DESCRIPTION OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 8, "THE DEATH TAX ELIMINATION ACT"

Scheduled for Markup

before the

HOUSE COMMITTEE ON WAYS AND MEANS

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Prepared by

the Staff of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of the provisions of H.R. 8, the "Death Tax Elimination Act," on March 29, 2001.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the provisions of a Chairman's amendment in the nature of a substitute to the provisions of H.R. 8.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 8, "The Death Tax Elimination Act,"* (JCX-20-01), March 28, 2001.

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

Present Law

Estate and gift tax rules

In general

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between $10 million and $17,184,000, which has the effect of phasing out the benefit of the graduated rates. Thus, these estates are subject to a top marginal rate of 60 percent. Estates over $17,184,000 are subject to a flat rate of 55 percent, as the benefit of the graduated rates has been phased out.

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $10,000 (indexed for inflation occurring after 1997) of transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $20,000. Unlimited transfers between spouses are permitted without imposition of a gift tax.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax transfers totaling $675,000 in 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter. The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2001, the unified credit applies between the 18-percent and 37-percent estate and gift tax rates. Thus, in 2001, taxable transfers, after application of the unified credit, are effectively subject to estate and gift tax rates beginning at 37 percent.

Transfers to a surviving spouse

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of a “qualified terminable interest” also are eligible for the marital deduction. A “qualified terminable interest” is property: (1) which passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use property during the spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Expenses, indebtedness, and taxes

An estate tax deduction is allowed for funeral expenses and administration expenses of an estate. An estate tax deduction also is allowed for claims against the estate and unpaid mortgages on, or any indebtedness in respect of, property for which the value of the decedent's interest therein, undiminished by the debt, is included in the value of the gross estate.

If the total amount of claims and debts against the estate exceeds the value of the property to which the claims relate, an estate tax deduction for the excess is allowed, provided such excess is paid before the due date of the estate tax return. A deduction for claims against the estate generally is permitted only if allowable by the law of the jurisdiction under which the estate is being administered.

A deduction also is allowed for the full unpaid amount of any mortgage upon, or of any other indebtedness in respect of, any property of the gross estate (including interest which has accrued thereon to the date of the decedent's death), provided that the full value of the underlying property is included in the decedent's gross estate.

Basis of property received

In general.--A taxpayer who receives property from a decedent's estate or from a donor of a lifetime gift may want to sell or otherwise dispose of the property. Gain or loss, if any, on the disposition of the property is measured by the taxpayer's amount realized (e.g., gross proceeds received) on the disposition, less the taxpayer's basis in such property.

Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor plus any gift tax paid on any unrealized appreciation. The basis of a lifetime gift, however, generally may not exceed the property's fair market value on the date of the gift.

Property passing from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of any income on the appreciation of the property that occurred prior to the decedent's death, and has the effect of eliminating the tax benefit from any unrealized loss.

Special rules for interests in certain foreign entities.--Stepped-up basis treatment generally is denied to certain interests in foreign entities. Under present law, stock or securities in a foreign personal holding company takes a carryover basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of accumulated earnings and profits. In addition, stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Provisions affecting small and family-owned businesses and farms

Special-use valuation.--An executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997). Real property generally may qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction.--An estate is permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to $675,000.[2] A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income. In the case of a trade or business that owns an interest in another trade or

[2] The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount is equal to $625,000, increased by the difference between $675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above the generally applicable exemption amount in effect for the taxable year.

business (i.e., “tiered entities”), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent’s family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent’s date of death. In addition, at lease one qualified heir (or member of the qualified heir’s family) is required to materially participate in the trade or business for at least 10 years following the decedent’s death.

The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent’s death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent’s death, then 100 percent of the tax is recaptured. The remaining percentage of recapture based on the year after the decedent’s death in which a disqualifying event occurs is as follows: the disqualifying event occurs during the seventh year after the decedent’s death, 80 percent; the disqualifying event occurs during the eighth year after the decedent’s death, 60 percent; the disqualifying event occurs during the ninth year after the decedent’s death, 40 percent; and the disqualifying event occurs during the tenth year after the decedent’s death, 20 percent. For purposes of the qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent’s death. However, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent’s death.

An estate may claim the benefits of both the qualified family-owned business deduction and special-use valuation. For purposes of determining whether the value of the trade or business exceeds 50 percent of the decedent’s gross estate, if the estate claimed special-use valuation, then the property’s special-use value is used.

State death tax credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia with respect to any property included in the decedent’s gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, based on the size of the decedent’s adjusted taxable estate. Most States impose a “pick-up” or “soak-up” estate tax, which applies when the State death tax liability is less than the maximum Federal death tax credit. In such a case, a tax is imposed by the State, which is equal to the difference between the State death tax liability and the maximum State death tax credit. This provides States with the maximum amount of death tax for which the State death tax credit provides.

Estate and gift taxation of nonresident noncitizens

Nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Estates of nonresident noncitizens generally are taxed at same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death. This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Special rules apply which treat certain property as being situated within and without the United States for these purposes.

Unless modified by a treaty, a nonresident who is not a U.S. citizen generally is allowed a unified credit of $13,000, which effectively exempts $60,000 in assets from estate tax.

Generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. The generation-skipping transfer tax is imposed at a flat rate of 55 percent (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of $1 million (indexed for inflation occurring after 1997).

Selected income tax provisions

Transfers to certain foreign trusts and estates

Transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

Net operating loss and capital loss carryovers

Under present law, a capital loss and net operating loss from business operations sustained by a decedent during his last taxable year are deductible only on the final return filed in his or her behalf. Such losses are not deductible by his or her estate.

Transfers of property in satisfaction of a pecuniary bequest

Under present law, gain or loss is recognized on the transfer of property in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount) to the extent that the fair market value of the property at the time of the transfer exceeds the basis of the property, which generally is the basis stepped up to fair market value on the date of the decedent's death.

Income tax exclusion for the gain on the sale of a principal residence

A taxpayer generally may exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years.

To be eligible, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five year prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

Excise tax on nonexempt trusts

Under present law, a split-interest trust may be subject to certain restrictions that are applicable to private foundations if an income, estate, or gift tax charitable deduction was allowed with respect to the trust. A split-interest trust subject to these rules would be prohibited from engaging in self-dealing, retaining any excess business holdings, and from making certain investments or taxable expenditures. Failure to comply with the restrictions would subject the split-interest trust to certain excise taxes imposed on private foundations, which include excise taxes on self-dealing, excess business holdings, investments which jeopardize charitable purposes, and certain taxable expenditures.

Description of Proposal

Overview of proposal

Beginning in 2011, the estate, gift, and generation-skipping transfer taxes would be repealed. After repeal, the basis of assets received from a decedent generally would equal the basis of the decedent (i.e., carryover basis) at death. However, a decedent's estate would be permitted to increase the basis of assets transferred by up to a total of $1.3 million. The basis of property transferred to a surviving spouse could be increased by an additional $3 million. Thus, the basis of property transferred to a surviving spouse could be increased by a total of $4.3 million. In no case could the basis of an asset be adjusted above its fair market value. For these purposes, the executor would elect which assets receive an increase in basis and the extent to which each asset receives an increase in basis. The $1.3 million and $3 million amounts would be adjusted annually for inflation occurring after December 31, 2010.

In 2002, the unified credit would be replaced with a unified exemption, the 5-percent surtax, which phases out the benefit of the graduated rates, and the rates in excess of 53 percent would be repealed. Beginning in 2003, the estate, gift, and generation-skipping transfer tax rates would be reduced each year until the estate, gift, and generation-skipping transfer taxes are repealed in 2011.

Phaseout and repeal of estate, gift, and generation-skipping transfer taxes

In general

In 2002, the top estate and gift tax rates above 53 percent would be repealed, as would the 5-percent surtax, which phases out the benefit of the graduated rates. In 2003, all rates in excess of 50 percent would be repealed. In each year 2004 through 2006, each of the rates of tax would be reduced by one percentage point. In each year 2007 through 2010, each of the rates of tax would be reduced by two percentage points. The generation-skipping transfer tax rate for a given year would be the highest estate and gift tax rate in effect for that year. The reduction in estate and gift tax rates would be coordinated with the income tax rates such that the highest estate and gift tax rate (and, thus, the generation-skipping transfer tax rate) would not be reduced below the top individual tax rate, and the lower estate and gift tax rates would not be reduced below the lowest individual tax rate. For each year 2002 through 2010, the State death tax credit rates would be reduced in proportion to the reduction in the estate and gift tax rates.

Beginning in 2011, the estate, gift, and generation-skipping transfer taxes would be repealed.

Replace unified credit with unified exemption

Beginning in 2002, the unified credit would be replaced with a unified exemption amount. The unified exemption amount, which would follow the dollar amounts of the present law unified credit effective exemption amounts, would be determined as follows: in 2002 and 2003, $700,000; in 2004, $850,000; in 2005, $950,000; and in 2006 and thereafter (until repeal in 2011), $1 million. For decedents who are not residents and not citizens of the United States, the exemption would be $60,000.

Basis of property acquired from a decedent

In general

Beginning in 2011, after the estate, gift, and generation-skipping transfer taxes have been repealed, the present-law rules providing for a fair market value basis for property acquired from a decedent would be repealed. Instead, a carryover basis regime generally would take effect. Recipients of property transferred at the decedent's death generally would receive the transferor's adjusted basis in the property, but not in excess of the fair market value of the property on the date of the decedent's death (i.e., recipients generally would take a carryover basis in the property).

Basis increase for certain property

The proposal also would allow an executor to increase the decedent's basis in assets transferred to beneficiaries at death. Under this rule, a decedent's estate generally would be permitted to increase the basis of assets transferred by up to a total of $1.3 million. The $1.3 million would be increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse could be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses could be increased by a total of $4.3 million. Basis increase would be allocable on an asset-by-asset basis (e.g., basis increase could be allocated to a share of stock or a block of stock). However, in no case could the basis of an asset be adjusted above its fair market value. For these purposes, the executor would elect which assets receive a step up in basis and determine the extent to which each asset receives an increase in basis. The $1.3 million and $3 million amounts are adjusted annually for inflation occurring after December 31, 2010.

Nonresidents who are not U.S. citizens would be allowed to increase the basis of property by up to $60,000 (indexed for inflation occurring after December 31, 2010).

Certain property would not be eligible for a basis increase. This includes: (1) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death; (2) property that constitutes a right to receive income in respect of a decedent; (3) stock or securities of a foreign personal holding company; (4) stock of a domestic international sales corporation (or former domestic international sales corporation); (5) stock of a foreign investment company; and (6) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

The character of gain on the sale of property received from a decedent's estate would be treated the same as if the property had been acquired by gift. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent would be subject to recapture if sold by the heir.

Reporting requirements

In general

Lifetime gifts.--A donor would be required to report to the Internal Revenue Service ("IRS") the basis and character of any non-cash property received by gift with a value in excess of $25,000 (except for gifts to charitable organizations). The donor would be required to report to the IRS:

- the name and taxpayer identification number of the donee,
- an accurate description of the property,
- the adjusted basis of the property in the hands of the donor at the time of gift,
- the donor's holding period for such property,
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income, and
- any other information as the Treasury Secretary may prescribe.

Similar information (including the name, address, and phone number of the person making the return) would be required to be provided to recipients of such property.

Transfers at death.--For transfers at death of non-cash assets in excess of $1.3 million and for appreciated property the value of which exceeds $25,000 received by a decedent within three years of death, the executor of the estate (or the trustee of a revocable trust) would report to the IRS:

- the name and taxpayer identification number of the recipient of the property,
- an accurate description of the property,
- the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
- the decedent's holding period for the property,
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- the amount of basis increase allocated to the property, and
- any other information as the Treasury Secretary may prescribe.

Similar information (including the name, address, and phone number of the person making the return) would be required to be provided to recipients of such property.

Penalties for failure to file required information

Any donor required to report the basis and character of any non-cash property with a value in excess of $25,000 who fails to do so would be liable for a penalty of $500 for each failure to report such information to the IRS and $50 for each failure to report such information to a beneficiary.

Any person required to report to the IRS transfers at death of non-cash assets in excess of $1.3 million in value who fails to do so would be liable for a penalty of $10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property valued in excess of $25,000 within three years of death who fails to do so would be liable for a penalty of $500 for the failure to report such information to the IRS. There also would be a penalty of $50 for each failure to report such information to a beneficiary.

No penalty would be imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under the proposal is due to intentional disregard of the rules, then the penalty would be five percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift).

Certain tax benefits extending past the date for repeal of the estate tax

Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax. Because repeal of the estate tax would be effective for decedents dying after December 31, 2010, these estate tax recapture provisions would continue to apply.

Qualified conservation easements

A donor may have retained a development right in the conveyance of a conservation easement that qualified for the estate tax exclusion. Those with an interest in the land may later execute an agreement to extinguish the right. If an agreement to extinguish development rights is not entered into within the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement time, then those with an interest in the land are personally liable for an additional tax. This provision would be retained after repeal of the estate tax, which would ensure that those persons with an interest in the land who fail to execute the agreement remain liable for any additional tax which may be due after repeal.

Special-use valuation

Property may have qualified for special-use valuation prior to repeal of the estate tax. If such property ceases to qualify for special-use valuation, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the estate tax, which would ensure that those estates that claimed this benefit before repeal of the estate tax would be subject to recapture if a disqualifying event occurs after repeal.

Qualified family-owned business deduction

Property may have qualified for the family-owned business deduction prior to repeal of the estate tax. If such property ceases to qualify for the family-owned business deduction, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the estate tax, which would ensure that those estates that claimed this benefit before repeal of the estate tax would be subject to recapture if a disqualifying event occurs after repeal.

Installment payment of estate tax for closely-held businesses

The present-law installment payment rules would be retained so that those estates that entered into an installment payment arrangement prior to repeal of the estate tax would continue to make their payments past the date for repeal.

If more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary. This rule would be retained after repeal of the estate tax, which would ensure that such dispositions that occur after repeal of the estate tax will continue to subject the estate to the unpaid portion of the tax upon notice and demand.

Transfers to foreign trusts, estates, and nonresidents who are not U.S. citizens

The present-law rule providing that transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange would be expanded. Under the proposal, transfers by a U.S. person to a nonresident who is not a U.S. citizen would be treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor.

Transfers of property in satisfaction of a pecuniary bequest

Under the proposal, gain or loss on the transfer of property in satisfaction of a pecuniary bequest would be recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).

Transfer of property subject to a liability

The proposal would clarify that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in that property. Similarly, no gain would be recognized by the estate on the distribution of such property to a beneficiary of the estate by reason of the liability.

Income tax exclusion for the gain on the sale of a principal residence

The income tax exclusion of up to $250,000 of gain on the sale of a principal residence would be extended to estates and heirs. Under the proposal, if the decedent's estate or an heir sells the decedent's principal residence, $250,000 of gain may be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of occupancy of the property as a principal residence may be added to the heir's subsequent occupancy in determining whether the property was occupied for two years as a principal residence.

Excise tax on nonexempt trusts

A split-interest trust would be subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust.

Anti-abuse rules

The Secretary of the Treasury would be given authority to treat a transfer that purports to be a gift as having never been transferred, if, in connection with such transfer (1) the transferor (or any person related to or designated by the transferor or such person) has received anything of value in connection with the transfer from the transferee directly or indirectly or (2) there is an understanding or expectation that the transferor (or any person related to or designated by the transferor or such person) will receive anything of value in connection with the transfer from the transferee directly or indirectly.

Study mandated by the proposal

The proposal would require the Treasury Secretary to conduct a study of opportunities for avoidance of the income tax, if any, and potential increases in income tax revenues by reason of enactment of the proposal. The results of such study would be required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance no later than December 31, 2002.

Effective Date

The unified credit would be replaced with a unified exemption, the 5-percent surtax would be repealed, and the rate in excess of 53 percent (i.e., the 55 percent rate) would be repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2001. The estate and gift tax rate in excess of 50 percent is repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2002.

The additional reductions of estate and gift tax rates and of the State death tax credit would occur in 2004 through 2010.

The estate, gift, and generation-skipping transfer taxes would be repealed and the carryover basis regime would take effect for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2010.

The provisions relating to purported gifts and recognition of gain on transfers to nonresidents noncitizens would be effective for transfers made after December 31, 2010.

II. EXPAND AVAILABILITY OF ESTATE TAX EXCLUSION FOR CONSERVATION EASEMENTS

Present Law

In general

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

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

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

Retained development rights

The exclusion for land subject to a conservation easement does not apply to any development right retained by the donor in the conveyance of the conservation easement. An example of such a development right would be the right to extract minerals from the land. If such development rights exist, then the value of the conservation easement must be reduced by the value of any retained development right.

If the donor or holders of the development rights agree in writing to extinguish the development rights in the land, then the value of the easement need not be reduced by the development rights. In such case, those persons with an interest in the land must execute the agreement no later than the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement. If such agreement is not entered into within this time, then those with an interest in the land are personally liable for an additional tax, which is the amount of tax which would have been due on the retained development rights subject to the termination agreement.

Description of Proposal

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

Effective date

The proposal would be effective for estates of decedents dying after December 31, 2000.

III. MODIFY GENERATION-SKIPPING TRANSFER TAX RULES

A. Deemed Allocation of the Generation-Skipping Transfer Tax Exemption to Lifetime Transfers to Trusts that are not Direct Skips

Present Law

A GST tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a Askip person@ (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

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

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

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

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

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

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

Description of Proposal

Under the proposal, GST tax exemption would be automatically allocated to transfers made during life that are Aindirect skips.@ An indirect skip would be any transfer of property (that is not a direct skip) subject to the gift tax that is made to a GST trust.

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

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

- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals; the trust instrument provides that, if 1 or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of 1 or more of such individuals or is subject to a general power of appointment exercisable by 1 or more of such individuals;

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

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

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

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

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

Effective Date

The proposal would apply to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

B. Retroactive Allocation of the Generation-Skipping Tax Exemption

Present Law

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates GST tax exemption to a trust prior to the taxable termination or taxable distribution, GST tax may be avoided.

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

Description of Proposal

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

Effective Date

The proposal would apply to deaths of non-skip persons occurring after December 31, 2000.

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

Present law

A generation-skipping transfer tax (AGST tax@) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a Askip person@ (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

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

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

Description of Proposal

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

Effective Date

The provision would be effective for severances of trusts occurring after December 31, 2000.

D. Modification of Certain Valuation Rules

Present Law

Under present law, the inclusion ratio is determined using gift tax values for allocations of GST tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of GST tax exemption made to transfers at death. Treas. Reg. 26.2642-5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

Description of Proposal

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

Effective Date

The proposal would be effective for transfers subject to estate or gift tax made after December 31, 2000.

E. Relief from Late Elections

Present Law

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

Description of Proposal

Under the proposal, the Treasury Secretary would be authorized and directed to grant extensions of time to make the election to allocate GST tax exemption and to grant exceptions to the time requirement. If such relief were granted, then the value on the date of transfer to trust would be used for determining GST tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.

Effective Date

The proposal would apply to transfers subject to estate or gift tax made after December 31, 2000.

F. Substantial Compliance

Present Law

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

Description of Proposal

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

Effective Date

This proposal would apply to transfers subject to estate or gift tax made after December 31, 2000.

IV. EXPAND AVAILABILITY OF INSTALLMENT PAYMENT OF ESTATE TAX FOR ESTATES OF DECEDENTS WITH AN INTEREST IN A CLOSELY-HELD BUSINESSES

Present Law

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in 2 or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely-held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate pays only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.[3] A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998) in taxable value of a closely-held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely-held business in excess of $1 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

For purposes of these rules, an interest in a closely-held business is: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership is included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation is included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

If more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, then the extension of time for the payment of tax generally no longer applies, and the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary.

Description of Proposal

Under the proposal, the definition of a closely-held business would be expanded. The proposal would increase from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that could be considered an entity in which a decedent held an

[3] For example, assume estate tax is due in 2001. If interest only is paid each year for the first five years (2001 through 2005), and if 10 installments of both principal and interest are paid for the 10 years thereafter (2006 through 2015), then payment of estate tax would be extended by 14 years from the original due date of 2001.

interest in a closely-held business and thus qualify the estate for installment payment of estate tax.

Effective Date

The proposal would be effective for decedents dying after December 31, 2001.