TAXATION OF WEALTH TRANSFERS WITHIN A FAMILY: A DISCUSSION OF SELECTED AREAS FOR POSSIBLE REFORM

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INTRODUCTION

The Federal estate and gift tax rules are in flux. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the estate tax and the gift tax are partially unified: a single tax rate schedule applies under the estate tax and the gift tax, but after 2003 the exemption amounts differ. The highest rate of estate and gift tax has decreased in steps from 55 percent in 2001 to 45 percent last year, this year, and next year. The estate tax exemption amount is increasing in several steps from $1 million in 2002 to $3.5 million next year. The gift tax exemption amount remains at $1 million during that period. The credit against Federal estate tax liability for State estate and inheritance taxes was phased down from 2002 through 2004 and was replaced by a deduction starting in 2005. For 2010, the estate tax is repealed, but the gift tax remains in effect with an exemption of $1 million and a maximum rate of 35 percent. In the year of estate tax repeal, property transferred at death generally has the same basis in the hands of the heir as it had in the hands of the decedent (that is, a carryover basis). Under the present estate tax, by contrast, the heir's basis generally equals the property's fair market value at the time of the decedent's death. Estate tax repeal lasts only for one year. In 2011, the estate and gift tax rules are scheduled to be the same as those that would have been in effect without enactment of EGTRRA. Under pre-EGTRRA law, the estate and gift tax was fully unified: a single rate schedule and exemption amount applied to gifts made during life and to transfers at death. Consequently, unless rules are changed, starting in 2011 the estate and gift tax exemption amount will be $1 million, and the highest estate and gift tax rate will be 55 percent. The credit for State estate and inheritance taxes will return, and property acquired from a decedent will take a fair market value basis rather than a carryover basis.

It is in this context of changing Federal estate and gift tax rules that Congress is considering reform of the system for taxing transfers of wealth. The Committee on Finance is holding a series of public hearings to examine the current system and possible changes to, or replacements of, that system. A November 14, 2007 hearing addressed broad design issues such as rates, exemption amounts, and the treatment of farms and family businesses.[1] A hearing on March 12, 2008 studied alternatives to the present estate and gift tax system. These alternatives include an inheritance tax, an income inclusion approach (under which gifts and bequests are included in the income of the recipient), and a deemed realization system (under which a gratuitous transfer is treated as a realization event and the transferor is taxed on any gain in the property transferred, generally at rates applicable to capital gains).[2] Among the 30 member countries of the Organisation for Economic Co-operation and Development ("OECD"), only the United States and the United Kingdom have estate and gift tax systems. The majority of OECD countries have inheritance taxes. A public hearing scheduled by the Finance Committee for

[1] For a background discussion related to that hearing, see Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-108-07), November 13, 2007. That document describes the history of the U.S. Federal estate and gift tax system, summarizes the present estate and gift tax rules, and sets forth data and an economic analysis related to wealth transfer taxation.

[2] For a discussion of these alternative systems, see Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008.

April 3, 2008 will include a discussion of possible reforms to the existing Federal estate and gift tax rules. This document,[3] which is intended to supplement the discussions set forth in Joint Committee on Taxation pamphlets prepared in connection with the two previous hearings, provides an overview of several selected areas for possible reform.

This document is divided into two parts. The first part describes a prominent feature of the current Federal estate and gift tax system, the partially unified credit against estate and gift tax, and evaluates two possible reforms to that credit. The credit against estate and gift tax is partially unified under present law because a single tax rate schedule applies to gifts made during life and transfers at death but the effective exemption amount under the gift tax ($1 million) is different from the effective exemption amount under the estate tax ($2 million in 2008).[4]

One possible reform to present law's partially unified credit would be to make the credit fully unified. Under a fully unified credit, a common rate schedule and a single exemption amount would apply to gifts made during life and transfers at death. Two bills that passed the House of Representatives in 2006 included provisions for a fully unified credit. Arguments in favor of replacing the current credit with a fully unified credit are that a fully unified credit would simplify planning and that the current credit distorts behavior by encouraging taxpayers to hold onto property until they die to take advantage of the higher exemption amount under the estate tax than under the gift tax. The extent to which raising the gift tax exemption amount so that it equaled the estate tax exemption amount would counteract the gift tax's role in preventing income tax avoidance is unknown. In the absence of a tax on gifts, income tax liability may be reduced when high-income individuals make gifts to lower-income individuals. An increased gift tax exemption amount permits an increased amount of this income shifting. A fully unified credit also could encourage gifts over bequests, the opposite of the distortion that may be caused by present law's significantly larger exemption amount under the estate tax than under the gift tax. The distortion in favor of lifetime gifts would arise because the tax exclusive nature of the gift tax (tax is not imposed on funds used to pay the gift tax) and the tax inclusive nature of the estate tax (tax is imposed on funds used to pay the estate tax) causes the effective rate of tax on gifts to be lower than the effective rate of tax on bequests.

A second possible reform to the unified credit, referred to as portability, would allow a surviving spouse to benefit from unused exemption amount of the first spouse to die. The 2006 bills that passed the House of Representatives also included provisions making unused exemption portable from one spouse to another. As for a fully unified credit, a principal argument for portability of unused exemption is that portability would simplify wealth transfer tax planning. Portability, however, raises concerns about the IRS's ability to administer the

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[3] This document may be cited as Joint Committee on Taxation, *Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform* (JCX-23-08), April 2, 2008. The document also is available on the internet at www.house.gov/jct.

[4] The credit against estate and gift tax operates as an exemption by shielding a certain amount of transfers from tax. In 2008 the estate tax effective exemption amount is implemented by means of a $780,800 credit against tax.

transfer tax rules. Certain design features, such as the treatment of multiple marriages, also may create difficulties.

The second part of this document sets forth a discussion of liquidity to pay estate tax when estates consist largely of farms or other businesses. Congress at various times has passed reforms intended to mitigate the effect of the estate tax on family farms and other family-owned businesses. A particular concern has been that if the value of an estate is largely attributable to a farm or other business, heirs of the estate may be forced to sell the business to pay the estate tax. Forced sales of family businesses are seen as undesirable in part because of possible job losses and other disruptions to communities.

This document describes three provisions intended to mitigate the effect of the estate tax on farms and other family-owned active businesses. One provision (in section 2032A) permits real property to be valued for estate tax purposes at its current-use value (for example, as a farm) rather than at a higher market value (for example, the price that could be received in a sale to a developer). A second provision (in section 6166) allows payment of estate tax attributable to certain family businesses to be deferred for five years and then made in installments over the succeeding ten years. A third provision (in section 2057, terminated after 2003 but scheduled to be in effect after 2010), grants a deduction from the value of the gross estate for the value of certain family-owned business interests.

This document evaluates criticisms of these three provisions. The principal criticisms have been that the provisions are complex and distort taxpayers' behavior by encouraging them to hold active business assets rather than other assets. This document concludes that although there may be validity to those criticisms, the policy goals underlying sections 2032A, 6166, and 2057 inherently involve complications and distortions. The discussion of liquidity closes with a presentation of data showing relative liquidities of estates that include closely held businesses and showing certain characteristics of estates for which the benefits of sections 2032A, 6166, and 2057 have been elected. This data presentation includes an analysis of the possible effects of the estate tax on closely held businesses. This analysis concludes that many estates that include farms and other businesses have enough liquidity to fund their estate tax liabilities. The estate tax may, however, harm the ongoing operations of these businesses by reducing cash available for investment and day-to-day needs.

This document includes an appendix. The appendix reprints previous Joint Committee on Taxation staff options for reforms of certain estate, gift, and generation-skipping transfer tax rules. These options were offered as part of a 2005 report prepared at the request of Senator Charles Grassley and Senator Max Baucus, at that time Chairman and Ranking Member, respectively, of the Senate Finance Committee.[5] The report described proposals that were intended to reduce the size of the tax gap by curtailing tax shelters, closing unintended loopholes, and targeting other areas of noncompliance with the tax laws. Proposals addressed the estate and gift tax and also, among other areas, the individual income tax, corporate and partnership

[5] Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005.

taxation, and international taxation. The estate, gift, and generation-skipping transfer tax proposals republished in this document deal with certain trust arrangements and with valuation discounts.

I. WEALTH TRANSFERS AND THE UNIFIED CREDIT

A. Overview

Some commentators argue that present law encourages costly and inefficient planning to maximize use of estate and gift tax exemption amounts, particularly in the case of certain transfers among family members. This section describes and discusses two proposed reforms that are designed at least in part to simplify tax planning with respect to estate and gift tax exemptions. The first reform would provide for "portability" between spouses of any unused exemption. In other words, a surviving spouse would be permitted to use, in addition to his or her own estate and gift tax exemption, the amount of any such exemption that had not been used by the deceased spouse at or prior to the deceased spouse's death. The second reform would fully "reunify" the estate and gift taxes, such that a common exemption amount and rate schedule would apply for both estate tax purposes and gift tax purposes.

B. Present Law and Recent Proposals Relating to Estate and Gift Tax Rates and Exemption Amounts

1. In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death. The unified credit offsets tax computed at the lowest estate and gift tax rates.[6]

Prior to 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continue to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes is increased above the effective exemption amount allowed for gift tax purposes, as described below.[7]

2. Increase in unified credit effective exemption amount and reduction in estate and gift tax rates under EGTRRA

Under EGTRRA, the estate, gift, and generation skipping transfer taxes are gradually reduced between 2002 and 2009. In 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) increased to $1 million, and the highest estate and gift tax rate was 50 percent. In 2003, the highest estate and gift tax rate was 49 percent. In 2004, the highest

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[6] Secs. 2010, 2505.

[7] Under present law in effect through 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

estate and gift tax rate was 48 percent, and the unified credit effective exemption amount for estate tax (but not gift tax) purposes increased to $1.5 million. In 2005, the highest estate and gift tax rate was 47 percent. For 2006, the highest estate and gift tax rate was 46 percent, and the unified credit effective exemption amount for estate tax purposes was increased to $2 million, also the amount for 2007 and 2008. In 2007 and 2008, the highest estate and gift tax rate is 45 percent. In 2009, the unified credit effective exemption amount for estate tax purposes is scheduled to increase to $3.5 million.[8]

The unified credit effective exemption amount for gift tax purposes remained at $1 million in 2004 and later years, as the exemption amount for estate tax purposes increased above $1 million.[9] Therefore, under present law for the years 2004 through 2009, the estate and gift taxes are not fully unified because the estate and gift tax effective exemption amounts differ.

3. Repeal of estate and generation skipping transfer taxes in 2010

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a $1 million exemption amount and a gift tax rate of 35 percent.

4. Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010

The estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the unified estate, gift, and generation skipping transfer tax rates and exemption amounts as in effect prior to 2002 will apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million will apply for purposes of determining the tax on cumulative taxable transfers made by a taxpayer by lifetime gift or bequest.

5. H.R. 5638 and H.R. 5970

In 2006, the House of Representatives passed two bills, each of which contained two provisions designed at least in part to simplify planning, principally in the case of intra-family transfers.[10]

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[8] Secs. 2001(c)(2), 2010(c), 2502, 2505(a).

[9] Sec. 2505(a).

[10] H.R. 5638 (109th Cong.) (as passed by the House); H.R. 5970 (109th Cong.) (as passed by the House).

Reunification of the estate and gift taxes

The first such reform would have reunified the estate and gift taxes such that a common rate schedule and a single effective exemption amount would apply for purposes of determining the cumulative tax on taxable transfers. In general, H.R. 5638 would have increased the effective exemption amount for estate and gift tax purposes to $5 million for transfers after 2009, whereas H.R. 5970 would have phased in a $5 million effective exemption amount over a period of years. Each bill would have applied an estate and gift tax rate equal to the long-term capital gains rate specified in section 1(h)(1)(C) (currently 15 percent in 2010 and 20 percent thereafter) on the first $25 million in taxable transfers. For transfers in excess of $25 million, H.R. 5638 would have applied a rate equal to twice the long-term capital gains rate described above, whereas H.R. 5970 would have phased in a 30-percent rate over a period of years.

Portability between spouses of unused exemption

Second, H.R. 5638 and H.R. 5970 each contained a provision that generally would permit a surviving spouse to use any effective exemption amount that was not used by the predeceased spouse. Under the bills, for gift and estate tax purposes, the unified credit effective exemption amount that remains unused as of the death of a spouse who dies after December 31, 2009 (the "deceased spousal unused exclusion amount"), generally would be available for use by such spouse's surviving spouse, in addition to such surviving spouse's own exemption amount.[11]

The aggregate amount of unused exemption equivalent (the "aggregate deceased spousal unused exclusion amount") that would be available for use by a surviving spouse from all predeceased spouses could not exceed the basic exclusion amount in effect at any given time (e.g., $5 million in H.R. 5638). The bills would permit a surviving spouse to use the aggregate deceased spousal unused exclusion amount for taxable transfers made during life or at death.

Under the bills, a deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the bills provide that the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse.

Example 1.−Assume that Husband 1 dies in 2015, having made taxable gifts of $3 million and having no taxable estate. Assume further that the basic exclusion amount under the above-referenced bills would be $5 million as of that time. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased

[11] H.R. 5638 and H.R. 5970 would not permit a surviving spouse to use a predeceased spouse's unused exemption for generation skipping transfer tax purposes.

spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

Example 2.−Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 predeceases Wife in a year in which the basic exclusion amount is assumed for purposes of this example to be $5 million, having made no taxable gifts and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the deceased spousal unused exclusion amount from Husband 2 is $5 million (the amount of his unused exclusion), only $3 million of this amount is available for use by Wife, because she previously received the benefit of $2 million of deceased spousal unused exclusion amount from Husband 1, and the bills place a limit equal to the basic exclusion amount ($5 million for purposes of this example) on the aggregate deceased spousal unused exclusion amount available to a surviving spouse from all predeceased spouses.

Example 3.−Assume the same facts as in Example 2, except that Wife predeceases Husband 2 in a year in which the basic exclusion amount is assumed for purposes of this example to be $5 million. Husband 2 had no prior spouses. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount. Wife made no taxable gifts and has a taxable estate of $3 million. Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of the deceased spousal unused exclusion amount from Wife (computed as Wife's $7 million applicable exclusion amount less her $3 million taxable estate).

C. Issues Related to Reunification of Estate and Gift Tax Exemptions and Rates and Portability Between Spouses of Unused Exemption

1. Issues related to unification

As described above, under present law as in effect from 2004 through 2009, the gift tax effective exemption amount remains $1 million, while the estate tax effective exemption amount rises above $1 million (ultimately to $3.5 million in 2009). Commentators have argued that this decoupling of the estate and gift tax exemption amounts complicates wealth transfer tax planning and raises administrability issues.

For example, some commentators argue that, as a result of the lower gift tax exemption amount, taxpayers are likely to engage in complicated and costly planning to avoid gift tax.[12] They argue that the lower gift tax exemption (and resulting higher cost of the gift tax) could encourage taxpayers to create complicated long-term trusts at death designed to avoid gift tax on transfers to successive generations. They further argue that the lower gift tax exemption will encourage taxpayers to delay transfers until death, "encouraging family wealth to remain 'locked in' older generations."[13]

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[12] ABA Task Force, p. 22.

[13] *Ibid.*, pp. 22-23.

The extent to which such practices have increased in use since the exemption amounts were decoupled in 2004 is uncertain. In addition, the effect of the lower gift tax exemption amount from 2004 through 2009 is partially mitigated by a structural difference between the estate tax and the gift tax that generally benefits taxpayers who make inter vivos gifts: the gift tax is "tax exclusive," whereas the estate tax is "tax inclusive." In other words, under the estate tax, the assets used to pay the tax are included in the estate tax base. Thus, if the estate and gift taxes were fully reunified, the gift tax would be a less costly tax.

Furthermore, the gift tax often is viewed as being necessary to protect the income tax base. In the absence of a gift tax, it may be possible for a taxpayer to transfer an asset with built-in gain or that produces income to a taxpayer who is in a lower tax bracket, where the gain or income would be realized and taxed at a lower rate before the asset is returned to the original holder. Therefore, if the gift tax effective exemption amount were increased to equal the higher estate tax exemption amount, the effectiveness of the gift tax as a tool to protect the income tax base may be diminished.

2. Issues related to exemption portability

Simplification of wealth transfer tax planning

Proponents of portability between spouses of unused exemption generally argue that it eliminates the need for inefficient and costly tax planning and results in similarly situated taxpayers being treated equally.[14]

Assume, for example, that Husband and Wife each have $2 million in assets titled in their separate names. Husband and Wife both die in 2008 (when the effective exemption amount is $2 million), and each bequeaths $2 million to Son. Husband and Wife collectively have used $4 million in exemption, successfully maximizing use of their available exemptions. Now assume that Husband dies in early 2008 and bequeaths his $2 million estate to Wife. No estate tax is due on the transfer, because the transfer qualifies for the 100-percent marital deduction. Wife, who now owns $4 million in assets, dies in late 2008 and bequeaths her entire estate to Son. Wife has available only her own $2 million exemption to offset the transfer to Son; the additional $2 million transferred to Son will be subject to estate tax. Husband's estate tax exemption was not used.

To maximize the use of a couple's estate tax exemption amounts, couples frequently employ a tax planning strategy under which assets of the first spouse to die pass into a "credit shelter trust" at the time of that spouse's death. The trust is designed to benefit the surviving spouse during his or her lifetime while using the exemption of the first spouse to die to shield trust assets that ultimately will pass to another beneficiary (such as Son in the above example) from estate tax. To take advantage of this strategy, couples generally must hire a lawyer to draft

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[14] See, e.g., American Institute of Certified Public Accountants, Tax Simplification Recommendations (Apr. 30, 1997), reproduced in 97 TNI 95-21 (May 16, 1997); American Bar Association Task Force on Federal Wealth Transfer Taxes, Report on Reform of Federal Wealth Transfer Taxes (2004) (hereafter, "ABA Task Force Report"), pp. 99-101.

the trust documents and also must ensure that each spouse has sufficient assets titled in his or her separate name to fund a credit shelter trust up to the full amount of his or her exemption amount. Couples who do not have such trusts in place at the death of the first spouse to die may not be able to take full advantage of both spouses' exemption amounts. Even where couples do have such trusts in place, if the first spouse to die does not have sufficient assets titled in his or her own name at the time of death to fund the trust up to the amount of the then-applicable exemption amount, a portion of such spouse's exemption amount may be lost.

For these reasons, the American Bar Association Task Force on Wealth Transfer Taxes (the "ABA Task Force") has argued that "the law rewards both sophisticated planning and constant reallocation of wealth, but does not offer the same benefits to couples who do not engage in sophisticated planning or whose assets do not lend themselves to appropriate allocation, such as property held in a qualified retirement plan."[15] Therefore, allowing for portability between spouses of unused exemption arguably would contribute to simplicity and facilitate compliance with the law, because it largely would eliminate the need for couples to employ the credit shelter trust strategy or to monitor and adjust the titling of assets.

Although proponents of portability generally assert that portability simply allows spouses to achieve the results that otherwise would have been achieved through costly tax planning and re-titling of assets, a portability provision (depending on how it is drafted) may allow couples to achieve better results than they could have achieved through the best estate planning. Assume, for example, that Wife dies when Husband's and Wife's collective assets were $4 million. The most exemption that Wife's estate could have used is $4 million (which could, for example, be achieved by titling all of the couple's assets in Wife's name). Husband dies a decade later with $10 million in assets, $5 million of which would be exempt under his own $5 million exemption. Combined, the maximum amount of exemption Wife and Husband could have used without portability would have been $9 million. With portability, it may be possible for Husband and Wife to use a combined amount of $10 million (assuming that Wife used none of her $5 million exemption because she had made no taxable gifts and either had no taxable estate at death or bequeathed all assets to Husband). If this situation were viewed as problematic, it could be addressed through a rule that would limit the amount of exemption that could be passed to a surviving spouse to the lesser of (1) the combined value of the spouses' assets as of the death of the first spouse to die or (2) the unused exemption amount of the first spouse to die. However, such a rule would add complexity and raise administrability concerns, as one would need to value the assets of both the decedent and the surviving spouse as of the death of the first spouse to die.

Administrability issues

Portability of unused exemption raises a number of other administrability issues. For example, to determine the amount of additional exemption available to a surviving spouse, one must know the amount of unused exemption remaining at the death of the first spouse to die. Under the above-described House-passed bills, for example, unused exemption may be made

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[15] ABA Task Force Report, pp. 99-100.

available to a surviving spouse regardless of the value of assets owned at the time of the first spouse's death, e.g., even where the first spouse to die otherwise would not have been required to file an estate tax return because the estate assets were below filing thresholds. If no return were filed, it would be virtually impossible at the death of the surviving spouse to determine the amount of unused exemption that remained at the death of the first spouse to die, which may have occurred years or even decades earlier.[16] These problems could be mitigated by requiring (as in the House-passed bills) that, in order to preserve unused exemption for a surviving spouse, the estate of the first spouse to die file a return computing the amount of unused exemption. However, such a return requirement likely would result in the filing of numerous returns solely to preserve exemption for a surviving spouse, potentially burdening the IRS. In many cases, the filings will prove to have been unnecessary, as the surviving spouse ultimately will have no need for additional exemption to offset transfers. Nevertheless, estates are likely to file prophylactic returns to preserve unused exemption, because of the possibility (however remote) that a surviving spouse may accumulate significant additional wealth by the time of his or her subsequent death.

Furthermore, even if a return is filed to preserve unused exemption, the IRS likely will have little incentive to examine the return at the death of the first spouse to die. The IRS has limited resources, and examination of a return filed solely to preserve unused exemption generally would not lead to additional tax due from the estate of the first spouse to die. In addition, by the time the surviving spouse dies, the statute of limitations with respect to the estate of the first spouse may have expired. The House-passed bills attempt to address this issue by providing that, notwithstanding any statute of limitations that may apply with respect to the estate of the first spouse to die, the IRS may examine the return of the deceased spouse for purposes of determining the amount of unused exemption available for the surviving spouse (though not for purposes of adjusting the liability of the estate of the first spouse to die). Even so, it could be difficult for the IRS to adjust the claimed amount of unused exemption. Particularly in situations in which the spouses die many years apart, there may not be contemporaneous records to support the claimed unused exemption amount.[17]

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[16] A similar issue may arise if, after many years, the surviving spouse instead makes taxable gifts using ported exemption.

[17] Designing a portability regime in which the estate and gift taxes are not reunified (i.e., if the gift tax exemption and rates are different from the estate tax exemption and rates) would raise additional policy issues. For example, assume the estate tax exemption is $5 million and the gift tax exemption is $1 million. Husband dies with no taxable estate, but he used $500,000 of exemption on lifetime taxable gifts, such that he passes a total of $4.5 million unused exemption to Wife. Should Wife be permitted to use only $500,000 of this amount to offset lifetime taxable gifts (the amount of Husband's unused gift tax exemption), with the remainder available for use only at Wife's death? Should such a regime include a gift tax cap and a separate cumulative cap on the amount of exemption a person can receive from predeceased spouses?

Multiple marriage situations

Portability of unused exemption presents additional policy and complexity issues in multiple marriage situations. Assume, for example, the estate tax effective exemption amount is $5 million, as under the House-passed bills containing portability provisions. If a surviving spouse is predeceased by more than one spouse, should that surviving spouse be allowed to use the full amount of unused exemption of all predeceased spouses (e.g., should the surviving spouse have available (in addition to his own $5 million exemption) as much as $5 million from each of two predeceased spouses, for a total of $15 million)? The House-passed bills partially address this question by capping the cumulative amount of additional ported exemption from all predeceased spouses from which a surviving spouse may benefit at the basic exemption amount then in effect ($5 million in the example here).

To highlight another issue, assume that the estate tax exemption amount is $5 million and that Husband 1 dies with no taxable estate and having made no taxable gifts, such that his entire $5 million exemption is available for Wife, in addition to her own exemption. Therefore, Wife has $5 million for her use for purposes of making lifetime gifts or bequests. Further assume that Wife remarries and predeceases Husband 2. From a policy perspective, one may question whether the amount of unused exemption passed from Husband 1 to Wife should be available to Husband 2 following Wife's death. As noted above, the House-passed bills cap the amount of exemption a person may receive from all predeceased spouses at $5 million (the basic exemption amount under such bills when fully phased in), such that in this situation, Husband 2 could benefit from only $5 million of Wife's $10 million unused exemption. But the bills do not differentiate between a decedent's own exemption and ported exemption for this purpose. So, for example, if Wife had made taxable gifts prior to Husband 1's death and had only $2 million of her own exemption remaining, and subsequently received $5 million of unused exemption from Husband 1 (for a total of $7 million), she could still pass $5 million of unused exemption to Husband 2 at her death, even though a portion of this amount originally had been the exemption of Husband 1. The Congress could craft a rule to address this issue, but such a rule would raise additional administrability issues. Such a rule, for example, would make relevant at the death of Husband 2 the amount of unused exemption passed from Husband 1 to Wife at Husband 1's death. As an alternative, one simply could provide that unused exemption received from Husband 1 expires if Wife remarries.

D. Estimates of Utilization

The following table provides estimates of the number of taxpayers that would potentially benefit if exemption portability were in effect. The second column assumes that portability had been enacted effective for decedents dying after 1998. The third column assumes that portability will be enacted for decedents dying after 2008. Estimates are provided for two selected years: 2009 (when the effective exemption amount is scheduled to be $3.5 million) and 2012 (when the effective exemption amount is scheduled to be $1 million). For purposes of determining the number of estates that would benefit from enactment of exemption portability, the estimates assume enactment of a provision substantially similar to the portability provisions included in the above-described House-passed bills. The estimates assume that other aspects of present law remain unchanged. The estimates in the second column (which assume portability had been enacted for decedents dying after 1998) are intended to show utilization when a portability

provision has been in effect for a number of years. Portability only is used at the death of a surviving spouse, and a surviving spouse may survive a predeceased spouse by many years. Therefore, the full benefits of portability likely would not be seen until portability had been in effect for several decades. The estimates of utilization in 2012 (when the exemption is scheduled to be $1 million) as compared to 2009 (when the exemption is scheduled to be $3.5 million) generally show that more taxpayers will benefit from portability when the effective exemption amount is lower because more estates will have estate tax liabilities.

Table 1.–Estimated Number of Estates Benefiting From Portability

	Total number of taxable estate tax returns	Number of estates that benefit assuming portability was effective 1999	Number of estates that benefit assuming portability was effective 2009
Returns filed in 2009 ($3.5 million exemption)	18,400	10,000	730
Returns filed in 2012 ($1 million exemption)	66,500	41,000	3,900

II. WEALTH TRANSFERS AND LIQUIDITY

A. Overview

At various times, Congress has expressed concern about the special burdens an estate tax may place on farms and other family-owned businesses. A particular concern has been that if a large part of the value of an estate subject to estate tax consists of a farm or another family-owned business, the estate may not include sufficient liquid assets to fund estate tax liability. It has been argued that if an estate lacks this liquidity, heirs may be forced to sell the business to generate funds to pay the estate tax. Potential forced sales of farms and other family businesses have been viewed as undesirable: farming and other family-owned businesses have been seen as important to the U.S. economy and culture, and sales of those businesses might harm local communities by causing job losses and other disruptions.

Congress has acted on its concerns about the effects of the estate tax on farming and other family-owned businesses by passing bills with provisions that make it easier for certain estates that include those businesses to satisfy their estate tax liabilities. One provision permits a farm or other real property used in a business to be valued at the property's current use rather than at its higher market value.[18] Another provision allows the estate tax attributable to an interest in a closely held business to be deferred for five years and then paid in installments over the following ten years.[19] A third provision allows a deduction from the value of the gross estate for the value of certain family-owned business interests in the estate.[20] The House Report of the Ways and Means Committee accompanying the bill that included current-use valuation and installment payment rules largely similar to those in present law makes the following statement:

> [T]he estate tax can impose acute problems when the principal asset of the estate is equity in a farm or small business. Because assets are valued at their "highest and best use" rather than on the specific use to which the assets are being put and because these assets are illiquid, family members have been forced to sell farms and small businesses in order to pay the estate tax. . . . The[ ] changes [to the current-use valuation and installment payment rules] are intended to preserve the family farm and other family businesses, two very important American institutions, both economically and culturally.[21]

Similarly, the Senate Report of the Finance Committee accompanying the bill that led to the enactment of section 2057 states:

> The Committee believes that a reduction in estate taxes for qualified family-owned businesses will protect and preserve family farms and other family-owned enterprises,

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[18] Sec. 2032A.

[19] Sec. 6166.

[20] Sec. 2057. This provision is terminated after 2003 but is scheduled to be in effect after 2010.

[21] H.R. Rep. No. 94-1380, p. 5 (1976).

and prevent the liquidation of such enterprises in order to pay estate taxes. The Committee further believes that the protection of family enterprises will preserve jobs and strengthen the communities in which such enterprises are located.[22]

This section discusses wealth transfers and liquidity. It first describes sections 2032A, 6166, and 2057. It then evaluates criticisms of those provisions. Last, to help assess the extent to which the estate tax creates cash flow problems for family businesses, it presents data showing relative liquidities of estates with farms and other closely held businesses and showing certain characteristics of estates for which benefits have been claimed under section 2032A, 6166, or 2057. The data suggest that many estates that are comprised largely of farms or other closely held businesses have enough liquid assets to satisfy estate tax liabilities. Nonetheless, the decreased liquidity attributable to payment of estate tax may impair a business's ability to function and grow. It is difficult to assess the extent of this impairment caused under the current estate tax.

B. Present and Prior Law for Special-Use Valuation, Installment Payments, and Family-Owned Businesses

1. Valuation

In general

For Federal estate and gift tax purposes, the value of property generally is its fair market value, that is, the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. For Federal estate tax purposes, fair market value generally is determined at either (1) the time of the decedent's death, or (2) the "alternate valuation date," which is six months after the decedent's death.[23] For federal gift tax purposes, fair market value generally is determined on the date the gift is made.

Special-use valuation

If certain requirements described below are satisfied, an executor of an estate that includes real property used in farming or another trade or business generally may elect for estate tax purposes to value the property based on its current-use value, rather than based on its highest and best use.[24] For an estate of a decedent dying in 2008, the maximum special-use valuation reduction in value for this real property resulting from an election under section 2032A is $960,000.[25]

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[22] S. Rep. No. 105-33, p. 40 (1997).

[23] Sec. 2032(a).

[24] Sec. 2032A.

[25] Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (November 5, 2007).

An executor of an estate may elect application of the special-use valuation rules if, among other conditions, the following chief requirements are satisfied:

- The decedent must be a citizen or resident of the United States at the time of death, and the real property qualifying for special-use valuation must be located in the United States;
- At least 50 percent of the adjusted value of the decedent's gross estate must consist of real or personal property being used at the time of the decedent's death as a farm or in another trade or business;
- At least 25 percent of the adjusted value of the gross estate must consist of real property that passes to a qualified heir and that was used as a farm or in another closely held trade or business by the decedent or a member of the decedent's family for at least five of the eight years ending on the date of the decedent's death;[26]
- For at least five of the eight years ending on the date of the decedent's death, the real property qualifying for current-use valuation must have been owned by the decedent or a member of the decedent's family and must have been used by the decedent or a member of the decedent's family as a farm or other business (a "qualified use"), and the decedent or a member of the decedent's family must have materially participated in the operation of the farm or other business;[27] and
- The real property qualifying for current-use valuation must pass to a qualified heir.[28]

If, after an election is made to value property at its current-use value, the heir who acquired the real property disposes of the property or ceases to use it in its qualified use within 10 years after the decedent's death, an additional estate tax is imposed as a way of recapturing the estate tax benefit of the current-use valuation.

Recipients of property for which special-use valuation is elected take a basis equal to the property's special-use value, rather than its fair market value.

2. Installment payment of estate tax for closely held businesses

In general, an estate tax return must be filed, and estate tax is due, within nine months of a decedent's death.[29] If, however, certain conditions described below are satisfied, an executor

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[26] In applying the 50-percent and 25-percent tests, the value of property and the value of the gross estate are determined (1) based on property's highest and best use rather than on its current-use value, and (2) by subtracting the amount of any indebtedness in respect of property.

[27] Material participation is defined by reference to section 1402(a)(1) (relating to net earnings for self employment).

[28] For any property, the term "qualified heir" means a member of the decedent's family who acquires the property. For this purpose a member of the family includes, among others, the spouse of the decedent, lineal descendants of the decedent or the decedent's spouse, or the spouse of any of these lineal descendants.

generally may elect to pay estate tax attributable to an interest in a closely held business in two or more, but in no more than 10, equal installments.[30] If the election is made, the first installment of tax must be paid within five years after the normal nine-months-after-date-of-death deadline for payment of estate tax. Each succeeding installment must be paid within one year after the preceding installment.

If payment of tax is deferred during the initial five-year period, interest on the unpaid tax amount must be paid annually during that period. After the initial five-year period, interest on the remaining unpaid tax amount must be paid at the time each installment payment is made. For an estate of a decedent dying in 2008, interest on the amount of deferred estate tax attributable to a maximum of $1.28 million in taxable value of a closely held business is computed at a two-percent rate.[31] The maximum amount for which interest is computed at a two-percent rate is adjusted annually for inflation. If the taxable value of a closely held business exceeds the maximum amount for which the two-percent rate is available, the interest rate applicable to

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[29] Secs. 6075(a), 6151(a).

[30] Sec. 6166(a). Other provisions of the Code permit the time for payment of estate tax to be extended in certain circumstances. The Treasury Secretary may extend, for reasonable cause, the time for payment of estate tax or for payment of an installment under section 6166 for a reasonable period not in excess of 10 years. Sec. 6161(a)(2). Under regulations, the district director or the director of a service center may grant, at the request of the estate's executor, an extension of time to pay estate tax for a reasonable period of time not to exceed 12 months if such request, based on all the facts and circumstances, is based on reasonable cause, such as liquid assets being located in several jurisdictions and not being immediately subject to the control of the executor. Treas. Reg. sec. 20.6161-1(a)(1). If the district director determines that payment of estate tax, payment of a deficiency for estate tax, or an installment payment of estate tax under section 6166 would impose undue hardship on the estate, the district director may extend the time for payment for a period not to exceed 10 years. Undue hardship must be more than an inconvenience or the sale of an asset at its fair market value. Undue hardship may exist where the executor needs additional time to raise funds instead of selling a farm or other closely held business to an unrelated person or where assets of the estate can only be sold at a sacrifice price. Treas. Reg. sec. 20.6161-1(a)(2).

The Treasury Secretary also may extend, for reasonable cause, the time for the payment of a deficiency of estate tax for a period not to exceed four years. No extension may be granted for any deficiency that is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax. Sec. 6161(b)(2).

The estate tax attributable to a reversionary or remainder interest in property included in the value of a gross estate may, at the election of the estate's executor, be postponed until six months after the termination of the precedent interest. At the end of this postponement period, the Treasury Secretary may, for reasonable cause, extend the time for payment for a reasonable period not to exceed an additional three years. Sec. 6163.

The Treasury Secretary may require the furnishing of a bond for payment of any tax for which an extension of time for payment has been granted. Sec. 6165.

[31] Sec. 6601(j)(1)(A); Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (Nov. 5, 2007).

estate tax attributable this excess is 45 percent of the rate applicable to underpayments of tax.[32] Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

The installment payment election for payment of estate tax is available only if the decedent at the date of death was a citizen or resident of the United States and the decedent's interest in the closely held business exceeds 35 percent of the adjusted gross estate. An interest in a closely held business includes:

- an interest as a proprietor in a trade or business carried on as a proprietorship;
- an interest as a partner in a partnership carrying on a trade or business if the partnership has 45 or fewer partners or if at least 20 percent of the total capital interest in the partnership is included in determining the decedent's gross estate; and
- stock in a corporation carrying on a trade or business if the corporation has 45 or fewer shareholders or if at least 20 percent of the value of the corporation's voting stock is included in determining the decedent's gross estate.

There are special rules for applying these ownership requirements and the 35-percent test.[33] Stock or a partnership interest held by a husband and wife as community property, joint tenants, tenants by the entirety, or tenants in common is treated as owned by one shareholder or one partner, respectively. Property indirectly owned by or for a corporation, partnership, estate, or trust is treated as owned proportionately by its shareholders, partners, or beneficiaries. All stock and all partnership interests held by the decedent or by any member of the decedent's family (within the meaning of section 267(c)(4)) is treated as owned by the decedent. For purposes of the 35-percent test, an interest in a closely held farming business includes an interest in residential buildings and related improvements on the farm that are regularly occupied by the owner or lessees of the farm or by employees that operate or maintain the farm.

In determining whether the 35-percent requirement described above is satisfied and in determining the value of the closely held business, the value of an interest in a closely held business is reduced to the extent the interest is attributable to certain passive assets held by the business.[34] Passive assets generally include any assets not used in carrying on a trade or business. Special rules, however, allow executors to elect to treat stock in certain lending and finance businesses to be treated as an active trade or business interest.[35] Under this election, the five-year deferral of principal payments is not allowed, and the maximum number of installment payments is five rather than ten.

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[32] Sec. 6601(j)(1)(B). The underpayment rate is the Federal short-term rate plus three percentage points. The underpayment rate for the second quarter of 2008 is six percent. Rev. Rul. 2008-10, 2008-13 I.R.B. 676 (March 31, 2008).

[33] Sec. 6166(b)(2), (b)(3).

[34] Sec. 6166(b)(9).

[35] Sec. 6166(b)(10).

In general, the installment payment election is available only if the estate directly owns an interest in a closely held active trade or business. Under a special rule, however, an executor may elect to look through certain non-publicly traded holding companies that own stock in a closely held active trade or business.[36] If this election is made, neither the five-year deferral of principal payments nor the two-percent interest rate on the first $1.28 million of taxable estate is available.

If the installment payment election is made for an estate, the amount deferred under section 6166 is a lien in favor of the Federal government on designated property that has passed to beneficiaries of the estate.[37]

If 50 percent or more of the value of the closely held business is distributed, sold, exchanged, or otherwise disposed of, then, in general, the extension of time for the payment of tax no longer applies, and the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary.[38] An exception to this rule is provided for transfers of property to a person entitled to receive the decedent's property under the decedent's will, applicable State law, or a trust created by the decedent. A similar exception applies in the case of a series of subsequent transfers of the property by reason of death so long as each transfer is to a member of the decedent's family (including the decedent's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants).

3. Qualified family-owned business interests

An estate of a decedent dying in 2003 or earlier was permitted to deduct from the value of the gross estate the adjusted value of the qualified family-owned business interests of the decedent.[39] The deduction was limited to $675,000.

The qualified family-owned business deduction and the estate tax applicable exclusion amount were coordinated. If the maximum deduction amount of $675,000 was allowed, the applicable exclusion amount was $625,000. The effective estate tax exclusion amount therefore became $1.3 million. If the qualified family-owned business deduction was less than $675,000, the applicable exclusion amount was equal to $625,000 plus the difference between $675,000 and the amount of the qualified-family owned business deduction. The applicable exclusion amount for an estate was not, however, permitted to be increased above the amount that would apply to the estate if section 2057 did not apply. The deduction was terminated for estates of decedents dying after 2003.[40] Under present law, however, the qualified family-owned business

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[36] Sec. 6166(b)(8).

[37] Sec. 6324A.

[38] Sec. 6166(g).

[39] Sec. 2057.

[40] Sec. 2057(j). Even without formal termination, the section 2057 deduction effectively would be terminated: for estates of decedents dying after 2003, the applicable exclusion amount ($1.5 million in 2004 and 2005, and $2 million in 2006, 2007, and 2008) has exceeded the maximum effective exclusion

interest deduction will be available for estates of decedents dying after 2010. The rules for the deduction are therefore summarized below.

A qualified family-owned business interest generally was defined as an interest in a trade or business with a principal place of business in the United States if the decedent and members of the decedent's family owned at least 50 percent of the trade or business, two families owned at least 70 percent of the trade or business, or three families owned at least 90 percent of the trade or business. The 70-percent and 90-percent tests also required the decedent and the decedent's family to own at least 30 percent of the trade or business. An interest in a trade or business did not qualify if any interest in the business (or a related entity) was readily tradable on an established securities market or secondary market at any time within three years of the decedent's death. An interest in a trade or business (other than a bank or a domestic building and loan association (within the meaning of section 542(c)(2)) also did not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the taxable year that included the decedent's death would have been considered personal holding company income (under section 543 with certain modifications) if the business had been a corporation. The value of a trade or business qualifying as a family-owned business interest generally was reduced to the extent the business held cash or marketable securities in excess of reasonably expected day-to-day working capital needs of the business or held other assets that produced passive income (within the section 954(c)(1) definition of personal holding company income, with certain modifications).

The qualified family-owned business deduction was allowed to an estate only if certain other requirements were satisfied. The decedent was required to be a citizen or resident of the United States on the date of death. 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 ending on the date of the decedent's date of death. The adjusted value of the qualified family-owned business interests (plus certain gifts of those interests) was required to exceed 50-percent of the decedent's gross estate.

The benefit of the deduction for qualified family-owned business interests was subject to recapture (by imposition of an additional estate tax under detailed rules in section 2057(f)(2)) if, within 10 years of the decedent's death and before the qualified heir's death, one of the following events occurred:

- the material participation requirements of section 2032A(c)(6)(B) were not satisfied;
- the qualified heir disposed of any portion of a qualified family-owned business interest, other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under section 170(h);
- the principal place of business of the trade or business ceased to be located within the United States; or

($1.3 million) that was allowed for an estate for which the qualified family-owned business deduction was claimed.

- the qualified heir lost U.S. citizenship (or certain conditions related to long-term U.S. residence no longer were satisfied).

C. Issues and Data Related to Liquidity

1. Criticisms of sections 2032A, 6166, and 2057

Commentators have criticized the special-use valuation, installment payment, and qualified family-owned business interest rules in several ways. A chief criticism has been that those rules are complex, uncertain in their application, and a poor fit with actual business structures.[41] A task force of the American Bar Association's Real Property, Probate and Trust Law Section has provided detailed criticisms of section 6166 and recommendations for reform.[42] It has argued, among other things, that the qualification rules for section 6166 vary based on whether a business is a sole proprietorship, corporation, or partnership; that a business with multiple legal entities is treated differently from a business conducted in a single entity, particularly in determining whether assets of the business are passive assets; that the ownership rules are inconsistent with ownership requirements for qualifying as a subchapter S corporation; that the requirement that a section 6166 election be made by the time the estate tax return is filed may prevent estates from satisfying the 35-percent test when changes or new information learned after filing would allow the test to be satisfied; and that the lien requirements for making a section 6166 election (described previously) in some circumstances have made elections impractical. The task force's recommended changes follow from these criticisms.

Other commentators have found complexity and lack of certainty in section 6166 and also in sections 2032A and 2057. The ABA Task Force has argued that the installment payment rules make planning difficult because they require a subjective determination whether a closely held business is an active business; include special rules for distinguishing between passive assets and non-passive assets and for looking through certain holding companies to their underlying assets; and demand post-death monitoring of dispositions or similar transactions that would end deferral of estate tax payments.[43] Another commentator has made similar observations about section 6166 and also has argued that the rules for determining whether a business is closely held – specifically the ownership attribution rules – create complexity.[44] The

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[41] For a broad critique of all three sets of rules as being too complex, see James R. Repetti, *Democracy, Taxes, and Wealth,* 76 New York University Law Review 825, 868 (June 2001).

[42] Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, *Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee,* 41 Real Property, Probate and Trust Journal 73 (Spring 2006).

[43] ABA Task Force Report, pp. 136-38.

[44] See Leah LaPorte, *Keeping the Farm: Estate Tax Deferral and Closely Held Business Owners,* 41 Columbia Journal of Law and Social Problems 177, 186-202 (Winter 2007). LaPorte advocates creating an alternative to sections 6161 (the short-term deferral rule described previously) and 6166 that would permit varying lengths of deferral based on the extent to which an estate is comprised of business assets. This alternative, however, might introduce other administrative complexities.

ABA Task Force has criticized the qualified family-owned business interest rules as unduly complicated and uncertain in their application, in particular because of the 50-percent test described previously and the requirement that a decedent or a member of the decedent's family materially participate in the operation of the business for a certain period of time before the decedent's death.[45] Another commentator has argued that the definitions of a family in sections 2032A and 6166 are conflicting, complicated, and under-inclusive.[46] The perceived complications in sections 2032A, 6166, and 2057 are seen not only to make planning and post-death business management difficult; they are also viewed as creating inequity between well-advised and less well-advised taxpayers.[47]

The special-use valuation, installment payment, and qualified family-owned business interest rules are detailed and in certain ways subjective, but it is not clear that Congress could achieve its stated objective of ameliorating burdens on family-owned businesses without creating complexity. If Congress is concerned about operating businesses, a distinction between active businesses and other activities – for example, buying and selling securities for investment – is necessary. To determine what constitutes an active business, rules (such as those in present law section 6166) defining passive assets and addressing the treatment of holding companies may be unavoidable. Similarly, the material participation requirement of section 2057 is a logical way to ensure that the family-owned business interest rules are available only for an active, closely held business. If Congress wants preferential rules to be available only when estates are insufficiently liquid to fund their tax liabilities, rules for defining circumstances in which this illiquidity is likely – such as the 35-percent test in section 6166 and the 50-percent test in section 2057 – are needed. If Congress intends to allow preferential treatment only when businesses are family-owned or closely held, there must be rules defining a family, rules limiting ownership to a certain number of individuals, and rules for when ownership is attributed from one person to another person. Last, if the chief policy goal is to prevent the forced sale of farms and other family businesses but not to allow preferential treatment when heirs choose to cease operating a business, rules providing consequences on such a cessation are appropriate.[48]

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[45] ABA Task Force Report, pp. 139-42.

[46] Bridget J. Crawford, *The Profits and Penalties of Kinship: Conflicting Meanings of Family in Estate Tax Law*, 3 Pittsburgh Tax Review 1 (Fall 2005). One suggestion Crawford makes is that the definition of a family in section 2032A be expanded so that real property can qualify for special-use valuation if it is left to a long-term employee (rather than to a spouse, child, or other family member).

[47] See Repetti, note 41, pp. 868-69.

[48] The legislative history for section 2032A notes Congress's intent not to provide benefits when property ceases to be used in a qualifying business after a decedent's death:

> [Y]our committee recognizes that it would be a windfall to the beneficiaries of an estate to allow real property used for farming or closely related business purposes to be valued for estate tax purposes at its farm or business value unless the beneficiaries continue to use the property for farm or business purposes, at least for reasonable period of time after the decedent's death. Also, your committee believes that it would be inequitable to discount speculative values if the heirs of

Commentators have proposed changes to sections 2032A, 6166, and 2057 to address concerns about complexity. Certain proposed changes may reduce complexity but may do so at the expense of changing the policy of those sections. For instance, the ABA Task Force has suggested, among other alternatives, modifying section 6166 to allow deferral, for a shorter period than the current fifteen years, for all estates, not just estates that satisfy the present law conditions.[49] A universal deferral rule would be simpler than current section 6166 but would not be targeted to estates for which liquidity is likely to be a problem. It is unclear whether other proposed changes would have their intended effect of reducing complexity. One commentator has suggested that in place of existing preferential rules, it may be possible to exempt from the estate tax family farms and small businesses.[50] In theory, this exemption may not seem complicated. In practice, however, determining what constitutes a family farm or another small business may be contentious and difficult. Examples of questions include the following. What is the result if some number of acres of land is regularly planted with crops but some number of contiguous acres is planted only occasionally? What sort of ownership is needed for a farm to be a family farm? How is a small business distinguished from a medium-sized business? Is the relevant measure number of employees, value of assets, amount of gross receipts, or some other criterion?[51] These and other questions underlie many of the current rules in sections 2032A, 6166, and 2057.

A second broad criticism of sections 2032A, 6166, and 2057 has been that those provisions favor the holding of certain assets over other kinds of assets, thereby encouraging planning and distorting economic behavior.[52] In 2001 testimony before the Senate Finance Committee on the subject of tax simplification, Richard M. Lipton, then chair of the American Bar Association Section of Taxation, stated:

> Much attention has been focused on specific provisions designed to alleviate the impact of the gift and estate tax on specific groups, such as the owners of family farms, ranches, and businesses. As a result of that attention, specific relief has been enacted to assist those affected individuals. However, despite the best intentions of these provisions,

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> the decedent realize these speculative values by selling the property within a short time after the decedent's death.

H.R. Rep. No. 94-1380, p. 22 (1976).

[49] ABA Task Force Report, p. 139.

[50] Repetti, note 41, p. 869.

[51] Repetti understands the need for rules: "[O]nce a business has a certain number of employees or reaches a certain size, the social benefits of the small business begin to decrease, and the estate tax should apply. Whatever criteria are adopted for identifying which businesses qualify for the exemption, however, they should be simple and apply automatically to all similarly situated taxpayers so that less sophisticated taxpayers will not suffer." *Ibid.*

[52] For criticism of sections 6166 and 2057 on these grounds, see ABA Task Force Report, pp. 138-40.

> qualification for and compliance with them are onerous, and in many cases business decisions are driven purely by planning for a tax result instead of being based on sound economics.[53]

Lipton argued that a "truly meaningful increase" in the estate tax exclusion amount would remove many taxpayers from the estate tax entirely, thereby reducing the need for complicated planning, and would allow repeal of sections 2032A and 2057.[54] Another commentator has noted that as a result of the special-use valuation and installment payment rules, the estate of a decedent who dies holding a business "will benefit from more favorable treatment under the estate tax than if the estate's assets consisted of passive investments. . . ."[55] This commentator has argued that this preference for business assets over passive investments is part of a systemic (though, in the commentator's view, likely accidental) "tax subsidy for entrepreneurship" throughout the Code.[56] It is undeniable that by granting favorable treatment to estates that consist largely of family-owned business assets, sections 2032A, 2057, and 6166 encourage planning (and the incurrence of significant related costs). This planning likely produces real economic distortions. The extent of these distortions is unknown.

2. Effects of present law on small and family-owned businesses

Overview

Some observers note that the transfer tax system may impose special cash flow burdens on small or family-owned businesses. They note that if a family has a substantial proportion of its wealth invested in one enterprise, the need to pay estate taxes may force heirs to liquidate all or part of the enterprise or to encumber the business with debt to meet the estate tax liability. If the business is sold, while the assets generally do not cease to exist and remain a productive part of the economy, the share of business represented by small or family-owned businesses may be diminished by the estate tax. If the business borrows to meet estate tax liability, the business's cash flow may be strained.[57]

Others argue that potential deleterious effects on investment by small or family-owned businesses are limited. The present (2008) exemption value of the unified credit is $2 million per decedent. As a result, small business owners can obtain an effective exemption of up to $4

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[53] Testimony reprinted in 54 Tax Lawyer 617, 624 (Spring 2001).

[54] *Ibid.* At the time of Lipton's testimony, the unified credit effective exemption amount for gift and estate tax was $675,000.

[55] Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax,* 65 Ohio State Law Journal 1401, 1475-76 (2004).

[56] *Ibid.*, p. 1477.

[57] In an earlier pamphlet, Joint Committee on Taxation, *History, Present Law, and Analysis of the Federal Wealth Transfer Tax System* (JCX-108-07), November 13, 2007, the staff of the Joint Committee on Taxation reviewed a number of issues related transfer taxes and small business.

million per married couple, and other legitimate tax planning can further reduce the burden on such enterprises. For example, lifetime gifts to heirs of interests in the closely held business reduce the eventual estate tax liability attributable to business assets. Alternatively, lifetime gifts of cash or securities may provide funds to heirs to meet some or all of an estate tax liability that may be attributable to closely held business assets. Also, as described previously, sections 2032A, 6166, and (for estates before 2004) 2057 are provided to reduce the impingement on small business cash flow that may result from an estate tax liability.

It is difficult to assess the degree to which estate tax impedes the survival and future growth of a closely held small business. Any tax payment reduces funds available to the heirs, but at the choice of the heirs, some or all of the reduction in funds could come from reduced personal consumption by the heirs rather than by reduced future business investment. Similarly, rather than reduce business investment, the decedent may have chosen to reduce his or her personal consumption to assure that the business would be adequately funded after payment of any transfer taxes.

Examination of 2001 data

A recent study of estate returns of persons who died in 2001 shows that many estates that claimed benefits under secs. 2032A, 2057, or 6166 held liquid assets nearly sufficient to meet all debts against the estate and that only 2.4 percent of estates that reported closely held business assets and agricultural assets elected the deferral of tax under section 6166.[58] This study uses detailed estate tax return data to calculate a liquidity ratio, the ratio of liquid assets (cash, cash management accounts, State and local bonds, Federal government bonds, publicly traded stock, and insurance on the life of the decedent) to the sum of the net estate tax plus mortgages and liens. A liquidity ratio of one implies that the estate has liquid assets sufficient to pay the net estate tax plus pay off all mortgages and liens. The study found that in 2001, on average, this ratio exceeded three for estates of less than $2.5 million claiming benefits of the special deduction for qualified family owned business assets or the section 2032A special use valuation.[59] This means that, on average such estates had $3 in liquid assets for every $1 of estate tax liability and mortgage and lien. The study found that for estates of less than $2.5 million electing deferral of tax, the average liquidity ratio was slightly larger than one.[60]

A liquidity ratio of one or more suggests that closely held business assets need not be sold, nor need a loan be incurred, to pay the estate tax. While the existence of liquid assets can

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[58] Martha Eller Gangi and Brian G. Raub, "Utilization of Special Estate Tax Provisions for Family-Owned Farms and Closely Held Businesses," *SOI Bulletin*, 26, Summer 2006, pp. 128-145. Gangi and Raub report that in 2001 of 12,683 estates with farm real estate, 831 elected special use valuation; of 15,612 estates with closely held businesses or agri-business assets, 1,144 claimed a deduction for qualified family-owned business interests; and 382 estates elected to defer payment of the estate tax.

[59] *Ibid.*, Figures D and I.

[60] *Ibid.*, Figure N.

insure that core business assets are unencumbered by the estate tax, the business's ability to function could be adversely affected by the reduction in liquid assets. Ongoing businesses need liquid assets in order to purchase raw materials, pay labor, finance expansion, and engage in other routine business activities. The greater the liquidity ratio is above one, the less likely that on-going business needs are impaired. The study found that generally all estates claiming special use valuations had an average liquidity ratio of at least one. For larger estates claiming benefits of the special deduction for qualified family owned business assets or deferral of tax, liquidity ratios averaged 0.5 or more.[61] While a liquidity ratio of less than one suggests that it is likely that closely held business assets would be impaired by the estate tax liability, it is important to remember the limitations of the estate tax data. These data do not show pre-death estate planning transfers of assets to the heirs who might ultimately be running the business. For example, the purchase of life insurance by the heirs is a common planning technique to insure that business assets need not be sold to meet estate tax liabilities. Insurance amounts paid on the death of the decedent to a person other than the estate are not included as liquid assets for the purpose of computing the liquidity ratios reported in the study.

A limitation of the study discussed above is that it reports the average liquidity ratio. If there is substantial variation in the way owners of closely held business assets manage their affairs, an average does not provide sufficient detail as to the extent to which the estate tax may or may not be thought to impair the continuity of closely held businesses upon the death of an owner. In Tables 2 though 6, below, the staff of the Joint Committee on Taxation ("JCT staff") replicates the computation of the liquidity ratio on the 2001 estates with closely held business assets, but in addition to reporting the overall average liquidity ratio, the tables report average liquidity ratios from the second and ninth deciles of the distribution of such returns. Specifically, Tables 2 and 3 report liquidity ratios for 2001 estates that included farm land as an asset in the estate (13,981 estates) and those that claimed the special use valuation for some or all of the farmland in the estate (788 estates). Table 2 reports liquidity ratios for all such estates, while Table 3 reports liquidity ratios for those estates with an estate tax liability ("taxable estates"). The first row reports the average liquidity ratio of all 2001 estates that included farm land as an asset in the estate and all 2001 estates that claimed the special use valuation for some or all of the farmland in the estate. For this purpose, the JCT staff assigns a zero liquidity ratio to estates with no tax liability or outstanding debts.[62] The JCT staff ranks and numbers all estates with farmland and all estates with farmland claiming a special use valuation from the estate with the lowest liquidity ratio to the estate with the highest liquidity ratio. The second decile is made up of estates with farmland numbered 1,398 to 2,796 and for estates with farmland claiming the special use valuation numbered 79 to 157. Likewise the ninth deciles are estates with farmland numbered 11,184 to 12,583 and for estates with farmland claiming the special use valuation

[61] *Ibid.*, Figures D, I, and N.

[62] This is not conceptually correct as mathematically if an estate has any liquid assets and no tax or debt liability the liquidity ratio would be infinite. An infinite value would render reported averages as meaningless. However, it is important to recognize that an estate could also have liquidity ratio of zero if it had no liquid assets and some, however modest, estate tax or debt liability. In the 2001 data almost all of the zero liquidity ratios are estates with no estate tax or debt liabilities.

numbered 630 to 709. The second row reports the average liquidity ratio for the second decile, the third row reports the median liquidity ratio, and the fourth row reports the average liquidity ratio for the ninth decile.

Table 2.–Liquidity Ratios for Estates with Farmland and Estates with Farmland Claiming Benefits Under Sec. 2032A [2001 Decedents]

	All Estates including Farmland	Estates including Farmland and claiming special-use valuation
Average liquidity ratio	3.4	0.5
Average liquidity ratio of the second decile	0	0
Median liquidity ratio	0	0
Average liquidity ratio of the ninth decile	8.0	1.3

Table 3.–Liquidity Ratios for Taxable Estates with Farmland and Estates with Farmland Claiming Benefits Under Sec. 2032A [2001 Decedents]

	All estates including Farmland	Estates including Farmland and claiming special-use valuation
Average liquidity ratio	2.7	0.9
Average liquidity ratio of the second decile	1.0	0.4
Median liquidity ratio	3.0	2.6
Average liquidity ratio of the ninth decile	26.0	7.0

Tables 2 and 3 present rather similar results. The majority of estates with farmland and those claiming benefits of section 2032A have either a liquidity ratio of zero (meaning no estate tax or debt liability) or a liquidity ratio of one or more. In Table 3 the average liquidity ratio in the second decile of estates with farmland is one. That is, the estate includes liquid assets equal in value to the sum of the estate's estate tax liability and other debts. For estates claiming the special-use valuation the liquidity ratio of half of the estates exceeds 2.6. These data suggest that estates with farmland and estates that claim the special use valuation generally are not directly

impaired by an estate tax liability. In 2001, these estates generally included sufficient liquid assets to pay the estate tax, if any, without necessitating a sale of farmland.[63]

A more detailed examination of liquidity ratios for those estates reporting closely held business assets and those claiming benefits under section 2057 suggest a greater potential for the estate tax to create a direct impairment of closely held business assets. While Table 4, below, reports that more than 50 percent of all such estates have no estate tax liability (median liquidity ratio of zero), among taxable estates (Table 5) the median liquidity ratio is 0.2. That is, the value of liquid assets in the estate equals only 20 percent of the sum of the estate's estate tax liability and other outstanding debts. Even in the ninth decile of taxable estates claiming the benefit of section 2057 in 2001 the average estate had liquid assets somewhat less in value than the sum of the estate tax liability and other outstanding debts (average liquidity ratio of 0.9). On the other hand, among taxable estates reporting some closely held business assets (the second column of Table 5) more than 50 percent of estates had liquidity ratios in excess of one (median liquidity ratio of 3.0 implying the median estate had liquid assets equal to three times the value of the sum of the estate tax and other outstanding debts). To be eligible for the benefit of section 2057, closely held business assets had to constitute a significant proportion of the estate. Many estates included some closely held business assets but were not eligible for the exclusion under section 2057. For those estates with closely held business assets that did not claim the benefit of section 2057 in 2001, closely held business assets generally were not a large portion of the estate.

Table 4.–Liquidity Ratios for Estates with Closely Held Business Assets and Estates Claiming Benefits Under Sec. 2057 [2001 Decedents][1]

	All estates including closely held business assets	All estates including closely held business assets and claiming deduction for qualified family owned business interests
Average liquidity ratio	2.8	1.0
Average liquidity ratio of the second decile	0	0
Median liquidity ratio	0	0
Average liquidity ratio of the ninth decile	8.0	3.0

[1] The total number of estates with closely held business assets was 15,784. Of those estates, 1,022 elected section 2057.

[63] It is important to remember that the operation of the farm going forward could be impaired by a reduction in liquid operating capital.

Table 5.–Liquidity Ratios for Taxable Estates with Closely Held Business Assets and Estates Claiming Benefits Under Sec. 2057 [2001 Decedents][1]

	All estates including closely held business assets	All estates including closely held business assets and claiming deduction for qualified family owned business interests
Average liquidity ratio	2.2	0.4
Average liquidity ratio of the second decile	0.8	0.1
Median liquidity ratio	3.0	0.2
Average liquidity ratio of the ninth decile	24.0	0.9

[1] The total number of taxable estates with closely held business assets was 6,640. Of those estates, 91 elected section 2057.

In 2001, an estate could claim benefits under section 2032A or 2057 and reduce the value of the estate below the threshold at which any estate tax would be liable. Unlike section 2032A or section 2057, section 6166 is only beneficial to an estate if the estate has an estate tax liability after application of the provision. Table 6 below again reports liquidity ratios for estates with closely held business assets but reports data only for those estates with a positive estate tax liability. Therefore the second column of Table 6 is identical to the second column of Table 5. The third column of Table 6 reports liquidity ratios for those estates that defer payment of the estate tax liability under section 6166. Comparison of column three to column two indicates that estates that use the deferred payment of section 6166 have lower liquidity ratios than all estates that include closely held business assets. Such a result is consistent with the purpose of section 6166, to provide deferral when sale of closely held business assets might otherwise be necessary to meet an estate tax obligation. However, Table 6 also suggests that in some cases even when there is sufficient liquidity in the estate, the estate elects deferral under section 6166, as the average liquidity ratio of the ninth decile of estates that elect deferral under 6166 is 2.0 (the estate holds liquid assets equal to twice the value of the sum of the estate tax liability and other outstanding debts). However, without knowing the business needs for operating capital, it is not possible to conclude that such estates are taking advantage of perceived favorable interest rates under section 6166.

Table 6.–Liquidity Ratios for Estates with Closely Held Business Assets and Estates Electing to Defer Payment Under Sec. 6166 [2001 Decedents][1]

	All estates including closely held business assets	All estates including closely held business assets and electing deferral of tax liability under sec. 6166
Average liquidity ratio	2.2	0.5
Average liquidity ratio of the second decile	0.8	0.01
Median liquidity ratio	3.0	0.7
Average liquidity ratio of the ninth decile	24.0	2.0

[1] The total number of estates making an election under section 6166 was 488.

More recent data

As described previously, several Code provisions may reduce the burden of the estate tax borne by small or family-owned businesses. Table 7,[64] below, presents data from estate tax returns filed in 2005 on the utilization of these provisions in comparison to all estate tax returns filed. In 2005, among estates valued at less than $5 million, and with a positive estate tax liability, approximately 0.6 percent elected deferral under section 6166, while among estates valued at $5 million or more approximately 3.6 percent of estates elected deferral under section 6166. With respect to estates claiming a special-use valuation under section 2032A, the percentages are roughly the reverse. Among estates valued at less than $5 million, and with a positive estate tax liability, approximately 1.4 percent claimed a special use valuation under section 2032A, while among estates valued at $5 million or more approximately 0.6 percent of estates claimed a special use valuation under section 2032A.

[64] This is similar to Table 7 in JCX-108-07, but reports data from estate tax returns filed in a more recent year. The 2003 included information on estates that claimed benefits under section 2057. The special deduction available under section 2057 was not available for estates in 2005.

Table 7.–Estates Claiming a Special Use Valuation or Electing Deferral of Tax Liability, Returns Filed in 2005

Item	Estates with Value of total gross estate less than $5 million	Estates with Value of total gross estate $5 million or greater
Number of returns filed	29,060	5,108
Percentage of all returns filed	85%	15%
Number of taxable returns	12,804	2,981
Percentage of total taxable gross estate on all taxable returns	39%	61%
Number of returns claiming a special use valuation under sec. 2032A	181	17
Number of returns making sec. 6166 election	74	108

Source: JCT staff tabulations from Statistics of Income data.

Table 8,[65] below, reports data on the extent to which estates are made up of closely held stock or business interests. The data show that approximately 14.4 percent of estate tax returns filed in 2005 reported some holdings of closely held stock. For estates claiming the tax benefits provided by section 2032A or 6166, the holdings of closely held stock comprised 46 percent of the taxable estate for estates valued at $5 million or greater and comprised 34 percent for estates valued less than $5 million. For estates holding closely held stock, but not claiming the tax benefits provided by section 2032A or 6166, closely held stock represented less than 20 percent of the taxable gross estate on average.

[65] This is similar to Table 8 in JCX-108-07, but reports data from estate tax returns filed in a more recent year. The 2003 included information on estates that claimed benefits under section 2057. The special deduction available under section 2057 was not available for estates in 2005.

Table 8.–Closely Held Stock in Estate Tax Returns Filed in 2005

Item	Estates with Value of total gross estate less than $5 million	Estates with Value of total gross estate $5 million or greater
Number of returns filed	29,060	5,108
Total gross estate (millions of dollars)	$64,379	$77,049
Value of closely held stock millions of dollars)	$1,778	$7,267
Value of closely held stock as a percentage of total gross estate	2.8%	9.4%
Number of estates with closely held stock	3,420	1,507
Number of estates with closely held stock as a percentage of all returns filed	11.8%	29.5%
Total gross estate of those estates with closely held stock (millions of dollars)	$9,187	$32,418
Number of estates with closely held stock and claiming benefits of secs. 2032A or 6166	54	74
Value of closely held stock as a percentage of the taxable gross estate of estates claiming benefits of secs. 2032A or 6166	34%	46%
Number of estates with closely held stock not claiming benefits of secs. 2032A or 6166	3,366	1,433
Value of closely held stock as a percentage of the taxable gross estate of estates not claiming benefits of secs. 2032A or 6166	19%	18%

Source: JCT staff tabulations from Statistics of Income data.

APPENDIX: REFORM OPTIONS PREVIOUSLY PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION[66]

A. Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)

Present Law

In general, present law imposes transfer taxes that are designed to tax transfers once each generation. These taxes are in the form of a gift tax for lifetime transfers, an estate tax for death time transfers, and a generation skipping transfer tax for transfers to persons more than one generation younger than the transferor. A generation skipping tax is imposed on all transfers, whether directly or indirectly, to "skip persons." A skip person includes a person who is two or more generations below the generation of the transferor or a trust, if all the interests are held by skip persons. The transferor generally is the individual who transfers property in a transaction that is subject to Federal estate or gift tax. Transfers that are subject to the generation skipping tax are direct skips (e.g., a transfer from a grandparent to a grandchild), taxable distributions (e.g., a distribution of income or corpus to a grandchild from a trust created by a grandparent), and taxable terminations (e.g., the death of a grandchild who was a beneficiary of a trust created by a grandparent).

Present law provides for a lifetime per-transferor exemption from the generation skipping transfer tax.[67] The amount of the generation skipping transfer tax exemption is $1,500,000 for generation skipping transfers made in 2005, $2,000,000 for generation skipping transfers made in 2006, 2007, or 2008, and $3,500,000 for generation skipping transfers made in 2009. In the case of a generation skipping trust, the exemption applies to distributions from, or terminations of interests in, that fraction of the trust that the portion of the exemption that is allocated to the trust bears to the value of trust's assets at its creation. Thus, if a generation skipping trust is created with $1.5 million and $1.5 million of the creator's generation skipping transfer tax exemption is allocated to that trust, no generation skipping transfer tax ever is imposed on any distributions from, or termination of interests in, that trust regardless of the number of generations of the trust's beneficiaries that are skipped.

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[66] These reform options are reprinted from Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 392-408.

[67] Every transferor is entitled to a generation skipping tax exemption that may be allocated to transfers made by the transferor either during the transferor's life or at death. The amount of the generation skipping transfer tax on a transfer technically is determined by multiplying the amount transferred by the applicable rate. The applicable rate is the maximum Federal estate tax rate multiplied by the inclusion ratio. The inclusion ratio is defined in turn as one minus the applicable fraction. The applicable fraction is a fraction the numerator of which is the generation skipping transfer exemption allocated to the trust (or the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip) reduced by Federal or State estate and death taxes actually recovered from the trust (or transferred property) and any charitable deduction allowed for Federal estate and gift tax on the transfer.

Many States limit the length of time that assets can be held in trust for the benefit of beneficiaries who were not alive at the time of the creation of the trust. This limitation is generally referred to as the rule against perpetuities. The rule against perpetuities was a judicially created rule of English common law. In many cases, States adopted the rule against perpetuities when they adopted British common law as their basic law. The rule has been criticized as being inconsistent with the present capital market system, and because of its complexity and resulting uncertainty of application. In order to alleviate this uncertainty, some States have adopted the Uniform Statutory Rule Against Perpetuities. Under that uniform statute, "trust settlors may elect to create either a trust measured by lives in being at the creation of the trust plus 21 years or trust measured by ninety-years."[68] Other States have either repealed the rule against perpetuities, or provided an ability to opt out of the rule. In a State without a mandatory rule against perpetuities, it is possible to transfer assets to a trust created in that State, to which the transferor's generation skipping tax exemption has been allocated. The trust assets may grow for a potentially unlimited period of time without being subject to any transfer tax. Because of their potential long life and potential for substantial accumulation, such trusts generally are called "perpetual dynasty trusts."

Reasons for Change

Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation. In addition, perpetual dynasty trusts deny equal treatment of all taxpayers because such trusts can only be established in the States that have repealed the mandatory rule against perpetuities.

Description of Proposal

The proposal prohibits the allocation of the generation skipping tax exemption to a "perpetual dynasty trust," except to the extent that the trust provides for distributions to beneficiaries in the generations of the transferor's children or grandchildren. Under the proposal, the generation-skipping tax exemption effectively is limited to an exemption of a skip of one generation. A "perpetual dynasty trust" is defined as a trust whose situs (place of creation) is a State that either (1) has repealed the rule against perpetuities, (2) allows the creator of a trust to elect to be exempt from the rule against perpetuities and the creator so elects, or (3) has modified its rule against perpetuities to permit creation of interests for individuals more than three generations younger than the interest's creator. If the situs of a trust is moved from a State that has retained the rule against perpetuities to a State that has repealed the rule against perpetuities, the inclusion ratio thereafter will be changed to one.

Effective Date

The proposal is effective for transfers made after the date of enactment.

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[68] Jesse Dukeminier, "The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities," *Real Property Probate & Trust Journal*, 30 (1995) at 185.

Discussion

As Congress stated both when it originally imposed a tax on generation skipping transfers in 1976 and again when it revised the generation skipping tax in 1986, the purpose of imposing gift, estate and generation skipping tax was "not only to raise revenue, but to do so in a manner that has as nearly as possible a uniform effect."[69] Similarly, the Congress stated that it "believed that the tax law should basically be neutral and that there should be no tax advantage available in setting up trusts."[70] The imposition of a generation skipping tax was believed necessary to achieve the uniformity of imposing a transfer tax once every generation. A $1 million exemption from the generation skipping tax originally was provided when the generation skipping tax was revised in 1986. The size of the generation-skipping transfer tax exemption was increased beginning in 2002 to be equal to the amount of effective exemption for estate and gift taxes. Thus, the exemption from the generation skipping transfer tax is scheduled to increase to $3.5 million by 2009. When Congress originally enacted a tax on generation skipping transfers, it noted that "[m]ost States have a rule against perpetuities which limits the duration of a trust."[71]

Since that time, a number of States have either repealed the rule against perpetuities or provided an ability to opt out of such limitations. Thus, it is possible to transfer a relatively large initial amount of assets to a trust created in such States and to which the transferor's entire generation skipping tax exemption has been allocated. Potentially unlimited growth in the trust assets may occur, while the assets are not subject to any transfer tax even though the trust's beneficiaries have changed many generations. These "perpetual dynasty trusts" can be used to frustrate the uniform application of transfer tax that was envisioned when the generation skipping tax was enacted. This lack of uniformity is compounded by the fact that perpetual dynasty trusts can be created only in the limited number of States that have repealed or modified the rule against perpetuities.

The proposal would result in greater uniformity by limiting exemption from the generation skipping transfer tax for perpetual dynasty trusts. The proposal is consistent both with the purpose of enacting a generation skipping transfer tax, and with the operation of the present transfer tax system, which generally imposes a tax once every generation by limiting the amount of assets that can be placed beyond the present-law transfer taxes. The proposal also is consistent with the generation skipping tax exemption, in that it permits an exemption from the generation skipping transfer tax for transfers to the transferor's grandchildren. The proposal avoids the possible constitutional limitations of alternative proposals to limit the transfer tax advantage of perpetual dynasty trusts (e.g., impose an *ad valorem* tax every set number of years on perpetual dynasty trusts). In addition, the proposal is consistent with the purposes of the rule against perpetuities to prevent perpetuation of wealth disparities, promote alienability of

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[69] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 1263.

[70] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), December 29, 1976, at 565.

[71] *Id*.

property, and make property productive.[72] The proposal does not prevent an individual from creating a trust in a State that has repealed the rule against perpetuities. Thus, the proposal does not prevent the creation of a trust in a State if that State otherwise would be the best State in which to create a trust. The proposal does, however, eliminate a Federal transfer tax advantage for creating a trust in a State that has repealed the rule against perpetuities.

[72] Brian Layman, "Comment: Perpetual Dynasty Trusts: One of the Most Powerful Tools in the Estate Planner's Arsenal," *Akron Law Review*, 32 (1999), at 747.

B. Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.[73] The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.[74]

If actual sales prices and bona fide bid and asked prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook in the nation and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.[75]

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of a 50-percent shareholder's stock might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts used under present law are discussed below.[76] In many cases courts apply more than one discount. The theories of some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

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[73] Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternative valuation date if the executor so elects) in the case of the estate tax.

[74] Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

[75] Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237.

[76] Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities)* discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.[77] Minority discounts arise from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.[78]

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests often are less attractive to investors and have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,[79] but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.[80] Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases. However, the discount has been applied to a 100-percent ownership interest in a closely held corporation.[81] Marketability discounts often result in reductions in the value of transferred

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[77] See Rev. Rul. 93-12, 1993-2 C.B. 202; *Propstra v. United States,* 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner,* 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner,* 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

[78] See David T. Lewis and Andrea Chomakos, *The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities* (ABA Publishing 2004) at 11.

[79] E.g., *Central Trust Co. v. United States,* 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner,* T.C. Memo 1989-466.

[80] Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

[81] See, e.g., *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. ("Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.").

property of 20 to 30 percent[82] in addition to any applicable minority discount.[83] Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts created through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (e.g., a gift of an undivided fractional interest in real estate).[84] Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.[85]

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts can be as high as 50 percent and may overlap with the marketability discount.[86]

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[82] There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, i.e., converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

[83] The United States Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

[84] Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, para. 135.3.4 (2d ed. 1993). Courts, however, often apply a minority discount instead. See, e.g., *LeFrak v. Commissioner*, T.C. Memo 1993-526.

[85] See, e.g., *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

[86] For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

Reasons for Change

Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax purposes do not accurately reflect value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.

Description of Proposal

In general

The proposal provides rules for determining the value of property for Federal transfer tax purposes. These rules limit the availability of minority and marketability discounts. In certain situations the proposal also may have an effect on other discounts such as the investment company discount and the fragmentation discount. The property interests to which the proposal applies include shares of stock of a corporation, interests in a partnership or limited liability company, and other similar interests in a business or investment entity or in an asset. The proposal has two parts, aggregation rules and a look-through rule. Under the proposal, step transaction principles are used to determine whether two or more transfers are treated as a single transfer. Moreover, any interest in an asset owned by the spouse of a transferor or transferee is considered as owned by the transferor or transferee.

The aggregation and look-through rules described below generally apply to all gifts made during life without consideration, transfers at death, generation-skipping events, and any transfer of an asset by gift for an amount of consideration less than the value determined under those rules. The rules described below are not intended, however, to change the principles of present law concerning whether transfers made in the ordinary course of business are, or are not, treated as gifts.[87]

Aggregation rules

Basic aggregation rule

Under the proposal, the value for Federal estate, gift, and generation-skipping transfer tax purposes of any asset transferred by a transferor (a donor or decedent) generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor just before the transfer (the "basic aggregation rule").

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[87] See, e.g., *Estate of Anderson v. Commissioner*, 8 T.C. 706 (1947), acq. 1947-2 C.B. 1.

Example 1.–Mother owns 80 percent of the interests in a limited liability company ("LLC"). LLC's value is $100,000, and Mother's 80-percent interest has a value of $80,000.[88] Mother makes related gifts of 20-percent interests to each of her two children. Under the proposal, the value of each 20-percent interest for transfer tax purposes is one-quarter (20/80) of the value of Mother's 80-percent interest, or $20,000. Because this value is a pro-rata share of the value of Mother's controlling interest, the value does not reflect a minority discount.[89]

Example 2.–Mother owns a 40-percent interest in LLC. The value of this 40-percent interest is $32,000, reflecting a 20-percent minority discount. Mother dies. This 40-percent interest passes through Mother's estate in equal shares to two children who did not previously own any interests in the LLC. Under the proposal, the value of each 20-percent share for transfer tax purposes is $16,000, one-half (20/40) of Mother's interest at death.[90]

Transferee aggregation rule

A special rule applies if a donor or a decedent's estate does not own a controlling interest in an asset just before a transfer of all or a portion of the asset to a donee or heir and, in the hands of the donee or heir, the transferred asset is part of a controlling interest. In that case, the estate, gift, and generation-skipping transfer tax value of the asset transferred is a pro-rata share of the fair market value of the entire interest in the asset owned by the *donee or heir* (not by the transferor) after taking into account the gift or bequest (the "transferee aggregation rule").

Example 3.–The facts follow those in Examples 1 and 2 except that instead of making gifts and bequests to different children, Mother transfers interests in LLC only to one child. Thus, during her life Mother makes a single gift of a 40-percent interest to one child. After application of the basic aggregation rule, this gift has a value of $40,000, one half (40/80) of the value of Mother's entire 80-percent interest. At the time of her death, assume that an 80-percent interest in the LLC is still worth $80,000, but that Mother's remaining 40-percent interest is worth only $32,000, reflecting a minority discount. After application of the transferee aggregation rule, the 40-percent interest transferred to the child has a value of $40,000, one-half the $80,000 value of child's 80-percent interest after the bequest. Because the child has a controlling interest after the transfer, the value of the bequest for transfer tax purposes does not incorporate a minority discount.

[88] For illustrative purposes only, the $80,000 value, and the values described in all subsequent examples, disregard the possible existence of a control premium. The $80,000 value also assumes a marketability discount does not apply.

[89] The result is the same even if, just before the gifts, Mother owned only 65 percent of the LLC and her husband owned 15 percent.

[90] The result for a minority discount is the same as under present law.

Look-through rule

If, after application of the aggregation rules described above, a transferred interest in an entity is part of a controlling interest owned (before the transfer) by the transferor or (after the transfer) by the transferee, a look-through rule may apply to determine the value of that transferred interest. Under the look-through rule, if at least one-third of the entity's assets (by value) consists of marketable assets, the value of a transferred interest in that entity for Federal estate, gift, and generation-skipping transfer tax purposes is the sum of (1) the net value of the entity's marketable assets allocable to that transferred interest and (2) the value of the transferor's interest in the entity attributable to nonmarketable assets. Marketable assets include cash, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments. Marketable assets do not include assets that are part of an active lending or financing business.[91]

If the look-through rule applies, the effect is to deny a marketability discount to the extent the entity holds marketable assets. In all cases in which the look-through rule applies, no minority discount is permitted because a condition of the look-through rule is that the transferred interest must be part of a controlling interest either before or after the transfer.

> Example 4.–At her death, Aunt owns 80 percent of the interests in an LLC whose assets have a total value of $1 million. The LLC owns publicly-traded stock worth $600,000, real estate worth $200,000, and a laundromat business worth $200,000. Aunt's 80-percent interest in LLC passes through her estate to Niece. If it is assumed that a marketability discount, if available, is 25 percent, then under the proposal the estate tax value of this 80-percent interest is $720,000, computed in the following manner. Because 60 percent of the value of LLC's assets is represented by marketable assets (the publicly-traded stock) and because Aunt owns a controlling interest before the transfer, the look-through rule applies. The $720,000 value thus equals (1) 80 percent of the value of the publicly-traded stock, or $480,000 ($600,000 x 80 percent), plus (2) the value of Aunt's interest in the entity attributable to the real estate and laundromat business, or $240,000 (80 percent of $300,000 (with the $300,000 representing the value of the laundromat business and real estate after taking into account a 25-percent marketability discount)).[92]

> Example 5.–The facts are the same as in Example 4, except that the laundromat business is worth $1.2 million. The total value of LLC's assets is $2 million. Consequently, the value of the marketable assets equals only 30 percent of the value of the LLC, and the look-through rule does not apply. The estate tax value of this 80-percent interest is $1.2 million, which equals 80 percent of the value of the LLC (80 percent x $2 million = $1.6 million), less a 25-percent marketability discount

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[91] For purposes of this proposal, rules similar to those of section 6166(b)(10)(B) apply.

[92] As in all of these examples, the possible existence of a control premium is ignored.

($400,000). No minority discount is available because the 80-percent interest is a controlling interest.

Example 6.–The facts are the same as in Example 4, except that Aunt owns only a 10-percent interest in the LLC and Niece does not own any interest in it before she inherits her Aunt's interest. Accordingly, the look-through rule does not apply because the 10-percent interest is not part of a controlling interest either before or after the transfer. Therefore, a minority discount is available. Assume the minority discount is 20 percent. The value of the 10-percent interest is therefore $60,000, which equals 10 percent of the value of the LLC ($100,000), less (1) a 20-percent minority discount ($20,000) and (2) a 25-percent marketability discount ($20,000) computed after application of the minority discount (that is, 25 percent of $80,000, the value remaining after taking into account the minority discount).

Effective Date

The proposal applies to transfers occurring and estates of decedents dying on or after the date of enactment.

Discussion

The proposal responds to the frequent use of family limited partnerships ("FLPs") and LLCs to create minority and marketability discounts. In a common planning technique, a taxpayer forms an FLP or LLC, contributes to that entity marketable securities, real estate, and other assets, and makes gifts of noncontrolling interests in the entity. At death, the taxpayer owns only a noncontrolling interest in the FLP or LLC (rather than the underlying assets). Under present law the gifts made during life may qualify for minority and marketability discounts, and the estate tax value of the taxpayer's interest in the FLP or LLC also may be substantially reduced by those discounts.[93] The proposal seeks to curb the use of this strategy frequently

[93] Commentators have referred to this discounting as the "disappearing wealth" phenomenon: Wealth disappears from the transfer tax base even though no (or little) economic actual value is lost. See Mary Louise Fellows & William H. Painter, "Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome," 30 Stanford Law Review 895 (1978); James Repetti, "Minority Discounts: The Alchemy in Estate and Gift Taxation," 50 *Tax Law Review* (1995); Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 Tax Notes 1461 (2000).

Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001), provides a simple example of the creation of discounts shortly before death. Mrs. Church, who was the mother of the plaintiff and was suffering from a terminal illness, and her two children together formed a limited partnership. In exchange for limited partnership interests, Mrs. Church contributed to the partnership her interest in a Texas ranch (valued at $380,038) together with $1,087,710 in publicly traded securities, while her two children contributed their undivided interests in the ranch. A corporation owned equally by the two children was the general partner of the partnership. Two days after the formation of the partnership, Mrs. Church died. The District Court found that the date-of-death value of Mrs. Church's limited partnership interest was $617,591, despite the fact that Mrs. Church transferred assets to the partnership worth $1,467,748 just two days earlier. The court upheld a

employed to manufacture discounts that do not reflect the economics of the transfers during life and after death. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

The proposed aggregation and look-through rules restrict a taxpayer's ability to claim minority and marketability discounts in certain situations in which those discounts do not accurately reflect the value of the property interests transferred. In general, the basic aggregation rule of the proposal determines the existence of a minority discount by taking into account the entire interest held by the transferor just before the transfer. This is because the focus of the estate and gift tax should be on the amount a transfer depletes the value of the transferor's holdings. Thus, no minority interest should apply if the transferor holds a controlling interest in the property just before the transfer. Although inconsistent with this theory, the transferee aggregation rule is proposed to prevent the strategic sequencing of multiple gifts made to the same donee. The aggregate value of a series of lifetime and testamentary gifts made by one donor to the same donee should not depend upon the order in which controlling and non-controlling interests are transferred to the donee.

The proposed look-through rule addresses abusive situations in which a marketability discount is inappropriate. If an entity whose interests are nonmarketable holds marketable assets, a marketability discount for an interest in the entity results in the undervaluing of the interest if the owner has a controlling interest in the entity and can easily access the marketable assets.

The proposal does not eliminate minority and marketability discounts in other contexts in which facts generally support those discounts. If, for example, neither the transferor nor the transferee owns a controlling interest in an entity, the estate and gift tax value of an interest in that entity may be determined by taking into account the lack of control. Similarly, where an entity's value primarily is attributable to nonmarketable assets, the estate and gift tax value of an interest in that entity may reflect that illiquidity.

The proposal is similar to, but refines, several previous legislative proposals. First, the basic aggregation rule is similar to a proposal made by the Treasury Department in 1984 as part of a broad report on tax reform.[94] The 1984 proposal, however, based the value of transferred property on the transferor's highest level of ownership after taking into account prior gifts. This tracing of ownership backward through all gifts made by a transferor during his or her lifetime would create significant administrative difficulties. The proposed basic aggregation rule, therefore, looks only to the transferor's ownership interest just before the transfer. To eliminate the advantage of strategic sequencing of gifts to the same donee, the proposal adds a donee aggregation rule. Second, the look-through rule is similar to the approach taken in the Fiscal

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58-percent discount based upon the noncontrolling and illiquid nature of Mrs. Church's limited partnership interest.

[94] Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth,* vol. 2, General Explanation of the Treasury Department Proposals (November 1984) at 386-88.

Year 2000 Administration Budget Proposal.[95] That proposal would have required an interest in an entity to be valued at a proportionate share of the net asset value of the entity to the extent the entity held non-business assets. The proposal's look-through rule is narrower than the earlier Treasury proposal, on the theory that in certain cases it may be inappropriate to look through an interest in an entity if the entity primarily holds non-marketable assets.[96] Third, the proposal incorporates spousal attribution but does not include a broader family attribution approach taken by various legislative proposals. The proposal does not take this broader approach because it is not correct to assume that individuals always will cooperate with one another merely because they are related. Any proposal involving family attribution could include an exception based on family hostility, but that exception could entail significant administrative difficulties and might yield unintended incentive effects.

[95] Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (February 1999) at 167. The Fiscal Year 2001 Administration Budget Proposal included the same proposal. See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (February 2000) at 184-85.

[96] The proposal also bases its application on the existence of marketable assets, not non-business assets. The definitions of those two terms may differ.

C. Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)

Present Law

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One major exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to $11,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.[97] In order to qualify for the exclusion, the property interests transferred must be present interests, as opposed to future interests (such as remainders). In addition, spouses are allowed to "split" gifts for purposes of applying the exclusion.[98] For example, at both spouses' election, a $22,000 gift from one spouse to a third person could be treated as being made equally by both spouses, and thus would be sheltered entirely by the spouses' combined annual exclusion amounts.

Gifts in trust are treated as made to the trust beneficiaries for purposes of applying the annual exclusion.[99] Accordingly, if the trust beneficiaries have no right to present enjoyment of the transferred property, the annual exclusion will not apply, as no present interest will have been transferred. However, the courts and the IRS have long agreed that a temporary right of withdrawal of trust property on the part of a beneficiary may serve to create a present interest, thus qualifying such a gift for the annual exclusion. This result obtains even if the right of withdrawal is of short duration, and even if all parties involved expect that the right will not be exercised, and thus the beneficiary will not actually "enjoy" the transferred property on a current basis as a practical matter.[100] For example, a married couple may establish a trust for the benefit of their minor child, and the general terms of the trust may allow distributions to the child only upon reaching age 25. This couple nevertheless can transfer $22,000 per year to the trust, fully sheltered by the annual exclusion, as long as the child is given a temporary power to demand distribution of each new amount transferred into the trust, even if it is highly improbable that the power will be exercised. These powers, and these arrangements in general, are referred to as "Crummey powers," and "Crummey trusts" (so named after a court case upholding one such arrangement).

While Crummey powers may be used in connection with simple transfers of cash or any other kind of asset into a trust, use of the powers is particularly common in the case of life insurance trusts. In these arrangements, a trust owns the life insurance policy, the insured makes

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[97] The statute provides an amount of $10,000, adjusted in $1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2005 is $11,000.

[98] See sec. 2513.

[99] See *Helvering v. Hutchings,* 312 U.S. 393 (1941).

[100] See *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321.

periodic payments into the trust for the purpose of covering the premiums, and the trust beneficiaries are given Crummey powers with respect to these periodic payments, in order to ensure that the payments qualify as transfers of present interests eligible for the gift tax annual exclusion.

In recent years, taxpayers have used Crummey powers to achieve benefits extending beyond the conversion of future interests into present interests. Specifically, taxpayers have taken the position that the holder of the Crummey power need not even be a vested beneficiary of the trust, which creates the possibility of using multiple annual exclusions (one for each Crummey power holder) for what ultimately will be a gift to a single donee, as a practical matter. The Tax Court has sustained this position.[101]

Reasons for Change

Recent arrangements involving Crummey powers have extended the "present interest" concept far beyond what the Congress likely contemplated in enacting the gift tax annual exclusion, resulting in significant erosion of the transfer-tax base.

Description of Proposal

In general

The proposal sets forth three options that the Congress may wish to consider for improving the tax treatment of Crummey powers.

Option 1

Under the first option, for purposes of determining the applicability of the annual exclusion, a holder of a Crummey power is not treated as the donee with respect to an amount transferred into trust unless such holder is also a direct, noncontingent beneficiary of the trust. The Treasury Secretary is given regulatory authority to disregard other Crummey powers in cases in which the holder of a power is given a relatively small vested interest in a trust, with a principal purpose of avoiding the application of this provision. This option is designed simply to prevent taxpayers from claiming multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person.

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[101] See *Estate of Cristofani v. Commissioner,* 97 T.C. 74 (1991). Taxpayers still must exercise some caution in executing this strategy: under section 2514(e), the lapse of a Crummey power may itself be treated as a taxable gift from the power holder to the beneficiary of such lapse, but only if the property subject to the lapsed power exceeds the greater of $5,000 or five percent of the value of trust assets available to satisfy the power. To avoid the application of this rule, taxpayers either may limit their Crummey powers to $5,000 each, or may fund the underlying trust with at least $220,000 (such that an $11,000 Crummey power would not exceed five percent of trust assets).

Option 2

Under the second option, for purposes of determining the applicability of the annual exclusion, powers to demand the distribution of trust property are taken into account only if they cannot lapse during the holder's lifetime. This option effectively eliminates Crummey powers as a tax planning tool.

Option 3

Under the third option, for purposes of determining the applicability of the annual exclusion, powers to demand the distribution of trust property are taken into account only if: (1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power and disregards those that are found to be essentially lacking in substance. In view of the prevalence of Crummey powers that essentially lack substance, the practical effect of this option would be to eliminate Crummey powers as a planning tool in a wide range of cases.

Effective Date

The first option is effective for transfers made after the date of enactment.

The second and third options are effective for transfers made to trusts that are established after the date of enactment.

Discussion

In general

Crummey arrangements are often essentially shams, and yet they are for the most part respected for gift tax purposes. While it is arguably troubling for any arrangement essentially lacking in substance to be given credence for any purpose under the tax law, it nevertheless may be appropriate to distinguish among various uses of Crummey powers. In many cases, even though the Crummey power is essentially a sham, the results may be considered unobjectionable, as the powers may be used simply to provide somewhat greater flexibility in making a gift in trust to a single person without running afoul of the present-interest constraint. In other cases, the results may be considered more objectionable, such as when the powers are used to claim multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person.

Option 1

If Crummey powers held by individuals with no significant interest in the underlying trust assets are respected for purposes of determining the annual exclusion, then taxpayers are effectively free to mint multiple annual exclusions for what is in substance a gift through the trust to a single beneficiary. This power to mint exclusions is limited only by the number of friends and relatives that a donor can find and can trust not to exercise the withdrawal right during its brief existence. The use of Crummey powers for this purpose is an abuse of the annual

exclusion and may cause significant erosion of the transfer tax base. By requiring a Crummey power holder to be a significant, vested beneficiary of the underlying trust, the first option would curtail this abuse of Crummey powers. At the same time, this option would preserve the availability of the powers for the more limited purpose of allowing a donor to place practical constraints on a donee's enjoyment of a gift without running afoul of the present-interest limitation. This option would not affect standard life insurance trusts. Because this option narrowly targets abusive applications of Crummey powers, it is effective for transfers made after the date of enactment, regardless of whether the trust already existed prior to enactment.

Option 2

Crummey powers arguably have eviscerated the present-interest requirement. This requirement was originally designed to protect the integrity of the per-donee annual exclusion amount under the gift tax. As the *Cristofani* case illustrates, if an exclusion amount is allowed to attach to an interest that lapses, then it becomes possible for the benefit of the gift shielded by the exclusion ultimately to inure to some other person, resulting in an inappropriate multiplication of the exclusion amount. Narrowly targeted anti-abuse rules that leave Crummey powers basically intact--like the first option above--may leave open some avenues of abuse. The second option ensures that the benefit of a gift will inure only to the holder of a withdrawal power, by respecting that power for tax purposes only if it never lapses. On the other hand, as noted above, Crummey powers are well-established tools widely used for the purpose of making a gift in trust to a single person without running afoul of the present-interest constraint. Eliminating the powers could force a large number of individuals to revisit their family financial plans, although this problem would be mitigated significantly by grandfathering transfers made to existing trusts.

Option 3

Some may argue that Crummey powers are objectionable only insofar as they are effectively shams. According to this view, the case law on this subject is problematic only because it allows "wink and a nod" arrangements to dictate tax results, with little analysis of the surrounding facts and circumstances. It would arguably be inappropriate to disregard a lapsing withdrawal power that might actually be exercised as a practical matter, thus making the second option too aggressive according to this view. In such a case, possession of the power actually is tantamount to ownership of a present interest in property. The IRS and the courts are equipped to examine the substance of these arrangements, and doing so arguably would lead to appropriate, commonsense results: illusory powers would be given no tax effect, and real powers would be given tax effect. As a practical matter, if such a rule were applied vigorously, it would eliminate most common Crummey arrangements, as such arrangements generally involve powers that are not expected to be exercised. Thus, like the second option above, this option could force a large number of individuals to revisit their family financial plans (and thus, this option also would grandfather transfers to existing trusts). This option would present the administrative and compliance difficulties common to all rules that require facts-and-circumstances determinations.