for the couple to give away \$300,000 per year without gift or estate tax.

## V. DESCRIPTION OF BILLS

### 1. S. 404—Senator Symms

#### Repeal of Estate, Gift, and Generation-Skipping Taxes

##### *Present law*

Under present law, a gift tax is imposed on inter vivos transfers and an estate tax is imposed on death-time transfers. The rates of tax begin at 18 percent on the first \$10,000 of transfers and reach 70 percent for transfers in excess of \$5 million. Deductions are allowed for transfers to spouses (marital deduction) and to charities (charitable deduction). In addition, gift and estate taxes can be reduced by a unified credit of \$47,000 (which permits the transfer of \$175,625 free of gift or estate tax). In addition, present law imposes a generation-skipping tax on transfers if beneficiaries of more than one generation receive interests in the transfer.

##### *Explanation of the bill*

The bill would repeal the estate, gift, and generation-skipping transfer taxes. In addition to several conforming changes to other provisions of the Code, the bill also would provide that—

(1) Expenses of the decedent's last illness, paid within 1 year of the death, would be deductible under section 213 in computing the decedent's income tax for the year of his death as if they had been paid when incurred; and

(2) Section 303, which accords capital gains treatment for amounts received in redemptions of corporate stock to pay death taxes and administration expenses, would be repealed.

##### *Effective date*

The provisions of the bill would apply with respect to decedents dying after December 31, 1981, and to gifts made after that date.

##### *Revenue effect*

It is estimated that this bill would reduce budget receipts by \$117 million in fiscal year 1982, by \$8,480 million in fiscal year 1983, by \$9,443 million in fiscal year 1984, and by \$10,370 million in fiscal year 1985.

2. S. 858—Senator Durenberger

**Increase in Unified Estate and Gift Tax Credit, Current Use Valuation of Farms or Other Business Real Property, and Reduced Interest Rates on Extended Payments of Estate Taxes**

**a. Rate schedules and unified credit**

*Present law*

Under present law, the estate and gift tax rates range from 18 percent on the first \$10,000 in taxable transfers to 70 percent on taxable transfers in excess of \$5 million. The estate or gift liability is computed by first computing the gross gift or estate tax (without any exemption) and then subtracting the unified credit to determine the amount of gift or estate tax. The amount of the unified credit is \$47,000. With a unified credit of \$47,000, there would be no estate or gift tax on transfers of up to \$175,625.

*Explanation of provisions*

The bill would increase the unified credit for estate tax purposes to \$192,800 beginning in 1982. The bill also would increase over a 4-year period the amount of the unified credit for gift tax purposes from \$47,000 to \$192,800. With a unified credit of \$192,800, there would be no estate or gift tax on transfers aggregating approximately \$600,000. The bill would make conforming changes to the estate tax filing return requirements. The bill does not alter the present rate schedule.

*Effective date*

These provisions of the bill would be effective for gifts made, and decedents dying, after December 31, 1981.

**b. Special valuation of farm or other business real property**

*Present law*

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value, rather than full fair market value, provided that the gross estate may not be reduced by more than \$500,000 (Code sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his 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 debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;<sup>1</sup> (4) the

<sup>1</sup> For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

real property qualifying for current use valuation must pass to a qualified heir;<sup>2</sup> (5) such real property must have been owned by the decedent or a member of his 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 his family in 3 years out of the 8 years immediately preceding the decedent's death (Code secs. 2032A (a) and (b)).<sup>3</sup>

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

#### *Explanation of provisions*

This provision would make several modifications to the rules relating to the current use valuation of farm and other business real property for estate tax purposes.

First, the bill would provide that the material participation requirement for qualification for current use valuation need only be met until the date upon which the decedent retires or becomes disabled.

Second, the bill would provide an "active management" qualification test, rather than a material participation test, with respect to farm or other business real property included in the gross estate if the property had been inherited from a spouse and had qualified for current use valuation in that spouse's estate. "Active management" is defined to mean the making of the management decisions of a business, other than the daily operating decisions.

Third, in the case of woodlands, the bill would provide that qualification for special valuation can be attained if the decedent or a member of his family is engaged in the "active management" of the woodlands for the 10-year period prior to his death.

Fourth, the period during which the benefits from reduced valuation could be recaptured would be reduced from 15 years to 10 years. The current rules applicable after the tenth year would be repealed.

Fifth, the bill would provide that recapture of the benefits from reduced valuation would not occur where an agent of the qualified heir engages in the active management of the property in the case of all farming property or where the qualified heir was a surviving spouse

<sup>2</sup> 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.

<sup>3</sup> 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 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.

of the decedent, a minor student or is disabled in the case of other property.

Sixth, the \$500,000 limit on the reduction of the decedent's gross estate would be repealed. Consequently, the current use value, computed under section 2032A, would be substituted on the estate tax return for the full fair market value.

Seventh, the bill would expressly provide that an exchange pursuant to Code section 1031 of the qualified real property solely for real property to be used for the same qualified use as the original unqualified real property would not trigger a recapture of the benefits from reduced valuation. If, however, the like-kind exchange under Code section 1031 were not entirely for qualified property, then a proportionate amount of the recapture tax would be payable.

Eighth, a qualified heir would not be required to make an election to secure the benefits of the special rules for involuntary conversions.

Ninth, the bill would provide that if there is no comparable land from which to determine the average annual gross cash rental, then the average net share rental could be substituted for the average gross cash rental in applying the formula valuation method. The net share rental would be (1) the value of the produce grown on the leased land received by the lessor, reduced by (2) the cash operating expenses of growing the produce that are paid, under the terms of the lease, by the lessor.

Finally, the bill would provide that, upon the recapture of the estate tax benefits, the basis of the property would be increased to its fair market value on the date of the decedent's death.<sup>4</sup>

#### *Effective date*

Generally, these provisions would be effective for estates of decedents dying after December 31, 1981, except that the provision permitting cash rentals to family members would apply for all years after December 31, 1976.

#### **c. Reduced interest rates on extended payments of estate taxes**

##### *Present law*

Code section 6166, as added by the Tax Reform Act of 1976, provides a 15-year period for the payment of the estate tax attributable to a decedent's interest in a closely held business (including a farm). Under this provision, an executor may elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first 5 years is payable annually. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 annual installments. A special 4-percent interest rate is allowed on the estate tax attributable to the first \$1 million of closely held business property, and interest on amounts of estate tax in excess of this amount is at the regular rate for interest on deferred payments (currently 12 percent).

<sup>4</sup>Technical modifications would be necessary to the bill to clarify that the basis is stepped up to its value as of the decedent's death and to insure that the current use value is not double counted in determining basis.

***Explanation of provision***

If the time for payment of the tax is extended under Code section 6166, a reduced rate of interest would apply to that amount of tax attributable to closely held property which is in excess of the amount eligible for the four-percent rate. Under the provision, the applicable interest rate would be the lesser of (1) six percent or (2) 90 percent of the statutory rate for interest on deferred payments.

***Effective date***

This provision would be applicable to the estates of decedents dying after December 31, 1981.

***d. Revenue effect of the bill***

It is estimated that this bill would reduce budget receipts by a negligible amount in fiscal years 1981 and 1982, by \$4,362 million in fiscal year 1983, by \$4,879 million in fiscal year 1984, and by \$5,459 million in fiscal year 1985.

**3. S. 395—Senators Wallop, Boren, Byrd (Va.), and others  
Reduction in Estate and Gift Tax Rates, Increase in Unified  
Credit, Unlimited Marital Deduction, Increase in Gift Tax  
Exclusion, Current Use Valuation of Farms and Other Business  
Real Property, and Other Modifications to the Estate and Gift  
Taxes**

**a. Rate schedules and unified credit**

*Present law*

Under present law, the estate and gift tax rates range from 18 percent for the first \$10,000 in taxable transfers to 70 percent on taxable transfers in excess of \$5 million. The estate or gift tax liability is determined by first computing the gross gift or estate tax (without any exemption) and then subtracting the unified credit to determine the amount of gift or estate tax. The amount of the unified credit is \$47,000. With a unified credit of \$47,000, there is no estate or gift tax on transfers of up to \$175,625.

Under present law, the statute of limitations on the value of a gift does not begin to run until a gift tax return is filed upon which tax is paid. Also, under present law, any unused unified credit must be used to reduce the gift tax payable. A donor cannot elect not to use a portion of the unified credit otherwise available. As a result, the statute of limitations on the value of gifts does not begin to run until the entire unified credit has been used.

*Explanation of provisions*

The bill would reduce the estate and gift tax rates and widen the applicable brackets so that rates would range from 10 percent on the first \$25,000 in taxable transfers to 60 percent on taxable transfers in excess of \$5 million.

The bill also would increase, over a 5-year period, the amount of the unified estate and gift tax credit from \$47,000 to \$124,750. With a unified credit of \$124,750, there would be no estate or gift tax (under the revised rate schedule) on transfers aggregating \$600,000. The bill would make conforming changes to the estate tax filing requirements.

The bill would allow the donor to elect to use any portion of the unified credit with respect to a particular gift. As a result, a donor could elect to pay some gift tax with respect to a particular gift and begin the running of the statute of limitations on its valuation.

*Effective date*

These provisions of the bill would be effective for gifts made, and decedents dying, after December 31, 1980.

**b. Marital deduction***Present law*

Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of \$200,000.

In addition, an estate tax marital deduction is allowed for the value of property passing from a decedent to the surviving spouse for the greater of \$250,000 or one-half of the decedent's adjusted gross estate. This amount is adjusted by the excess of the amount of unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

Under these provisions, transfers of community property or terminable interests generally do not qualify for either the gift or estate tax marital deduction.

*Explanation of provision*

The bill would provide an unlimited marital deduction for both estate and gift tax purposes. The bill would not change the present law rule that transfers of terminable interests do not qualify for the marital deduction.

*Effective date*

This provision would be effective for decedents dying after December 31, 1981, in the case of the estate tax marital deduction, and for gifts made after December 31, 1981, in the case of the gift tax marital deduction.

**c. Gift tax exclusion***Present law*

Under present law, an annual exclusion of \$3,000 per donee<sup>1</sup> is allowed with respect to gifts of present interests in property (Code sec. 2503(b)).

A gift made by a husband or wife may, with the consent of both, be treated for gift tax purposes as made one-half by each (Code sec. 2513). The full annual exclusion is allowed with respect to each spouse's one-half share of gifts of present interests in property. Thus, in these cases, a donor may make up to \$6,000 in excludible transfers to a donee during a calendar year.

*Explanation of provision*

The provision would increase the gift tax annual exclusion to \$10,000 per donee.

*Effective date*

This provision of the bill would be effective for gifts made after December 31, 1981.

<sup>1</sup>The annual exclusion has been \$3,000 since January 1, 1943. When the gift tax was first enacted under the Revenue Act of 1932, the amount of the annual exclusion was \$5,000. The annual exclusion was reduced to \$4,000 in 1938 and then was reduced further to its present \$3,000 amount under the Revenue Act of 1942.

#### d. Current use valuation of farm or other business real property

##### *Present law*

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value, rather than full fair market value, provided that the gross estate may not be reduced by more than \$500,000 (Code sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his 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 debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;<sup>2</sup> (4) the real property qualifying for current use valuation must pass to a qualified heir;<sup>3</sup> (5) such real property must have been owned by the decedent or a member of his 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 his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2032A (a) and (b)).<sup>4</sup>

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

##### *Explanation of provisions*

This provision would make several modifications to the rules relating to the current use valuation of farm and other business real property for estate tax purposes.

First, the bill would provide that the material participation requirement for qualification for current use valuation need only be met until the date upon which the decedent retires or becomes disabled. In addition, the required trade or business use could be that of the decedent or a member of the decedent's family.

<sup>2</sup> For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

<sup>3</sup> 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.

<sup>4</sup> 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 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.

Second, the bill would provide an "active management" qualification test, rather than a material participation test, with respect to farm or other business real property included in the gross estate if the property had been inherited from a spouse and had qualified for current use valuation in that spouse's estate. "Active management" is defined to mean the making of the management decisions of a business, other than the daily operating decisions.

Third, in the case of woodlands, the bill would provide that qualification for special valuation can be attained if the decedent or a member of his family is engaged in the "active management" of the woodlands for the 10-year period prior to his death.

Fourth, the period during which the benefits from reduced valuation could be recaptured would be reduced from 15 years to 10 years. The current rules applicable after the tenth year would be repealed.

Fifth, the bill would provide that recapture of the benefits from reduced valuation would not occur where an agent of the qualified heir engages in the active management of the property in the case of all farming property or where the qualified heir was a surviving spouse of the decedent, a minor, a student or is disabled in the case of other property.

Sixth, the \$500,000 limit on the reduction of the decedent's gross estate would be repealed. Consequently, the current use value, computed under Code section 2032A, would be substituted on the estate tax return for the full fair market value.

Seventh, the bill would expressly provide that an exchange pursuant to Code section 1031 of the qualified real property solely for real property to be used for the same qualified use as the original qualified real property would not trigger a recapture of the benefits from reduced valuation. If, however, the like-kind exchange under Code section 1031 were not entirely for qualified property, then a proportionate amount of the recapture tax would be payable.

Eighth, a qualified heir would not be required to make an election to secure the benefits of the special rules for involuntary conversions.

Ninth, the bill would provide that, instead of using gross cash rentals from actual tracts of comparable land, the gross rental value of comparable land could be used in applying the formula valuation method. This change would allow the use of crop share rentals.

Finally, the bill would provide that, upon the recapture of the estate tax benefits, the basis of the property would be increased to its fair market value on the date of the decedent's death.<sup>5</sup>

***Effective date***

This provision would be effective for estates of decedents dying after December 31, 1981.

**e. Coordination of provisions permitting deferred payment of estate tax where estate consists largely of interests in closely held business**

***Present law***

Under present law, two overlapping provisions permit deferred payment of estate taxes attributable to interests in closely held busi-

<sup>5</sup> Technical modifications would be necessary to the bill to clarify that the basis is stepped up to its value as of the decedent's death and to insure that the current use value is not double counted in determining basis.

nesses. If the value of the closely held business (reduced by allowable expenses, losses, and indebtedness) exceeds 65 percent of the value of the gross estate, the applicable estate taxes may be deferred up to 15 years (annual interest payments for five years, followed by up to ten annual installments of principal and interest) (Code sec. 6166). If the value of the closely held business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the applicable taxes may be paid in up to ten annual installments (Code sec. 6166A). Under both provisions, all payments are accelerated if there is a failure to timely pay any installment, or if there is a disposition of a specified fraction of the value of decedent's interest in the business. This fraction is one-third in the case of Code section 6166 and one-half in the case of Code section 6166A.

Under current income tax law, if more than 50 percent of the gross estate (reduced by allowable expenses, losses, and indebtedness) consists of stock in a single corporation, redemption of all or portion of that stock to pay estate taxes, funeral and administration expenses, will be treated as capital gain instead of dividend income.

***Explanation of provision***

Under the bill, Code section 6166A would be repealed and the provision of present law allowing for the payment of estate taxes over a 15-year period would be expanded to include all estates in which the value of a closely held business (or businesses) included in the decedent's estate exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate. Also, the provision relating to the qualified redemption of stock to pay the estate tax would apply if the value of the closely held business met the same test.

The bill would also permit the disposition of up to 50 percent of the business interest before accelerating payments.

***Effective date***

This provision would be effective for estates of decedents dying after December 31, 1980.

**f. Estate tax treatment of transfers made within three years of death**

***Present law***

Under present law, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were actually made in contemplation of death. However, an exception to this rule applies for transfers of property (other than a transfer with respect to a life insurance policy) where no gift tax return was required to be filed with respect to the gift.

When a gift made within three years of the decedent's death is required to be included in the decedent's gross estate, it is valued at the time of the decedent's death. However, a credit is allowed against the estate tax for any gift tax paid by the decedent on the gift. Generally, the net effect of these two rules is to include in the gross estate the appreciation in value of the property from the date of the gift until the date of death.

***Explanation of provision***

The bill would provide that the value of gifts which are includible in the gross estate by reason of being made within three years of death

is to be their value on the date of gift instead of their value at the date of death. The estate will continue to receive a credit for any gift taxes imposed on the gift. Thus, the net effect of the bill would be to subject the gift to the gift tax at its value at the time of gift and to exclude any appreciation in value from the date of gift to the date of death from the estate tax.

**Effective date**

This provision would be applicable to the estates of decedents dying after December 31, 1980.

**g. Disclaimers**

**Present law**

Under present law, in the case of a qualified disclaimer by a donee or heir, the donee or heir is not deemed to have made a gift. A disclaimer is qualified, for purposes of the Federal estate law, if among other criteria, the disclaimer is effective under local law to divest the disclaimant of ownership (Code sec. 2518).

**Explanation of provision**

Under the bill, a disclaimer that is not effective to pass title under local law would still be considered a qualified disclaimer for estate and gift tax purposes if the disclaimant timely transfers the property interest to the person who would have received the property had the disclaimant predeceased the original holder.

**Effective date**

The provision would be effective with respect to transfers made after December 31, 1980.

**h. Revenue effect of the bill**

It is estimated that the provisions of the bill would reduce budget receipts for fiscal years 1981-1985 as follows:

[In millions of dollars]

| Item  | Fiscal year--          |                     |       |       |      |
|---|------------------------|---------------------|-------|-------|------|
|   | 1981                   | 1982                | 1983  | 1984  | 1985 |
| Unified credit and rate schedule              | ( <sup>1</sup> ) 2,490 | 4,072               | 5,052 | 5,949 |      |
| Unlimited marital deduction <sup>2</sup>      |                        |                     | 100   | 100   | 100  |
| \$10,000 gift exclusion <sup>2</sup>          |                        | ( <sup>1</sup> ) 50 | 50    | 50    | 50   |
| Changes in current use valuation <sup>2</sup> |                        | 300                 | 300   | 300   | 300  |
| Other miscellaneous provisions <sup>2</sup>   | ( <sup>1</sup> ) 50    | 50                  | 50    | 50    | 50   |
| Total revenue effect of the bill              | ( <sup>1</sup> ) 2,840 | 4,572               | 5,552 | 6,449 |      |

<sup>1</sup> Less than \$50 million.

<sup>2</sup> Additional revenue loss after unified credit and new rate schedule are in place.

#### 4. S. 574—Senator Kassebaum

### Estate Tax Deduction for Transfers of Qualified Tangible Property to Decedent's Spouse and Certain Other Heirs

#### *Present law*

##### *Current use valuation*

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at its current use value, rather than full fair market value, provided that the gross estate may not be reduced by more than \$500,000 (Code sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his 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 debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;<sup>1</sup> (4) the real property qualifying for current use valuation must pass to a qualified heir;<sup>2</sup> (5) such real property must have been owned by the decedent or a member of his 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 his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2032A (a) and (b)).<sup>3</sup>

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

<sup>1</sup> For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

<sup>2</sup> 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.

<sup>3</sup> 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 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.

*Marital deduction*

Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first \$100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of \$200,000.

In addition, an estate tax marital deduction is allowed for the value of property passing from a decedent to the surviving spouse for the greater of \$250,000 or one-half of the decedent's adjusted gross estate. This amount is adjusted by the excess of the amount of unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

*Explanation of the bill*

Under the bill, an estate tax deduction would be allowed for the amount of qualified tangible property passing to the decedent's spouse or other qualified heirs. The deduction would be limited to the sum of (1) \$750,000 with respect to qualified tangible property passing to the decedent's spouse, and (2) \$750,000 with respect to all qualified tangible property passing to qualified heirs other than the decedent's spouse.

Qualified tangible property would be defined as all tangible property (other than cash) located in the United States which, on the date of death, was being used for a qualified use, provided that at least 50 percent of the gross estate consists of the adjusted value of such property which (1) was being used for a qualified use on the date of death, and (2) passed from the decedent to a qualified heir. In addition, to the extent that an interest in intangible property represents an interest in qualified tangible property which is real property, the intangible interest would be treated as an interest in qualified tangible property.

Definitions of "qualified use," "qualified heir," and "adjusted value" would be determined pursuant to Code section 2032A (which deals with current use valuation). The tax treatment of such property upon involuntary conversion, disposition, and recapture, also would be determined pursuant to Code section 2032A, except that the amount of the recapture would be reduced on a monthly basis if the recapture occurs after five years.

This deduction would supplement benefits available under present law through current use valuation and marital deductions, but only to the extent that the interest in qualified tangible property is included in determining the value of the gross estate and is not otherwise deductible under present law.

*Effective date*

The provisions of the bill would be effective with respect to the estates of decedents dying after December 31, 1980.

*Revenue effect*

It is estimated that this bill would reduce budget receipts by \$140 million in fiscal year 1982, by \$156 million in fiscal year 1983, by \$174 million in fiscal year 1984 and by \$194 million in fiscal year 1985.