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REPORT ON TRANSFER TAX RESTRUCTURING

AMERICAN BAR ASSOCIATION SECTION OF TAXATION
TASK FORCE ON TRANSFER TAX RESTRUCTURING*

1. INTRODUCTION

This report is submitted to the Council of the Section of Taxation, American Bar Association as a proposed response to the request of the Treasury Department for suggestions for reform of the Federal transfer taxes (the estate, gift, and generation-skipping transfer taxes). That request was contained in a letter dated November 19, 1985, from Ronald A. Pearlman, the Assistant Secretary (Tax Policy), to Hugh Calkins, then Section Chair.[1] After receiving individual comment papers on the subject from members of the Section's Committee on Estate and Gift Taxes, Mr. Calkins, on April 14, 1986, created this Task Force and asked it to prepare a more fundamental response.

The Task Force has received comments on an earlier draft of this report from members of Council, members of the Committee on Estate and Gift Taxes, and others. Comments of general interest are summarized below:

A. Some view, as the worst feature of the present transfer tax system, the complexity it generates for estate planning and will and trust drafting. They state that revision efforts should focus on a simpler and more neutral transfer tax system.

B. Others observe that change itself is complex. They find even more need for repose in the transfer taxes than in the income tax. At a minimum, if transfer tax revision must be attempted, it should be done carefully and with adequate opportunity for outside study and comment before enactment.

C. Most agree that transfer tax reform would be more acceptable if it were revenue neutral. Broadening of the transfer tax base (whether as suggested below or otherwise) should be offset by lower rates, a larger exemption (or equivalent credit) or both. The issue of the optimum transfer tax revenue yield should, if addressed, be addressed independently.

While the first two comments are somewhat at odds, our Task Force believes that all three have merit. Change to reduce complexity is desirable, but should

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This report has not been approved by the Council or membership of the Section of Taxation, and does not represent the position of the American Bar Association or the Section of Taxation. The members of the task force are K. Jay Holdsworth (Chair), Ronald D. Aucutt, Edward B. Benjamin, Jr., Kenneth W. Bergen, and James B. Lewis.

The report was transmitted to the Office of the Assistant Secretary for Tax Policy of the United States Treasury Department on May 27, 1987.

[1] A copy of that letter is attached as Exhibit A. (Ed. Note: All exhibits are represented at the end of this article.)

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not be undertaken hastily and without opportunity for outside comment.

2. PURPOSES OF THE TRANSFER TAXES

The transfer taxes serve, among other purposes, to limit the perpetuation of large private concentrations of wealth and, in furtherance of that purpose, to generate revenue. The gift tax not only backs up the estate tax, but it also discourages, or compensates for, loss of income tax revenue from transfer of income-producing assets from one owner to another in lower income tax brackets.

These are among the appropriate purposes of the federal transfer tax system. The revenue generated by the transfer taxes should be sufficient to achieve the above and other appropriate purposes, but it does not necessarily follow that the transfer taxes need be a major component of the federal revenues.

The present transfer tax system, with modifications, is adequate to carry out the stated purposes. The virtues of familiarity and working experience make a modified version of the present system preferable to untested alternatives.

3. THE ISSUE OF COMPLEXITY

As noted above, one of the chief complaints about the present system is that it complicates estate planning, wills, and trust instruments, perhaps unduly.

A. *The nature and magnitude of the issue*

To acquaint readers who are unacquainted with this subject with the nature of the complexity, we attach, as Exhibit B, a will clause illustrative of many in current use. We submit that a testator, even if above average intelligence, is unlikely to understand, or if he was once told, to remember, all that such a will clause is intended to accomplish.

Take the case of *H*, who has $5 million and his spouse, *W*, who has no monetary assets. Assume that *H* dies first. He may wish to postpone until *W's* death payment of estate tax on that portion of his estate that would otherwise fall into the top rate bracket. To do so, he would qualify that portion of his estate for the marital deduction. However, to prevent permanent loss of estate tax savings (particularly, the $600,000 exemption equivalent of the unified credit and, if desired, the portion of his estate taxable at rates below the top rate), he must limit the marital deduction so that he has a taxable estate large enough to absorb those benefits. Will clauses of considerable complexity are used for that purpose. The portion of the estate thus made ineligible for the marital deduction is referred to by some as the credit shelter portion or trust.

There is, of course, the risk that *W* may die first. To prevent the lapse of the estate tax savings potentially available to *W*, other estate planning measures

may be taken. *H* may transfer to *W* during her life property sufficient to absorb, at *W's* death survived by *H*, the $600,000 exemption equivalent of the unified credit and, if desired, the lower estate tax rate brackets. *W* must then dispose of that property so as not to qualify it for the marital deduction. If *H* is unwilling to give *W* that amount of property, he may give her the income from the property for life and elect to qualify the property for the gift tax QTIP marital deduction. In either case, the gift tax marital deduction shields *H* from gift tax.

If everyone followed the above courses the only problem would be complexity. The lack of stability of many marriages and other factors impede many from taking those tax saving steps. The fact that everyone does not act as described above introduced the additional factor of inequality in taxation. Those who do not so act are more heavily taxed than those who do.

We propose in this section 3 a number of reforms that, collectively, would simplify estate planning, wills, and trust instruments. Briefly stated, these proposals are for a flat tax rate, a flat-rate state death tax credit, conversion of the unified credit into an exemption, and portability of the exemption between spouses.

B. *Proposed flat rate tax*

Tax rate levels are primarily a political and economic issue. Nevertheless, the choice between the scheduled post-1987 rate structure and a flat rate presents also an issue of simplification.

The purpose of a progressive rate structure is to implement the concept of taxation in accordance with ability to pay. However, that purpose could also be served by utilization of a substantial exemption and a flat rate. The table below compares, for estates of stated sizes, the progressivity of (a) a low-exemption progressive-rate estate tax (we have used the pre-1977 estate tax, with a $60,000 exemption and 25 rate brackets ranging from 3% to 77%) and (b) a high-exemption flat-rate tax (we have assumed a $600,000 exemption and a flat 50% rate). The two right-hand columns show that the effective rate of the latter tax is approximately as progressive as that of the former.

Taxable estate before exemption	*Tax under clause (a) above*	*Tax under clause (b) above*	*Effective tax rate under (a)*	*Effective tax rate under (b)*
$ 500,000	$ 126,500	$ -0-	25.30%	-0-
1,000,000	303,500	200,000	30.35%	20%
2,000,000	726,200	700,000	36.31%	35%
3,000,000	1,231,400	1,200,000	41.05%	40%
4,000,000	1,802,000	1,700,000	45.07%	42.5%

The scheduled post-1977 seven-bracket rate table (37% to 50%)[2] is a truncation of the more progressive rate table enacted in 1976. For a taxable estate that reaches the top 50% bracket, the post-1987 rate table will produce a tax of only $117,000 less than a flat 50% rate and a $600,000 exemption would produce. The complexity in estate planning required to duplicate that tax saving for a married couple is, as we have shown, substantial. Some testators and their lawyers sacrifice that tax saving, in part to avoid the complexity.

Substitution of a flat rate for the present rate table would simplify estate planning and still preserve progressivity.

C. *Proposed flat-rate state death tax credit*

The present limit on the state death tax credit is provided by a 20-bracket table ranging from 0.8% for the portion of the taxable estate between $100,000 and $150,000 to 16% for the portion of the taxable estate exceeding $10,100,000.[3] The percentages in that table are set at 80% of the estate tax rates enacted by the Revenue Act of 1926.

As originally enacted, therefore, that state death tax credit was a straight percentage (80%) of the federal estate tax pre-credit liability. Obviously, a straight percentage is easier to work with than a multi-bracket table. Moreover, there is no rationale that supports a limit of different percentages on the credit for estates of different sizes.

Particularly in view of the above suggestion that there be a flat-rate federal tax, the limit on the state death tax credit should be reformulated as a flat percentage of the federal tax. The determination of the level of that percentage is a political issue, but there is a good argument for setting a percentage that would not substantially change the division of death tax revenues between the federal and state governments.

This proposed change in the state death tax credit should have a significantly deferred effective date, to permit state governments to consider what, if any, conforming changes should be made in their death tax statutes.

D. *Proposed exemption rather than credit*

If the proposal outlined in B above for a flat tax rate is adopted, a unified exemption should be substituted for the unified credit.

An exemption is preferable to a credit because an exemption is easier to understand and use.[4] With a flat rate, the argument in favor of a credit, namely,

[2] The reference in the text is to that part of the rate table in Code section 2001(b) applicable to estates exceeding the exemption equivalent of the $600,000 unified credit.

[3] For post-1986 estates taking the full unified credit against the estate tax, the effective limit on the state death tax credit is stated in 15 brackets, starting at $600,000 and ranging from 4.8% to 16%.

[4] The exempt amount can be determined without multiplication or use of a conversion table.

that an exemption is worth more to the wealthier who are in the higher brackets, disappears.

E. *Proposed portability of exemption between spouses*

Any exemption unused by a married individual or his estate should be made available for use after his death by his surviving spouse during her life or by her estate at her death.[5]

If that change were made, married testators would no longer need to utilize, for the purposes stated in A above, the complex credit shelter trust clauses illustrated by Exhibit B.[6] They would also no longer be required to consider lifetime transfers to the nonpropertied spouse to permit consumption of her exemption if she dies first.

This proposal for portability of the exemption is consistent with the existing gift-splitting and marital deduction provisions in treating husband and wife as, in effect, a single taxable unit.

The considerations that support portability of the exemption between spouses apply also to the generation-skipping transfer tax exemption. Techniques similar to those described above may be used today to duplicate that exemption where one spouse is unpropertied or insufficiently propertied. Portability would simplify.

In proposing portability of the exemption, we have not overlooked two problems that we now address. On balance, we submit, our proposal is simplifying despite the presence of those problems.

(i) *Situation where nonpropertied spouse dies first*

Assume that the first spouse to die is *W*, who has either no monetary assets or insufficient such assets to utilize fully the exemption.

We recommend that, as a condition to the proposed portability, *W's* executor be required to file a timely estate tax return. A simplified return form (say, Form 706EZ) might be promulgated for that purpose.

Because that return would show no estate tax liability, the Internal Revenue Service would not be expected to audit the return. For that reason, the Service should be permitted to adjust values on *W's* return when it audits *H's* subsequent return, but, if three years have expired after the filing of *W's* return, only for the purpose of determining *H's* estate tax liability.

Any human tendency to understate the value of *W's* assets would, at least

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[5] Unless otherwise stated, references in this report to the donor spouse or deceased spouse are in the masculine gender and references to the donee spouse or surviving spouse are in the feminine gender.

[6] They might have other reasons for creating nonmarital deduction gifts or bequests (e.g., to make current provision for children or to shield future appreciation in value from tax), but the trust or will clauses used for those purposes could be simple.

to some extent, be offset by the human tendency not to lose some income tax basis by understating their value.

While, in itself, the need for *W's* estate tax return complicates, we regard that complication as necessary to attain the simplification of portability of exemption.

The above procedure would be simplified where, as would frequently occur, *W* left everything to *H.* In that case, *W's* executor could, by checking the appropriate box on the return, avoid having to list on the return *W's* properties and their values.

(ii) *Successive marriages*

The other problem is whether the prospect of successive marriages makes portability unworkable. We do not see the problem as a sufficiently serious one to block portability.

First, we are proposing portability at death only, and not on divorce. The Tommy Manville scenario, therefore, is irrelevant to our proposal.[7] We know of husbands who have buried two, or even three, wives, but they are relatively rare.

Next, there is no problem where the propertied spouse dies first. Today, that spouse's estate tax benefits are generally used at his death by limiting the marital deduction. Under the proposal, portability would be an alternative.

We shall consider two situations in which the nonpropertied spouse (identified as *W*) dies first and *H* remarries.

Order of deaths: W1, W2, H. Various rules could be devised. Subject to the further discussion below, the assets of *W1* and *W2*, or the assets of *W2* only might be counted.

Order of deaths: W1, H, W2. The prospect of three exemptions, either today or under portability, must be considered.

Today, *W1's* exemption is utilized if *H* makes a sufficient lifetime transfer to her or for her benefit and she does not return the property to *H.* By making part of his estate ineligible for the marital deduction, *H* utilizes his exemption and enables *W2* to utilize her exemption. Three exemptions are, with careful planning, thus utilized today. Allowance of three exemptions under portability would, therefore, not exceed the number available today.

To return to the earlier-discussed order of deaths *(W1, W2, H)*, three exemptions are also available today. *H* would have to transfer sufficient property during life, first to or for the benefit of *W1* and later to or for the benefit of

[7] Had present law been in effect, Mr. Manville could have made a lifetime transfer to each of his 11 successive blond young wives, creating a total of 12 exemptions including his own.

W2, and W1 and W2 would have to make adequate nonmarital bequests.

The prospect of successive marriages did not prevent enactment of the marital deduction or the subsequent lifting of the 50% limitation thereon. We are aware of no evidence of significant abuse. The same should be true, we suggest, of the proposed portability.

F. *Revenue neutrality*

The proposed flat tax rate, if it were set at 50%, would increase the tax liability on that portion of the taxable estate that does not exceed $2.5 million by as much as $117,000. The other proposals described above would have smaller revenue impact.[8] The dominant revenue impact of a 50% flat rate suggests that compensating revenue neutrality should take the form of an increased exemption rather than rate reduction.

Inevitably, enactment of the above proposals and a compensating increase in the exemption would increase estate tax burdens of some estates and reduce those of others. We show below the tax impact for taxable estates at various levels up to $2,500,000, computed under the arbitrary assumption that an exemption increase from $600,000 to $750,000 would make the above proposals revenue neutral.

Taxable estate	*Tax under present law*	*Tax with assumed $750,000 exemption and 50% rate*	*Increase (or decrease) in tax*
$ 750,000	$ 55,500	-0-	($55,500)
1,000,000	153,500	$125,000	(28,500)
1,250,000	255,500	250,000	(5,500)
1,328,571	289,286	289,286	-0-
1,500,000	363,000	375,000	12,000
2,000,000	588,000	625,000	37,000
2,500,000	833,000	875,000	42,000

In short, estates of more than $1,328,571 would have their taxes increased, but in no case by more than approximately 5% (maximum of $42,000). Estates of less than $1,328,571 would have their taxes decreased by as much as $55,500, with the larger decreases in the lower levels.

Those changes in tax burden must, of course, be weighed against the simplification that would flow from the above proposals. We submit that the arguments for simplification should prevail.

[8] The proposed flat-rate state death tax credit would benefit smaller estates and increase tax on larger estates. The proposed exemption portability would benefit, primarily, the less sophisticated estate planners and thus, presumably, the smaller estates.

Akron Tax Journal, Vol. 5 [1988], Art. 7

4. GIFT TAX ANNUAL EXCLUSION

The present per-donee gift tax exclusion has led to complex rules and to serious tax avoidance, particularly in the use of so-called *Crummey* trusts. Moreover, the current level of the per-donee exclusion permits large-scale escape from transfer tax for a donor with many descendants or other donees.

An obvious alternative would be substitution of a flat per-donor annual exclusion of say, $30,000. However, a $30,000 annual exclusion might be regarded as excessive in some situations, for instance, for a divorced or widowed parent with one child.

The proposal below responds to the above problems. Under the proposal:

A. Subject to paragraphs B through E below, the first $10,000 of gifts to each donee in any calendar year would be excluded.

B. ABA Legislative Recommendation No. 1958-11 would be enacted to replace the "other than gifts of future interests" provisions of Code sections 2503(b) and (c).[9] If that were done, the interests qualifying for the exclusion might be described as "vested interests." See the comment in the last paragraph of this section 4.

C. The total exclusions for any calendar year, thus computed, would be limited to a maximum of, say, $30,000 per donor. The following gifts would not count against the $30,000: charitable or marital gifts deductible under Code section 2522 or 2523 or gifts to political organizations excluded by Code section 2501(a)(5).

D. To eliminate concern over the possible need to report relatively small gifts in excess of the $30,000, there would be an additional *de minimis* per-donee exclusion (of, say, $100) for donees not covered by the $30,000. That would prevent the requirement of a return where, for example, a widow gives $10,000 to each of her three sons and a $20 graduation present to a niece.

E. The above $10,000, $30,000, and $100 amounts would be doubled for a married couple.

The above proposal is built on the current $10,000 per-donee exclusion, and the amounts are intended to be illustrative. Other monetary limits could be established; the levels are political or economic issues. The proposal should be considered in conjunction with the proposal in section 5 below relating to the exclusion for educational and medical expenses.

The proposal in paragraph B would make *Crummey* powers unnecessary in many cases, i.e., where the donor chooses to create vested interests. To complete the elimination of the *Crummey* problem, it would also be necessary to tax the lapse of a "five-and-five" power of appointment, as proposed in sec-

[9] A copy of ABA Legislative Recommendation No. 1958-11 is attached as Exhibit C.

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tion 10A below.

5. GIFT TAX EXCLUSION FOR EDUCATIONAL AND MEDICAL EXPENSES, ETC.

The monetarily unlimited gift tax exclusions for payments of educational expenses and medical expenses should remain in effect. The exclusion for educational expenses should be expanded to cover items other than tuition. If that were done, the rule requiring payment directly to the supplier should be relaxed, at least in part.

Under the present law, payments for support of someone who is not the donor's legal dependent are gifts for gift tax purposes because they are not in discharge of the donor's legal obligation. The rationale for excluding payments of educational and medical expenses of nondependents logically extends to other payments for support of nondependents. This problem would be exacerbated by enactment of the $30,000 per-donor exclusion cap proposed in section 4 above.

The difficulty in extending the exclusion to other support payments to nondependents lies in the potential for abuse. That difficulty has led us to conclude, reluctantly, that the exclusion should not be extended to cover support payments for nondependents other than for educational and medical expenses.

6. GROSS-UP OF GIFT TAX

Under the present law, the estate tax base is tax-inclusive and the gift tax base tax-exclusive.[10]

A. *The Treasury proposal*

The Treasury Department, in its 1984 report to the President on tax reform,[11] proposed that the gift tax base be made tax-inclusive. The Treasury advanced two arguments in support of that proposal. First, its adoption would, by eliminating one of the preferences accorded lifetime gifts, make the transfer tax system more neutral.[12] Second, its adoption would facilitate adoption of a uniform and simpler set of gift and estate tax rules for determining when a

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[10] The following example contrasts the tax-inclusive (estate tax) and tax-exclusive (gift tax) bases. In 1988, when the top transfer tax rate is scheduled to drop to 50 percent, *A*, a widower with one child *(S)*, has made taxable gifts of $2.5 million in prior years (all more than three years previously), has given *S* $10,000 (the amount qualifying for the gift tax exclusion) during 1988, and has $1 million remaining. In that situation:

(a) If *A* dies and leaves his estate to *S*, the estate tax will be $500,000 and *S* will receive $500,000.

(b) If *A* instead makes a lifetime gift of his property to *S*, retaining $333,333 to pay the gift tax on the donated $666,657, and if *A* survives that gift by three years (thus escaping the grasp of Code section 2035(c)), *S* as *A's* donee will receive $666,667 (one-third more than under subparagraph (a)). To produce the same tax in the above example, the estate tax rate would have to be reduced to 33-1/3 percent or, alternatively, the gift tax rate would have to be increased to 100 percent.

[11] OFFICE OF THE SECRETARY, DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, (1984).

[12] *Id.* at 376. The Treasury acknowledged that other preferences for lifetime gifts would remain, namely, the $10,000 annual exclusion and the elimination from the tax base of post-gift appreciation in the value of the transferred property. *Id.*

transfer is complete.[13]

B. *Introductory comment*

If this feature of the transfer taxes is viewed in isolation, there are arguments for and against the Treasury proposal. The argument for the proposal is, simply stated, a vote for tax rate neutrality. The arguments against the proposal are two:

(1) Many believe that a transfer tax system that encourages lifetime giving is socially and economically beneficial because such a system causes business and investment capital to be moved into the hands of younger, more vigorous owners.

(2) If the gift tax is regarded as an advance payment of estate tax, the Treasury has the earlier use of the tax money. The gift tax advantage, therefore, may be analogized to a discount for early payment. To obtain that discount, the payment must be substantially (more than three years) early, because of the gross-up of gift tax required by Code section 2035(c) for gifts made within three years of death.

On the narrowly-focused debate outlined above, views (including those of members of the task force) might be expected to diverge. However, when other features of the existing transfer tax system are taken into account, the case for the Treasury proposal becomes more tenuous, as we shall now show.

C. *Income tax basis*

Property that has appreciated in value, if transferred at death, is given a new income tax basis equal to its fair market value on the estate tax valuation date. If transferred by gift, the basis of such property is augmented only by the gift tax allocable, under a proportional formula, to the element of the gift consisting of unrealized appreciation in value.

In his letter to Mr. Calkins (Exhibit A), Mr. Pearlman observed that, for gifts in the top 50% rate bracket, the Treasury proposal would cause basis to be stepped up to fair market value.[14] We have several problems with that observation.

First, the result is merely fortuitous. If rates are reduced, disparity will be reintroduced.

Second, relatively few gifts are taxed in the top bracket. For all gifts below that bracket, i.e., for almost all gifts, the gift tax basis adjustment does not

[13] *Id.* at 378.

[14] To illustrate, assume a gift by a top-bracket donor of property having an income tax basis of $300,000 and a fair market value of $800,000. The gift tax, if the tax base is made tax-inclusive and the top rate is 50%, would be $800,000. Five-eighths of that tax ($500,000), the portion allocable to the unrealized appreciation in value, would be added to basis, stepping basis up to fair market value.

fully eliminate gain.

Third, the adjustment described by Mr. Pearlman does not aid the donor who must sell other appreciated property to pay the gift tax. Assume, in the example in footnote 14, that the donor must sell other property, which is also worth $800,000 but has a basis of $300,000, to make the gift tax payment. The donor thus incurs income tax on the $500,000 of gain. No similar problem arises for transfers at death, because the basis of all property so transferred (including the portion that has to be sold to pay estate tax) is adjusted to fair market value.

D. *Other differences*

Other Code provisions that provide relief or benefits in connection with the estate tax, but not the gift tax, are section 303 (redemption of stock to pay estate taxes), section 2032 (alternate valuation), section 2032A (special use valuation), and sections 6161(a) (2), 6163, and 6166 (deferment of payment of estate tax).

E. *Concluding observations*

It may be reasonably argued, therefore, that the present system is one of rough justice. Our task force believes that the Treasury proposal should not be enacted at least so long as the income tax basis of property in the gross estate continues to be adjusted to fair market value.[15]

Also, in our opinion, gross-up of the gift tax is not essential to adoption of a uniform set of completed transfer rules (see section 7 below). The fact that estate tax collections exceed by many times gift tax collections indicates that the preferences accorded gifts are not sufficient to deplete estate tax revenues seriously. We do not believe that the uniform transfer completion rules proposed below would significantly tilt the balance.

7. UNIFORM TRANSFER COMPLETION RULES

A. *Introduction*

Approximately 40 years ago a Treasury study recommended adoption of a uniform set of rules, for gift and estate tax purposes, of what is a completed transfer.[16] Unification of the gift and estate taxes in 1976 (also an objective of the Treasury study) makes adoption of a uniform set of such rules even more desirable.

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[15] See in that connection section 14 below.

[16] The Treasury study also recommended that those rules be correlated with the income tax. Although we recognize the argument for at least substantial conformity with the grantor trust rules, other considerations, discussed below, have led us to propose a set of transfer tax rules that are not conducive to such conformity.

Present law is, briefly, as follows:

(i) *Gift tax:* A gift is incomplete when the donor has retained dominion and control, so as to leave him with power to change the disposition of the property for his own benefit or for the benefit of another. Regs. section 25.2511-2.

(ii) *Estate tax:* A lifetime transfer is incomplete if the transferor (a) retains dominion and control (i.e., the power to change the disposition of the property for his own benefit or for the benefit of another), (b) retains the income from the transferred property or dominion and control over the income (whether for his own benefit or the benefit of another), (c) retains a sufficiently large reversionary interest in the property and postpones enjoyment of subsequent interests of others therein until his death, or (d) in the case of transferred stock, retains voting power. Code sections 2036 through 2038.

The above-stated rules are further complicated by other differences between the two taxes: (a) Powers to change the disposition held jointly by the transferor and another person make the transfer incomplete, except that, for gift tax purposes only, the transfer is complete if the other person has a substantial adverse interest in the disposition of the property. (b) Where the transferor empowers another person to return the property to the transferor, some court decisions suggest that the transfer may be complete for estate tax purposes[17] but not the gift tax purposes.[18] (c) Powers to accumulate income or to invade principal apparently do not prevent a transfer from being complete, but only if they cannot be used to shift the disposition from the income beneficiary to the remainderman or vice versa.[19]

We propose a much simpler set of rules, to be applied for both gift and estate tax purposes: Two categories of transfers would be incomplete: (a) Those under which the transferor can recover the transferred property, through exercise of a power retained by him or conferred by him on another; and (b) those under which the transferor will receive the income from the transferred property, or can do so through exercise of a power retained by him or conferred by him to another. All other transfers would be complete, including those with retained dominion and control over disposition among persons other than the transferor. One of our objectives is to create relatively bright lines that will minimize uncertainty and controversy.

[17] *E.g.*, Estate of Sherman v. Commissioner, 9 T.C. 594 (1947); McCullough v. Granger, 128 F. Supp. 611 (W.D. Pa. 1955).

[18] *E.g.*, Estate of Gramm v. Commissioner, 17 T.C. 1063 (1951). *But see* Rev. Rul. 54-538, 1954-2 C.B. 316.

[19] *Compare* Regs. § 25.2511-2(d) (gift tax) *with* the cases cited *infra* note 24 (estate tax).

B. *The proposed rules*

The proposed uniform transfer completion rules are, in more detail, as follows:

Rule a: *Revocable transfers*

A revocable transfer would be an incomplete transfer for gift and estate tax purposes.

The term "revocable transfer" would be broadly defined to include a transfer subject to any express power to return the transferred property to the transferor. Such powers would include powers so exercisable solely by the transferor, by the transferor in conjunction with another person or persons, or solely by another person or persons. In other words, the transfer would be complete only if the transferor does not create a power expressly exercisable for his own benefit.

The above rule would apply without regard to whether the power is subject to an ascertainable standard. The rule would also apply without regard to whether the holder of the power has a substantial adverse interest.

However, the following powers would not make a transfer revocable: (1) The ability of the transferee as owner of the property to give or bequeath the property back to the donor. (2) A general power of appointment created by the instrument of transfer in a person other than the transferor. (3) A nongeneral power of appointment (exercisable in favor of a defined class or classes of persons or in favor of anyone other than designated persons or classes of persons) created by the instrument of transfer in a person other than the transferor, even though the transferor is not excluded as a potential appointee. If these exceptions were not made, outright transfers and other traditional forms of disposition would be incomplete.

In developing this proposed rule, we started with two assumptions: (1) that a revocable transfer should be incomplete and (2) that an outright gift should be complete. Of the many intermediate points at which the line could be drawn, the one proposed by us has, at least, the virtue of certainty. Wherever the line is drawn, there will be cases on either side that resemble one another. Those cases, under our proposal, are the express power in another to return the property to the transferor (incomplete) and the nongeneral power in another to appoint among a class that includes the transferor (complete).[20]

The rule under discussion (Rule a) would apply to currently exercisable powers over the principal of the transferred property. A power over income only would be tested under Rule c below. A power over a future interest would be tested under Rule d below.

[20] We propose to treat as complete transfers that confer nongeneral powers of appointment of the sort described in the text on persons other than the transferor, because of their common use.

Examples showing the operation of Rule a are set forth below:

(i) *T*, owner of Blackacre in fee, transfers Blackacre, reserving a power to revoke. The transfer is incomplete under Rule a.

(ii) Same as (i), except that the power to revoke extends only to an estate for *T*'s life. The transfer is wholly incomplete but the operative rule is Rule c below, and not Rule a.[21]

(iii) Same as (i), except that the power extends only to a future interest. Rule d, and not Rule a, applies.

(iv) Same as (i), except that the power extends only to, say, an undivided one-third fractional interest, an undivided 15% interest, an interest described in terms of value (a $100,000 undivided interest), or an interest described by metes and bounds, in the Blackacre fee. Rule a applies pro tanto.

(v) Same as (i), except that *T*, not having reserved the power to revoke, later had such a power conferred on him independently (i.e., not pursuant to an understanding had at the time of transfer). The transfer is complete. Subjection of the transferred property to estate tax on *T*'s death would be tested under the power of appointment provisions. That would eliminate the second parenthetical expression in Code section 2038(a)(1) (the words "without regard to when or from what source the decedent acquired such power"), but would codify the last sentence of Regulations section 20.2035-1(a).

(vii) Same as (i), except that the power is exercisable by *T* in conjunction with another person or persons. The transfer is incomplete under Rule a.[22]

(viii) Same as (i), except that the power is exercisable solely by another person or persons. The gift is incomplete under Rule a.[23]

Rule b: *Retained power to vary beneficial interests of others*

A transfer with no power to revoke but with a power to vary the beneficial interests of other persons would be a completed transfer for gift and estate tax purposes.

In developing Rule b, we started with the desire to eliminate the result of estate tax cases that treat as incomplete transfers in trust with the reserved power to accumulate income or invade corpus.[24] Finding it hard to distinguish such powers from powers to vary beneficial interests of others generally, we decided

[21] Consistent with the scope of Rule a, the results stated in example (ii) (and in the succeeding example (iii)) would apply without regard to whether the power is subject to an ascertainable standard or whether the holder has a substantial adverse interest.

[22] Suggested conforming changes to the power of appointment provisions are discussed in section 10D below.

[23] *See supra* note 22.

[24] *E.g.*, Lober v. United States, 346 U.S. 335 (1953); Commissioner v. Estate of Holmes, 326 U.S. 480 (1946); Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955); Industrial Trust Co. v. Commissioner, 165 F.2d 142 (1st Cir. 1947); Estate of Yawkey v. Commissioner, 12 T.C. 1164 (1949).

to eliminate all such powers as taxable strings if they cannot be exercised in favor of the transferor. Although we realize that Rule b may impede correlation of the transfer taxes with the income tax in this area, we nevertheless support the proposed rule for the reasons stated.

We note that adoption of Rules a and b would neutralize, from the transfer tax standpoint, the trust creator's choice of himself or another as trustee. In doing so, these proposed rules would put to rest the controversy engendered by Rev. Rul. 79-353,[25] which held that retention by the creator of a discretionary trust of the power to change the trustee made the transfer incomplete for estate tax purposes. That should permit, and make desirable, revocation of Rev. Rul. 79-353.[26]

Enactment of Rule b would require elimination of those portions of Code sections 2036(a)(1) and 2038 that relate to powers not exercisable in favor of the transferor.

Rule c: *Retained income interest*

A transfer with a retained income interest would be an incomplete transfer for gift and estate tax purposes, i.e., there would be a tax at expiration of the retained interest. The gift tax now imposed on the lifetime transfer of the remainder would be eliminated.

For this purpose, consistent with Rule a, the transferor would be treated as retaining an income interest if he or anyone else has an express power to pay the income to the transferor. Here again, the ascertainable standard and adverse interest concepts would be eliminated.

A problem in applying Rule c would arise where the transferor transfers property in trust and retains either an annuity payable out of trust income or principal, or the right to withdraw a fixed amount or percentage of principal, annually. We propose that such payments be treated, for purposes of Rule c, as though they were income. There would remain a problem of measurement. If the payment or amount withdrawable is less than the entire income, the transfer would be incomplete pro tanto; if it is equal to or greater than income, the transfer would be wholly incomplete. The statute should, we propose, provide that such measurement be established by prediction, utilizing a prescribed rate of return.

Another problem in applying Rule c would arise where *A* transfers property to *B* in return for *B*'s promise to make a stream of payments (such as a life annuity) to *A*. At one extreme, the transaction may be economically equivalent to retention of all or a part of the income. At the other, it may be

[25] 1979-2 C.B. 325.

[26] ABA Legislative Recommendations No. 1984-4 recommends that the Internal Revenue Code be amended to overrule the result of Rev. Rul. 79-353.

a sale for full (or for substantial, but inadequate) consideration. Here again, there are problems of classification, which the statute should address.

Examples showing the application of Rule c, in addition to Example (ii) under Rule a, follow:

(i) *T*, owner of Whiteacre in fee, transfers Whiteacre, reserving a life estate. Rule c applies, so that there would be an estate tax at *T*'s death but no gift tax on the lifetime transfer.

(ii) Same as (i), except that *T* reserves the right to have the income for his life used to discharge his support obligations or otherwise for his pecuniary benefit. Rule c should, in theory, apply, but we note the valuation problem presented.

(iii) Same as (i), except that *T* reserves a fractional, percentile, or otherwise identifiable share of the income for his life. Rule c applies to a corresponding share of Whiteacre.

(iv) Same as (i), except that *T* reserves an estate for 10 years and dies within that period. Rule c applies, without regard to *T*'s life expectancy at the time of transfer.

(v) Same as (iv), except that *T* survives the transfer by more than 10 years. The expiration of *T*'s term of enjoyment is a gift of Whiteacre. There is no estate tax, subject to the potential application of Code section 2035(c).

(vi) Same as (i), except that income from Whiteacre is payable to someone else (say, *T*'s sister *S*) for life and, if *T* survives *S*, to *T* for the balance of *T*'s life. Rule c does not apply, because a retained secondary life estate is not to be treated as a retained life estate for that purpose. There is an immediate gift of the whole of Whiteacre (as under Rule d below). The ripening into enjoyment of the retained secondary life estate will terminate at death.

(vii) Same as (vi), except that *T*'s sister *S* receives income from Whiteacre for one month and *T* receives such income for the balance of his life. Rule c applies. A brief primary income interest in another person should be disregarded, because Rule c would otherwise become, essentially, elective. Some arbitrary rule of substantiality should be developed for this purpose (e.g., for the transfer to be complete, *S*'s interest would have to be either a life estate or an interest the present value of which is, say, 20% of the value of Whiteacre).

(viii) Same as (i), except that *T* transferred Whiteacre in trust, reserved to himself semiannual payments of trust income, and further provided that the trust income between the last semiannual payment date and his death should not be paid to *T* or his estate. Rule c applies. That corresponds to present law.

(ix) Same as (i), except that someone (*T*, another person, or both) has an express power to pay the income from the transferred property to *T* for life.

Rule c applies, i.e., the income is treated as reserved.

(x) Same as (i), except that *T*, instead of reserving the income, obtains the transferee's promise to pay *T* an annuity for life equal in amount to the expected income. Rule c applies (but see the discussion in the fourth paragraph under this rule).

Rule d: *Transfer with reserved future interest*

A transfer under which the transferor retains a future interest in the transferred property would be fully subject to gift tax, without any carving out of the value of the retained future interest. Code section 2037 would be repealed, so as to reduce the impact of the estate tax in this area.

We begin with the view that a retained future interest, unlike a retained income interest, does not make the transfer inherently testamentary. Second, we wish to eliminate the gift tax difficulty of carving out by valuation, actuarially or by other means, the retained future interest. Third, by imposition of gift tax in all such cases, the need to classify for estate tax purposes retained future interests by character or size would become unnecessary. Most retained future interests are obliterated by the transferor's death[27] so that there would be no estate tax if Code section 2037 is repealed.

The following situations, however, must be considered:

(i) The transferor may have retained an absolute reversion in himself and his estate. An example is the popular Clifford ten-year term trust that was used to shift taxation of income before enactment of the Tax Reform Act of 1986. On the death of the transferor during the term of the trust, the reversion is includible in the gross estate under Code section 2033 as property owned by him.

(ii) The transferor may be the fee owner of the property at death because the retained future interest has become possessory. For example, if *A* transfers Blackacre to *A*'s sister (*S*) for life, with reversion to *A* if he survives *S*, and remainder to their brother (*B*) if *A* predeceases *S*, *A* again owns Blackacre in fee if *S* predeceases him. On *A*'s subsequent death Blackacre is includible in his gross estate under Code section 2033.

We do not suggest that section 2033 be made inoperative in the above situations. In the first situation the remainder interest would be taxed twice, and in the second the fee would be taxed twice. If desired, the statute could provide for offset of the first tax against the second.

An example relating to Rule d is Example (iii) under Rule a.

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[27] That is so of the future interests retained in Helvering v. Hallock, 309 U.S. 106 (1940), and its progeny, such as Estate of Spiegel v. Commissioner, 335 U.S. 701 (1949). Many other such interests are too remote to be valued, *e.g.*, the interest in Francis Biddle Trust v. Commissioner, 3 T.C. 832 (1944).

Rule e: *Retained voting power over transferred stock*

Retained power to vote transferred stock should not make the transfer incomplete. Such a power should be classified with a retained power to vary beneficial interests (Rule b). Therefore, Code section 2036(b) should be repealed and the result of *Byrum v. United States*,[28] codified.

C. *Comments on the proposed rules*

In certain respects, the above proposals would make gifts harder to complete. That would be true of transfers that are complete under present law but that would become incomplete under the proposed broader reach of Rules a and c.

In other respects, the above proposals would reduce application of the estate tax to lifetime transfers. That would be true under Rules b, d, and e.

The proposals would greatly reduce overlap between the gift and estate taxes and, therefore, the scope of the final clause ("other than gifts which are includible in the gross estate of the decedent") of Code section 2001(b).

D. *Transition problems in introducing the proposed rules*

For gift tax purposes, the above proposals would apply to gifts (as redefined) made after some reasonable prospective date (if appropriate, on or after the succeeding January 1).

If a lifetime transfer would otherwise be subjected to gift tax twice (first, under prior law before that effective date and, second, under new law after that date), the second tax would not be imposed.

For estate tax purposes, appropriate transition rules should also be provided. Any preenactment transfer excluded from the gross estate under prior law, but includible under the proposal, should be protected from inclusion. Any preenactment transfer includible in the gross estate under prior law, but excluded under the proposal, should be included.

8. TRANSFERS FOR PARTIAL CONSIDERATION

As under present law, transfers for an adequate and full consideration in money or money's worth would not be subject to transfer tax. The gratuitous element of a transfer for partial consideration would continue to be taxed. The present rule that relinquishment of marital rights in the decedent's property or estate is not consideration in money or money's worth would be preserved.

The application of the estate tax to lifetime transfers for partial con-

[28] 408 U.S. 125 (1972).

sideration should be revised and clarified. Code section 2043(a) should be replaced by the more rational formula of ABA Legislative Recommendation No. 1970-5.[29] The peculiar results of valuing the consideration at the date of transfer and the property at the date of death would thus be eliminated. Proportional inclusion is more logical than the holdings in cases such as *Estate of Davis v. Commissioner*.[30]

9. SURVIVOR BENEFITS (SECTION 2039)

Code section 2039 should be amended to eliminate as a test for inclusion of an annuity or other payment in the gross estate thereunder, the possession by the decedent of a right to receive an annuity or payment.[31] All contractual or statutory survivor benefits economically attributable to the decedent would thus be includible in the gross estate. Examples are Social Security death benefits and copyright renewal or termination rights. These rules would cover all payments to a survivor because of the decedent's services, whether as employee or independent contractor. (We also suggest that the title of section 2039 be changed from "Annuities" to "Survivor Benefits.")

All survivor benefits would be taxable at death only, and would in no case constitute lifetime gifts. If the nonemployee spouse were to die first, no property right in the benefit would be included in that spouse's gross estate, but there would be full taxation on the subsequent death of the employee spouse. These rules would apply to community property, to awards on divorce or separation, and to rights created by the Retirement Equity Act of 1984.

Section 2039 would be the exclusive estate tax provision applicable to such payments, to the exclusion of section 2033 and sections 2036-2038.[32] Section 2039, like present section 2042 (relating to life insurance proceeds), would apply to payments receivable by the executor.[33]

Section 2039 would also continue to cover commercial annuities, to the exclusion of section 2036.

Our task force has reached no consensus over the applicability of section

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[29] A copy of ABA Legislative Recommendation No. 1970-5 is attached as Exhibit D.

[30] 440 F.2d 896 (3d Cir. 1971).

[31] That would overrule the result in such cases as Estate of Kramer v. United States, 406 F.2d 1363 (Ct. Cl. 1969), and Estate of Fusz v. Commissioner, 46 T.C. 214 (1966). Death benefits of the type discussed in Technical Advice Memorandum 8701003, Sept. 19, 1986, would come within the scope of section 2039 as thus amended.

[32] The following decisions, among others, which held such payments to be includible under Code section 2033 under prior law, would have no continuing effect: Commissioner v. Estate of Albright, 356 F.2d 319 (2d Cir. 1966); Rosenberg v. United States, 309 F.2d 724 (7th Cir. 1962); Estate of Garber v. Commissioner, 271 F.2d 97 (3d Cir. 1959); Estate of Wolf v. Commissioner, 29 T.C. 441 (1957), *rev'd on other grounds*, 264 F.2d 82 (3d Cir. 1959); Beaver Trust Co. v. United States, 184 F. Supp. 553 (W.D. Pa. 1960).

[33] *See, e.g.*, Goodman v. Granger, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957). The holding of that case that inclusion is not impaired by the fact that the right to the payments had not vested during the decedent's life is intended to survive.

2039 to wrongful death benefits arising from the decedent's death.[34] Some of our members argue that there is no principle for excluding such benefits from the scope of section 2039, but others note that the valuation problem is difficult and may not be resolved during the estate tax assessment period.

A tax apportionment provision similar to that provided in Code section 2206 for insurance proceeds should be enacted for survivor benefits. In community property situations, where one-half of the benefit belongs to the nonemployee spouse (if she survives), or to the beneficiaries under her will (if she does not survive), the tax on that one-half of the benefit would be apportioned accordingly.

The marital deduction provision should be amended to qualify survivor benefits for that deduction if payment of such benefits begins reasonably promptly after the decedent's death and if all such payments during the life of his surviving spouse are payable, at least annually, to such spouse or to a trust for her benefit that qualifies for the marital deduction. That would eliminate the need, as a condition to qualification for the marital deduction, to provide that payments after the death of the spouse be made to her estate.

10. POWERS OF APPOINTMENT

General powers of appointment should continue to be subjected to gift or estate tax. Such powers are too much like outright ownership to be treated differently. The generation-skipping transfer tax is not an adequate surrogate.

A. *"Five-and-five" powers of appointment*

Code sections 2041(b)(2) and 2514(e), which shelter from tax the lifetime lapse of a power to the extent that the appointive property does not exceed the greater of $5,000 or 5% of the assets involved, should be repealed. There is no conceptual justification for that exception.[35] Five percent of a large trust can have a substantial value. This "five-and-five" exception and the resulting *Crummey* problem discussed above, may be routinely exploited by some sophisticated taxpayers. The treatment of the power-holder as the grantor of the affected portions of the trust for income tax purposes creates an area of noncompliance for unsophisticated taxpayers.

Repeal would ameliorate these problems by discouraging the routine creation of "five-and-five" powers. Repeal should be accompanied by appropriate "grandfathering" provisions. Post-repeal additions to existing trusts should not be so protected.

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[34] Tort and contract claims that pass from the decedent under his will are, of course, includible in his gross estate under Code section 2033.

[35] Although some argue that the "five-and-five" power relieves pressures on independent trustees, the task force does not think that argument justifies retention of the "five-and-five" exception.

B. *Powers of appointment subject to an ascertainable standard*

We recommend that powers to invade for the benefit of the holder that are subject to an ascertainable standard be allowed to remain nontaxable. *See* Code sections 2041(b)(1)(A) and 2514(c)(1).

In making that recommendation, we are aware (1) that we propose above (section 7B, Rule a) elimination of the ascertainable standard exception for retained powers and (2) that uncertainty over whether particular words create an ascertainable standard is common to the two areas. Our proposal for retained powers is that, to make a transfer complete, the transferor must eliminate himself as a potential beneficiary. That proposal does not require that, as a corollary, powers of appointment subject to an ascertainable standard be subjected to transfer tax.

Assume that *A* creates a trust for his son (*S*), makes the income payable to *S*, and gives *S* a power to invade principal for *S*'s health, education, or maintenance. If *S* exercises the power, there is, of course, no transfer tax because *S* has not transferred property to someone else. If *S*, in any year, does not exercise the power, it may be because he was not entitled under the standard to do so; here also, there should be no tax. If *S* fails to exercise the power even though he is entitled to do so, there is no tax if he can exercise it in the future. (For example, *S* drops out of college for a year, but reenters in the next year.) Even where a lapse could be alleged, there would be the difficult problem of measurement of the amount transferred.

These powers do not sufficiently involve the ceding of control over property to others to justify imposition of transfer tax on the holder of the power.

C. *Nongeneral powers of appointment*

We recommend retention of the present definition of a general power of appointment as a power exercisable in favor of the holder, his estate, his creditors, or the creditors of his estate.

We acknowledge that the holder of a power exercisable in favor of anyone other than the holder, his estate, his creditors, or the creditors of his estate has substantial dominion and control over the appointive property. However, a broader definition of a general power would introduce undesirable rigidity into dispositive instruments. Such a definition was attempted in the power of appointment provision enacted by the Revenue Act of 1942, and was the subject of much complaint.

Moreover, the subjection of such conferred powers to tax would be inconsistent with our proposal above with respect to reserved powers (section 7B, Rule b).

The present classification (beneficial vs. nonbeneficial powers) has, at least,

the virtue of producing a relatively bright line. For that and other reasons, it should be retained.

D. *Powers that make a lifetime transfer incomplete*

The term "general power of appointment" is defined to exclude a power exercisable jointly with the creator of the power.[36] The unstated (but apparent) purpose of this exclusion is to prevent, or at least to reduce, overlap between the power of appointment and incomplete lifetime transfer provisions. The power retained by the transferor will make the lifetime transfer incomplete under Code section 2038 (if the power is over the transferred property) or 2036 (if the power is over the income therefrom). Because the transferor remains potentially subject to transfer tax, the donee coholder's power is exempted.

If the incomplete lifetime provisions are revised as our task force has proposed (section 7B, *supra*), a conforming change should be made in the power of appointment definition. The term "general power of appointment" should be redefined to exclude any express power to return the transferred property to the transferor or to pay the income from that property to the transferor. Phrased differently, the excluded power would be any power that makes the lifetime transfer incomplete.

E. *Joint powers*

The present estate and gift tax statutes provide three rules governing jointly-held powers of appointment, which we summarize (and, for convenience, label) below:

Rule x: As stated in D above, a power exercisable jointly with the creator of the power is not a general power of appointment.[37]

Rule y: A power exercisable jointly with a person other than the creator is not a general power of appointment if that person has a substantial interest in the appointive property adverse to exercise of the power.[38]

Rule z: A jointly-held power not covered by Rule x or y is a general power of appointment in the hands of any holder on behalf of whom the power can be exercised. If there is more than one such holder, each has a general power of appointment over an aliquot share of the appointive property.[39]

If our proposal in D above is enacted, Rule x should be repealed.

To discuss concretely Rules y and z, we hypothesize a power held jointly

[36] I.R.C. §§ 2041(b)(1)(C)(i), 2514(c)(3)(A).

[37] I.R.C. §§ 2041(b)(1)(C)(i), 2514(c)(3)(A).

[38] I.R.C. §§ 2041(b)(1)(C)(ii), 2514(c)(3)(B).

[39] I.R.C. §§ 2041(b)(1)(C)(iii), 2514(c)(3)(C).

by *A* and *B* (neither of whom is the creator of the power) to appoint Blackacre. We note that:

(i) Rule y apparently applies to *A* (so that *A* has no general power of appointment) where *A* is a permissible appointee and *B* is the taker in default of appointment. *B*'s interest as taker in default is substantially adverse to appointment to *A*.

(ii) In situation (i), Rule y seems incomplete in not addressing the tax status of *B*.

(iii) If Rule y does not apply, and if *A* is a permissible appointee but *B* is not, *A* alone has a general power of appointment over Blackacre (Rule z).

(iv) If *A* and *B* are both permissible appointees and neither is a taker in default of appointment, each has a general power of appointment over one-half of Blackacre (Rule z).

(v) As a variation on (iv), if *A* and *B* are both permissible appointees and if *B* alone is the taker in default of appointment, Rule y (and not Rule z) apparently applies. As a result, *A* does not have a general power of appointment and the tax status of *B* is unaddressed.

(vi) As a further variation on (iv), if both *A* and *B* are permissible appointees, and if *A* and *B* or the survivor of them is the taker in default of appointment, the tax classification is unclear. At least arguably, Rule y applies and neither *A* nor *B* has a general power of appointment.

Further variations could be posited, but enough has been said to indicate the failings of the present system. We propose that this area be reexamined for the purpose of developing a better rule or rules.

The application of Rule z illustrated in (iv) above is a useful starting point. Because *A* and *B*, by cooperating, can divide Blackacre between them, they are treated, in effect, as though they were tenants in common. That might be made the universal rule, and takers in default of appointment, as well as permissible appointees, might be brought within that rule as, in effect, coowners. The resulting rule would, at least, be simple as applied to an area in which no rule, judged subjectively, can be perfect. Creators of powers who wish to avoid the proposed rule can refrain from naming beneficiaries of the power as holders thereof.

F. *Interests owned in property subject to a nongeneral power of appointment*

The possessor of a nongeneral power of appointment may also own an interest (e.g., an estate for years or a vested remainder) in the appointive property. The estate and gift tax regulations provide that if he exercises, releases, or dies possessing that nontaxable power, he is considered to have made a tax-

able transfer of his owned interest.[40] As an example, assume that *T* was the vested remainderman of a trust created by his mother; that he also had a limited power of appointment over the trust property; and that he exercises that power, thus divesting himself of the remainder. Under the regulations, he has made a gift, for gift tax purposes, of the remainder.

The court decisions on this subject are in conflict.[41]

Codification of the rule stated in the regulations (that there is a taxable transfer of the owned interest) would eliminate uncertainty and potential further litigation.[42]

For reasons stated below (section 12H), an exception to the above proposal should be made for transfers between spouses that do not qualify for the marital deduction.

11. PROCEEDS OF INSURANCE ON THE LIFE OF THE DECEDENT (SECTION 2042)

The tax treatment of the life insurance industry and its products is, in part, a political issue. There are also, however, issues of tax equity and efficiency that require discussion.

Under current law and under the recommendations in the above section 9, the question is not whether proceeds of insurance on the life of the decedent should be included in the gross estate, but, rather, the rules that should govern such inclusion. This is not an easy (and has not been to the task force a noncontroversial) subject, but, clearly, (a) escape from the current rules of inclusion of section 2042 is easy and (b) tracing problems made the former premium-payment test for inclusion ineffective, controversial, and difficult to administer.

We attach as Exhibit E, without recommendation, a study paper prepared for our consideration, which discusses alternative approaches to estate tax treatment of life insurance proceeds.[43] However, our task force has failed to develop a consensus on that subject.

In any event, we recommend that proceeds of insurance on the decedent's life payable in installments to his surviving spouse for life and then to others be brought within the QTIP marital deduction provisions. Like survivor benefits (section 9, last paragraph), insurance proceeds should so qualify if payments begin reasonably promptly after the insured's death and if all such payments

[40] Regs. § 20.2041-1(b)(2); Regs. § 20.2041-3(f), examples (1) and (4); Regs. § 25.2514-1(b)(2). These regulations are supported by the committee reports to the Powers of Appointment Act of 1951.

[41] *Compare* Regester v. Commissioner, 83 T.C. 1 (1984) (transfer of owned interest taxable), *with* Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956) (contra).

[42] We recommend that where the owned interest is a remote or minor one, incapable of valuation, there would be no gift tax.

[43] The study paper reflects various individual views, but does not reflect the position of the task force or of a majority of its members.

during the life of the surviving spouse are payable to her or to a trust that qualifies for the marital deduction. That would make it unnecessary for a decedent who desires the marital deduction for insurance proceeds payable in installments to arrange that payments made after the death of his surviving spouse be made to her estate or to her appointees under a general power of appointment.

12. MARITAL DEDUCTION (SECTIONS 2044, 2056, 2519, AND 2533)

The marital deduction provisions should be modified in the following respects:

A. Code sections 2056(b)(5) and 2523(e) should be repealed, thus eliminating the power-of-appointment trust as a separate category of interest qualifying for the marital deduction.[44] Power-of-appointment trusts should instead be qualified for the marital deduction as QTIP trusts under Code section 2056(b)(7) or 2523(f) if the QTIP election is made.[45] To accommodate this proposal, the definition of a QTIP trust should be changed to permit the donee spouse or surviving spouse to be given a lifetime power (either general or limited) to appoint out of the trust to third parties. Enactment of this and related proposals would promote simplification and eliminate unneeded rules.

B. The above proposals (in sections 9 and 11) for qualification for the estate tax QTIP marital deduction of survivor benefits and life insurance proceeds would also permit, and make desirable, repeal of Code section 2056(b)(6).

C. In connection with the above changes, power-of-appointment marital deduction trusts, etc., would, as regards the donee spouse or surviving spouse or her estate, become taxable under Code sections 2044 and 2519, rather than under sections 2041 and 2514.

D. Enactment of the above proposals A and B would subject power-of-appointment marital trusts to the rules applicable to QTIP marital trusts. For example, if the proposed regulations that would permit partial QTIP elections to be made only for a fractional or percentile share of property (as distinguished from a pecuniary amount) become effective, that rule would apply to power-of-appointment marital trusts.

E. Enactment of the above proposals A and B should be accompanied by enactment of a "grandfather" provision to protect Code section 2056(b)(5) or (6) or 2523(e) dispositions already irrevocably in existence from the necessity of making a QTIP election.

F. The QTIP election should remain in the law, because it is a useful lifetime

[44] The so-called "estate trust" should be preserved as a separate category of interest qualifying for the marital deduction, because that kind of trust permits income accumulation.

[45] Arguably, at least, if the change suggested in the next sentence of the text were made, every qualifying power-of-appointment trust would also electively qualify as a QTIP trust without need for any other statutory change.

and post-mortem tax planning tool. The requirement that the estate tax QTIP election be made on the return (including a delinquent, but first, return) should be preserved. The requirement that a gift tax QTIP election is good only if the gift tax return is filed by April 15 (or timely filed within a granted extension of time under section 1879(n) of the Tax Reform Act of 1986) should be eliminated, so that the election can be made on a delinquent, but first, gift tax return. (Although there is something to be said for providing no incentive for delay, the estate tax rule seems, on balance, to be the better one.)

G. The harsh rule of section 2519 should be repealed, so that a QTIP trust would not become wholly taxable upon any disposition of part of a qualifying income interest. A substitute set of rules should be enacted that would properly treat (1) donations out of the income interest of the surviving spouse or donee spouse and (2) exercise by such spouse of a lifetime power of appointment in favor of another person. The problem in each situation is when the gift made by the donee spouse or surviving spouse should be measured (1) by the property given or appointed or (2) by an amount determined because such gift is of an income interest, which appropriately should be capitalized (i.e., treated as a gift of a corresponding portion of principal). The following suggestions, which may not be comprehensive, are made:

(i) Assignment by the spouse of a fractional share of her income interest for life would result in a gift of the assigned portion of the income interest under section 2511 and of a corresponding fraction of principal under section 2519 as proposed to be revised.

(ii) If the trust has a charitable remainderman and the spouse assigns one-third of her income interest to, say, her child, there would be no charitable deduction for the one-third of the principal taxed under section 2519 as proposed to be amended, because the trust is not a unitrust or annuity trust.[46]

(iii) Any assignment of income by the spouse for a period shorter than her life should leave her taxable on the assigned income and, therefore, the trust would remain taxable under section 2044 at her death. Section 2519 would have no application.

(iv) Assume that the spouse remarries and assigns (say) one-third of her income interest to her new husband. Under present law, neither the income interest transferred to the new husband nor the remainder interest deemed under Code section 2519 to be transferred to the trust remainderman qualifies for the marital deduction. That should, we believe, remain the rule.

H. As a corollary to sections 2044 and 2519, property that passes to the donee spouse or surviving spouse (herein "*W*") but does not qualify for the

[46] We do not intend to suggest that the unitrust and annuity trust rules enacted in 1969 could not be replaced with better alternatives; we note only that those rules do not permit a deduction in the above situation.

marital deduction should be shielded from transfer tax in *W*'s hands. That is simply an application of the concept that the two spouses are, in effect, a taxable unit. Examples are given below:

(i) Assume that the amendments proposed in paragraphs A and B are made and that no election is made to qualify for the marital deduction all or a fraction of a trust that confers on *W* a general power of appointment. Because the property so disqualified is a part of the taxable estate or taxable gifts of the deceased spouse or donor spouse (herein "*H*"), it should not be taxed again to *W* or her estate.

(ii) Assume that the above amendments are made and that the will of *H* divides his estate into Trust *A*, which qualifies for the marital deduction, and Trust *B*, which does not so qualify because no election is made. *W* has the income for life from Trust *B* and a limited power to appoint property to others from Trust *B* by deed. *W* appoints all such property to her son (*S*). Under the rule discussed in section 10F above, *W* thus would make a gift of her life estate. That gift should not be taxed because Trust *B* was part of *H*'s taxable estate.

(iii) Assume that an interest in property passing from *H* to *W* does not qualify for the marital deduction under the terminable interest rule. Taxation to *H* should prevent taxation to *W*.

I. The rule that possession by *W* of a nongeneral power of appointment prevents a so-called "estate trust" from qualifying for the marital deduction should be overruled by statute. Although the concept that such a power causes such a trust to fall afoul of the terminable interest principle is technically correct, no valid tax policy is served by the rule, and it operates as a trap for the unwary.

J. Many state laws confer on a widow the right to an allowance from the corpus of the probate estate for her support. The Supreme Court has denied the marital deduction for such allowances because they are terminable interests.[47]

We propose that such allowances be made eligible for the marital deduction if the widow survives long enough to receive the allowance. This proposed new exception to the terminable interest rule is buttressed by considerations similar to those that underlie existing exceptions (subparagraphs (A) and (B) of Code section 2056(b)(3), which also turn on survival of the surviving spouse for a limited period).

13. Adjustments For Gifts Made Within Three Years Of Death

Subparagraphs (a), (b), and (d)(1) of Code section 2035 can be eliminated as deadwood.

Paragraphs (2), (3), and (4) of section 2035(d) are obscure. We recom-

[47] Jackson v. United States, 376 U.S. 503 (1964).

mend reexamination of the need for rules in this area, and the extent of such need. After policy is reformulated, it should be expressed in comprehensible language. See in that connection ABA Legislative Recommendation No. 1986-0, a copy of which is attached as Exhibit F.

Section 2035(c) should be retained.

14. UNREALIZED GAINS AT DEATH

Concerns have been expressed regarding the basis rule of section 1014, particularly its application to property qualifying for the marital deduction. We note, however, the difficulty of developing a rule for marital transfers only that would work under the community property and noncommunity property systems and that would avoid the "floating basis" problem where the assets of the probate estate are divided into marital and nonmarital shares. We note also the record-keeping problem.

We attach as Exhibit G, without recommendation, a study paper on this subject prepared for our consideration.[48] However, we have not been able to reach a consensus on a solution to this problem.

15. GENERATION-SKIPPING TRANSFER TAX

We have decided not to comment specifically on the generation-skipping transfer tax, in view of the substantial revision of that tax in the Tax Reform Act of 1986 and the substantial study that others are giving to that revision. We note with concern, however, the apparent subjection of direct skips to simultaneous estate and generation-skipping transfer taxes with no provision for deduction of either such tax from the base of the other.

16. TRANSFERS BY NONDOMICILED ALIENS

We note the growing investments by nondomiciled aliens in United States property, and are concerned about the ineffectiveness of the transfer taxes in that area, the ease of avoidance through incorporation, and the lack of consistency between the gift and estate tax situs rules. Although we have formulated no specific solution, and realize the difficulty of finding an effective one, we recommend that the Treasury focus on possible legislation affecting that area.

17. VALUATION MATTERS

The following thoughts on valuation of property for transfer tax purposes are submitted for consideration.

[48] The study paper reflects various individual views, but does not reflect the position of the task force or of a majority of its members.

A. *Valuation generally*

Code sections 2031(a) and 2512(a), each a single sentence, specify the date of valuation of the gross estate and of a gift, respectively. The methods for valuation of property are, appropriately, left to the estate and gift tax regulations. Those regulations cover the subject of valuation comprehensively.

Code section 2031(b), which prescribes valuation of unlisted stocks or securities by reference to comparables, is an aberration, and should be repealed as unnecessary. There is no need for the statute to prescribe one of the generally accepted valuation techniques. Repeal should not be taken to mean that comparables should not be used.

Code sections 2032 and 2032A, relating respectively to alternate valuation and farm and business real property valuation, are of a different character. They prescribe substantive departures from what would otherwise be the valuation rules. In our opinion, those sections serve useful purposes, and should be retained. We would like to see section 2032A simplified, but we have no specific recommendation.

B. *Effect of decedent's death on valuation*

Generally, effect is given to the fact of the decedent's death in valuing his interests in property includible in the gross estate under Code section 2033. Examples are given below:

(i) A conferred interest in property that is extinguished by the decedent's death is not included in his gross estate.[49] For instance, if the decedent's father devised Blackacre to the decedent for life with remainder to the decedent's son, no interest in Blackacre is included in the decedent's gross estate.

(ii) Where the decedent was a key man in a business, the value of his interest therein is reduced to reflect the loss of his ability, activity, or good will.[50]

(iii) The decedent's interest in a business that owned insurance on his life is valued by including in its assets the insurance proceeds, rather than the predeath value of the policy.[51]

(iv) Where the decedent's death terminated a contractual restriction under which the decedent's partners might acquire the decedent's interest in the partnership at a discount from fair market value, the decedent's partnership interest was includible in his gross estate at full value.[52]

[49] *See, e.g.*, Helvering v. Rhodes' Estate, 117 F.2d 509 (8th Cir. 1941); Commissioner v. Rosser, 64 F.2d 631 (3d Cir. 1933). The issue in these cases was whether the decedent had a fee or merely a life interest; it was accepted that the life interest would not fall into the gross estate.

[50] *E.g.*, Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933).

[51] *E.g.*, Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), *cert. denied*, 359 U.S. 913 (1959).

[52] United States v. Land, 303 F.2d 170 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962).

(v) Death benefits under employment contracts were included in the gross estate without regard to the possibility that the decedent might have forfeited the right to the benefits by terminating the employment relationship during life.[53]

(vi) A survivor's annuity under a joint and survivor annuity contract was valued without any reference to the deceased annuitant's life expectancy.[54]

We subscribe to the results in the above cases. A different situation is presented, however, where the decedent, during life, entered into arrangements under which the nature of his property interest is diminished at his death. The following such arrangements have come to our attention.

(i) In a recent Tax Court memorandum decision,[55] the decedent owned a 77.8% limited interest in a family partnership. He had the election, while alive, to dissolve the partnership. The parties stipulated in the Tax Court that the decedent would have received $59.6 million for his interest if he had exercised his election, but that the value of his interest immediately after his death (when there was no such election) was only $33 million. The Tax Court found a $33 million value.

(ii) Two relatively recent technical advice memoranda[56] addressed situations in which the decedent owned at his death shares in a family-owned corporation that represented voting control. In both cases, the certificate of incorporation provided that the decedent's shares would become nonvoting at his death.[57] The Service held in both cases that the decedent's voting control should be taken into account in valuing his stock for estate tax purposes.

(iii) We have considered the not uncommon situation in which, for example, the decedent owned all of the voting stock of a corporation and, by his will, left one-third of that stock to each of his three children.

In general, the view of our task force is that, in situations such as those described, the value of the decedent's partnership interest or stock should be determined by taking into account the powers (e.g., to dissolve the partnership or to exercise voting control over the corporation) that he retained until his death.[58]

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[53] Goodman v. Granger, 243 F.2d 264 (3d Cir.), *cert. denied,* 335 U.S. 835 (1957).

[54] Mearkle's Estate v. Commissioner, 129 F.2d 386 (2d Cir. 1942).

[55] Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306, T.C.M. (P-H) ¶ 87,007 (1987).

[56] T.A.M. 8510002, Nov. 26, 1984; T.A.M. 8401006, Sept. 28, 1983.

[57] In T.A.M. 8510002, a son of the decedent had voting control immediately after the decedent's death. In Technical Advice Memorandum 8401006, the decedent's death caused voting power to be divided among his wife, five children, and a trust, no one of which had voting control.

[58] In recommending the above approach to valuation of stock held by the decedent until his death, we are not suggesting that stock given away during life should be brought into the gross estate because of retention of voting power. *See supra* section 7B, Rule e.

C. *Treasury proposal on valuation of fractional interests*

In its 1984 report to the President on tax reform, the Treasury Department proposed a special valuation rule for transfers of fractional interests in property.[59] In valuing the interest transferred, that interest would be aggregated with other fractional interests in the same property previously given away by the transferor and any such fractional interest retained by him. For that purpose, any fractional interest owned by the transferor's spouse would be attributed to the transferor. The result of such aggregation might be to eliminate a discount for a fractional interest or, in the case of voting stock, to create a control premium.

We have had difficulty in evaluating this proposal. Its application to various fact patterns is unclear. We have considered a variety of potential applications, sometimes in agreement and at other times in disagreement, which we summarize below. We have taken as a basic pattern a case in which *H* (or *H* and his wife) owns or originally owned 60% of the stock of corporation *X* (all of which is voting) and *B*, an unrelated individual, owns the other 40%.

(i) *H*, the owner of 60% of the *X* stock, gives his son *(S)* 20% in year 1, 20% in year 4, and dies in year 7 bequeathing *S* 20%.

(ii) Same as (i), except that in each such year *H* transfers 10% to *S* and 10% to *E's* daughter *(D)*.

(iii) Same as (i) or (ii), except that the 60% stock interest is community property, one-half owned by *H's* wife *(W)*.[60]

(iv) Same as (i), except that *H*, two years prior to year 1, gave *W* one-half the stock as a marital deduction gift. *H* and *W* separately thereafter made the gifts described in (i).

(v) Same as (iv), except that the gift by *H* two years prior to year 1 was to a QTIP trust for *W*. There were no subsequent gifts. *H* died owning 30%, and 30% is later taxed to *W* under Code section 2044.

(vii) Same as (iii), with the addition that *H*, by his will, bequeathed his 30% stock interest to *W* as trustee for the benefit of their children. At *W's* subsequent death she owns 30% of the stock outright and holds 30% as trustee.

(viii) Same as (i), except that *H*, owning 60% at death, bequeaths it to his children *(S1, S2,* and *D)* for life, with remainder to their respective descendants per stirpes. Alternatively, (a) there is one trust, which will not terminate until the death of the survivor of *S1, S2,* and *D;* (b) there are three separate trusts, which will terminate at their respective deaths; (c) the three separate

[59] *See* TREASURY, *supra* note 11, at 387.

[60] The interests of *H* and *W* are not now aggregated. Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981); Estate of Lee v. Commissioner, 69 T.C. 860 (1978).

trusts have the same trustee; (d) the three separate trusts have different trustees.

(ix) Same as (vii), except that *H* bequeaths one-third of his stock to each of *S1, S2,* and *D*. Thereafter, each of *S1, S2,* and *D* make gifts of the stock to their respective children.

We assume that the Treasury would propose to find a control premium in each of (i) through (vi). Presumably, the death of one spouse would eliminate subsequent aggregation. There would be no aggregation for the gifts by *S1, S2,* and *D* in (ix), and therefore, not in (viii)(d). The Treasury has not addressed (vii) or (viii)(a) through (c).

On most, but not all, of the hypotheticals we have presented, our views are divided.

We have a number of observations:

(i) Our members who are familiar with the community property system understand that the result approved in *Bright* and *Lee*[61] is routinely applied in audits of community property estates. In other words, the interests of *H* and *W* are not aggregated in valuing the interest of the deceased spouse. If, for example, *H* and *W* each owns 50% of the voting stock of a corporation, the first of them to die is not treated as having had voting control.

(ii) The *Bright* case was decided *en banc* with the aid of briefs *amicus curiae* filed by leading members of the Texas tax bar. The opinion, after reviewing in detail the existing case law, concluded that the interests of *H* and *W* had traditionally not been, and should not be, aggregated for valuation purposes in either community property or common law jurisdictions.

(iii) There are happy families and unhappy families. The former may, for a time at least, act in concert and thus realize the values that would be found under the Treasury proposal. The latter often will not; we are all familiar with the bitter strife and litigation in which unhappy families can engage. For them the valuation process proposed by the Treasury could be ruinous because the tax would be exacted on values they would not realize.

(iv) Assume that closely-held corporation *X* is worth $90x, of which $30x is the value of voting control. Assume further that *A,* who owns all the stock of *X,* gives 1/3 of the stock to his son *(S)* in year 1, 1/3 in year 4, and 1/3 in year 7. Because the second gift shifts voting control from *A* to *S,* the three gifts might logically be valued, in order of time, at $20x, $50x, and $20x. We question whether the Treasury's proposal to value them at $30x, $30x, and $30x is superior.

(v) If the Treasury's proposal is adopted, then our task force's proposal, in the preceding subsection B, to value at death the retained voting control in

[61] *See* cases cited *supra* note 60; *see also supra* note 57.

the situations covered by the two cited technical advice memoranda would have to be reconsidered. Otherwise there would be double taxation of a portion of the value of voting control.

(vi) We have had difficulty in deciding whether situations such as that in T.A.M. 8401006, where no one succeeds to the decedent's voting control, should result in lower values than situations such as that in T.A.M. 8510002, where voting control shifts from the decedent to another. The Treasury has not specifically addresed that question.

(vii) We are unable to determine how the Treasury intended to determine when two classes of stock would be aggregated or segregated. For example, did the Treasury intend to accept the result in *Estate of Curry v. United States*,[62] in which the decedent's voting (53% of the vote) and nonvoting shares were given the same value per share?

(viii) In conclusion, we urge that new rules in this important area should not be proposed lightly. The subject should be given careful study and analysis. There should be an opportunity for public comment and hearings.

D. *Estate freezes; buy-sell agreements*

Other techniques that are used to reduce values for estate tax purposes are intra-family estate freezes and buy-sell agreements. These are also areas that might be addressed in regulations that would discourage the use of such arrangements for what are, essentially, substitutes for testamentary disposition. This does not mean that such arrangements should not be permitted where they conform to economic reality.

In view of the permissiveness with which the Service has policed these areas, consideration should be given to making any new rules that are embodied in the suggested regulations prospective only.

E. *Advance valuation determinations*

We recommend that the Treasury consider proposing enactment of a procedure for pre-transaction or pre-trial valuation of property by a panel of valuation experts. For pre-trial valuation, the taxpayer might be permitted to elect that valuation procedure within 90 days after the institution of the court proceeding.

18. DEADWOOD

The time has come to eliminate from the Code: section 2036(c); the expression "after September 7, 1916," in section 2037(a); the parenthetical expression in section 2037(a)(2); section 2038(a)(2) and the title of section 2038(a)(1); the expression "entered into after March 3, 1931" in section 2039(a); section 2041(a)(1); and all references to date of the creation of the power in

[62] 706 F.2d 1424 (7th Cir. 1983).

section 2041(a)(2) or 2041(b).[63]

In connection with the above repeals, a saving clause in the repealing act could preserve any existing tax benefits that would otherwise be lost.

19. OTHER SUBJECTS

We list below, with limited comments, other transfer tax subjects that our timetable did not permit us to examine adequately, but that, in our opinion, may require attention. They are:

A. Code sections 303 and 6166. (We note one argument in favor of retention of section 303, *i.e.*, that it provides a degree of neutrality among various business forms.)

B. Whether use of the exemption or credit should be discretionary. (*See* in this connection ABA Legislative Recommendation No. 1980-5, a copy of which is attached as Exhibit H.)

C. Estate tax apportionment, including whether and the extent to which there should be federal rules and whether, if so, they should be mandatory. (*See* in this connection our relevant comment in section 9 above.)

D. The prior transfers credit.

E. Code Section 691, including Treasury I proposals.

F. The election to take administration expenses as income tax deductions.

G. Deductibility of interest for estate tax purposes, including Treasury I proposals.

H. ESOPs (Code sections 2057 and 2210).

I. The new 15% additional estate tax on excess accumulations under employee plans. (Code section 4981A(d).)

J. Code section 2504(c), including the desirability of making it applicable to the estate and generation-skipping transfer taxes. (*See* in this connection the attached Exhibit H.)

K. The transfer tax charitable deduction provisions.

L. Code section 6163. (One commentator notes that the differential between the initially fixed interest rate used for discounting remainders and the floating interest rates on tax deficiencies flaws the operation of this provision.)

Respectfully submitted,

K. Jay Holdsworth, Chair
Ronald D. Aucutt
Edward B. Benjamin, Jr.
Kenneth W. Bergen
James B. Lewis

[63] Some commentators on this suggestion state that there are still too many pre-October 22, 1942 powers of appointment to make the proposed streamlining of section 2041 desirable. We are not persuaded.

EXHIBIT A
DEPARTMENT OF THE TREASURY
WASHINGTON
Nov. 19, 1985

Hugh Calkins
Chairman, Section of Taxation
American Bar Association
1800 M Street, N.W.
Washington, D.C. 20036

Dear Hugh:

As you know, the Treasury Department's November 1984 report to the President, *Tax Reform for Fairness, Simplicity, and Economic Growth,* included several recommendations for the reform and simplification of the Federal transfer tax system. In commenting on these recommendations, a number of professional groups and interested individuals expressed general support for the improvement and simplification of the transfer tax system, but also expressed concern that any transfer tax recommendations included in the Administration's fundamental tax reform proposals would be overshadowed by other issues and thus would receive inadequate study and consideration.

Primarily in response to these concerns, the President's *Tax Proposals to the Congress for Fairness, Growth and Simplicity* omitted any recommendations for the reform or simplification of the Federal transfer tax. The Treasury Department remains interested, however, in continuing efforts to reform the transfer tax system. In this regard, we hope to work with practitioners in developing proposals to make the present system fairer and simpler.

Using the Treasury Department's November recommendations as the starting point for discussion, we would solicit your recommendations for the simplification and improvement of the Federal transfer tax. In general, we would like to focus attention on the issues raised in the Treasury's November 1984 proposals; however, it is not our intention to preclude the consideration of other proposals to improve and simplify the system. Accordingly, in addition to your comments on the Treasury proposals, we are anxious to see *your* suggestions for improvements in the system.

With respect to certain of the proposals, some specific comments may help to focus the efforts of your group:

* *Unification of Estate and Gift Taxes* — We recognize the argument that the basis step-up for transfers at death precludes true parity between lifetime gifts and bequests. However, section 1015 provides a basis increase for the gift tax attributable to the appreciation in the property transferred; since the Treasury proposal contemplates that gifts in the top bracket

would be subject to a transfer tax equal to the amount received by the donee, all gifts in the top bracket would receive a full basis step-up to fair market value.

* *Powers of Appointment* — Present law's "ascertainable standard" creates a trap for the poorly advised. The Treasury proposal sought to eliminate this trap by providing a more liberal standard (similar to the current test under § 678 for determining whether a beneficiary is the owner of a trust for federal income tax purposes). Other suggestions have included (i) providing a disclaimer or reformation procedure for standards that are overly broad, and/or (ii) retaining current law for powers that are exercisable alone (or with a spouse) while removing the "adverse interest" rule so that any power exercisable only with the consent of a co-trustee (other than the spouse) would not be treated as a general power of appointment.

* *Retained Powers and Interests/Effective Date* — We would expect that any new rules would not apply to existing, irrevocable trust arrangements.

* *Transfers of Fractional Interests* — Our premises are that (i) the value of an asset for transfer tax purposes should be its value in the hands of the transferor, and (ii) the transfer of a single interest in property in two or more separate transactions should not present opportunities for transfer tax avoidance. Current law gives rise to such opportunities by permitting a minority discount for fractional transfers of an interest in a business entity or other asset, even though the discount would not be available upon a transfer of the entire interest. The original Treasury proposal sought to correct this problem with a straightforward, proportional rule. We are aware that if such a rule is adopted, close attention will need to be paid to the proper scope of the attribution rules.

* *Generation-Skipping Transfers* — Treasury's April 1983 Proposal to Simplify and Improve the Generation-Skipping Transfer Tax System antedates the current tax reform effort, and we remain committed to its enactment as a replacement for current Chapter 13.

* *Payment of Estate Tax in Installments* — Our primary objective is to simplify the system. In addition, repeal of the special 4-percent interest rate and disallowance of the estate tax deduction for interest on estate tax may permit enactment of a relatively liberal rule allowing installment payment for a broad class of illiquid estates. Careful attention should be given to the so-called acceleration rule.

To provide adequate time for all interested groups and individuals to respond to these issues, we will continue to accept comments through May 1986.

We hope to develop a set of recommendations that will enjoy broad support among practitioners. We look forward to working with your group to that end.

Sincerely yours,

Ronald A. Pearlman
Assistant Secretary (Tax Policy)

EXHIBIT B
ARTICLE XIII

I devise and bequeath all of the rest, residue, and remainder of my property and estate which I own or to which I am in any manner entitled at the time of my death, both real and personal, wherever situated, whether acquired before or after the execution of this will, including lapsed and disclaimed devises and bequests, but not including any property over which I may have a power of appointment (which power or powers of appointment I hereby expressly decline to exercise), as follows:

A. If my wife Mary Doe survives me, to her, absolutely and in fee simple, my entire residuary estate, or, if it is less than my entire residuary estate, an amount (undiminished by any payment of taxes pursuant to the preceding Article of this will) equal in value to the smallest marital deduction which must be allowed to my estate so that after taking into account all other allowable deductions, the unified credit, and the credit for state death taxes (except to the extent that use of the credit for state death taxes would result in an increase in the amount of such taxes paid) my estate is not subject to federal estate tax (disregarding any tax that might be imposed with respect to any excess retirement accumulation under section 4981A(d) of the Internal Revenue Code of 1986), less the value of all property and interests in property which are not a part of my residuary estate, but which are finally allowed to my estate as a marital deduction for federal estate tax purposes. For the purposes of this paragraph A, the values of the assets included in my gross estate shall be those finally determined for federal estate tax purposes. Elections made by my personal representative with respect to alternate valuation dates and with respect to deductions for estate tax or income tax purposes shall determine the aforesaid values and the amount of this devise and bequest. My personal representative shall satisfy this devise and bequest with cash and other property fairly representative of the net appreciation or depreciation, from the date of my death to the date of distribution, in the values of the properties available for distribution, but my personal representative shall not use for the satisfaction of this devise and bequest any property which does not qualify for the marital deduction for federal estate tax purposes or (except to the extent that other property is insufficient) any property which when distributed to my wife is subject to any estate, inheritance, succession, or other death tax payable to any foreign country.

B. The balance of my residuary estate, if any, or if my wife Mary Doe fails to survive me, my entire residuary estate, absolutely and in fee simple, to my descendants who survive me, per stirpes, or, if no descendants of mine survive me, half to those persons who survive me who would be entitled to distribution of my personal property and half to those persons who survive me who would be entitled to distribution of my wife's personal property (both in the proportions that they would be entitled to such distributions) if she and I died simultaneously (at the time of my death) without wills, as provided by the laws of the State of __________ in effect at the time I sign this will. If, however, any amount is thereby distributable to a descendant of mine who at that time has not attained the age of thirty years, that amount shall not be distributed to that descendant, but shall be distributed to the trustee, hereinafter named, in trust, to be held, administered, and distributed by the trustee in accordance with the provisions of Article VI of this will.

EXHIBIT C
ABA LEGISLATIVE RECOMMENDATION NO. 1958-11
APPLICATION OF ANNUAL GIFT TAX EXCLUSION TO CERTAIN GIFTS OF FUTURE INTERESTS

Resolved, That the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to allow the $3,000 annual gift tax exclusion with respect to any gift where the donee is identifiable, even though possession and enjoyment of the gift by such donee may be postponed until a future time; and

Be It Further Resolved, That the Association proposes that this result be effected by amending section 2503(c) of the 1954 Code; and

Be It Further Resolved, That the Section of Taxation be directed to urge the following amendment or its equivalent in purpose and effect upon the proper committees of Congress.

Sec. 1. Section 2503(c) of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(c) **[TRANSFER FOR THE BENEFIT OF MINOR]** *CERTAIN TRANSFERS NOT CONSIDERED FUTURE INTERESTS* — No part of a gift **[to an individual who has not attained the age of 21 years on the date of such transfer]** shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom *will, to the extent not distributed to or expended by, or for the benefit of, the donee during his life, be payable on his death either to his estate, or as he may appoint under a general power of appointment as defined in section 2514(c).*

**[(1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years; and

(2) will to the extent not so expended

(A) pass to the donee on his attaining the age of 21 years, and

(B) in the event the donee dies before attaining the age of 21 years be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c).]**

Sec. 2. Effective Date. This amendment shall be applicable to all gifts made subsequent to the date of its enactment.

EXPLANATION

Summary

This will grant the annual $3,000 gift tax exclusion to all gifts of future interests (to both minors and adults) where the property will be used solely for the benefit of a specified donee during his life and the remainder of the property, if any, will on his death, be included in his gross estate. Section 2503(c) of the 1954 Code (the so-called gifts to minors provision) will be amended to eliminate the present requirement for distribution to the donee at age 21 and to permit a gift-over to third persons should the donee die prior to termination of the interest.

DISCUSSION

Criticism of § 2503(c) has been directed mainly to its requirement for *complete distribution at age 21* and *to the impossibility of providing for a gift-over to a third person upon the minor's death prior to termination.* Congress has told us that the original purpose of the future interest exception to the annual exclusion was the "apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts." This policy can be preserved, however, so long as the property given to a donee will be used by or for him alone during his life and will be subject to federal estate tax at his death. It should not be material *when* the donee will receive the benefit from the property or who *will* receive it after his death.

Under this approach the donor could provide for termination at any particular age or even run the trust through the donee's entire lifetime. He could (but need not) provide for gifts-over to third persons on the donee's death, so long as the property was includible in the donee's gross estate. Minor and adult donees would thus be treated alike.

The proposal would apply to gifts whether outright to, or in trust for the benefit of, the donee and whether the donee is a minor or an adult.

It is not intended that this amendment provide an exclusive method of creating a present interest. Nor is it intended to affect the application of the annual exclusion to outright gifts, whether or not the donee is under disabilities arising under local law by reason of minority or otherwise. No retroactive application is sought.

EXHIBIT D
ABA LEGISLATIVE RECOMMENDATION NO. 1970-5 TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CLARIFY THE EXTENT OF INCLUSION IN THE GROSS ESTATE OF TRANSFERS MADE FOR INSUFFICIENT CONSIDERATION.

Resolved, That the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to clarify the rule for determining the extent of inclusion in the gross estate of lifetime transfers made for sufficient consideration; and

Further Resolved, That the Association proposes that this result be effected by amending section 2043(a) of the Internal Revenue Code of 1954; and

Further Resolved, That the Section of Taxation is directed to urge the following amendment, or its equivalent in purpose and effect, upon the proper committees of Congress:

Sec. 1. Section 2043(a) of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(a) *IN GENERAL* — If any **[one of the transfers, trusts, interests, rights or powers enumerated and]** *transfer of an interest in property, as* described in sections 2035 to 2038 inclusive, **[and section 2041 is made, created, exercised, or relinquished,]** *was made* for a consideration in money or money's worth, but **[is]** *was* not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of **[the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent]**:

(1) the value of such interest otherwise to be included in the gross estate over

(2) an amount equal to the same proportion of such value as the consideration in money or money's worth received by the decedent bore to the value of the interest on the date of transfer.

The lifetime exercise or release of a power of appointment as described

in section 2041(a) shall, for the purposes of this subsection, be treated as a transfer of the property with respect to which such power of appointment was exercised or released.

Sec. 2. This amendment shall apply to estates of decedents dying after the date of enactment thereof.

EXPLANATION

Summary

The purpose of the proposed legislation is to provide that a transfer of an interest in property made during life for partial consideration and otherwise includible in the gross estate shall be included by ascertaining the proportion of the interest that was transferred donatively and applying that proportion to the value of the interest at the estate tax valuation date.

DISCUSSION

Sections 2035 to 2038, inclusive, and 2041 of the Internal Revenue Code provide that the value of interests in property transferred by the decedent during his life, or the value of property with respect to which he exercised or released a general power of appointment during life, shall be included in the decedent's gross estate if the transfer, exercise or release meets certain tests. Each of these sections provides an exception in case of a bona fide sale for an adequate and full consideration in money or money's worth. Section 2043(a) provides that if any such includible transfer, exercise or release is made for less than an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the value otherwise to be included over the value of the consideration received.

The courts have generally held that section 2043(a) requires that the transferred interest be valued as of one date (the estate tax valuation date) and the consideration as of another date (the date of transfer). *Vardell's Estate v. Commissioner,* 307 F.2d 688, 693-94 (5th Cir. 1962); *United States v. Past,* 347 F.2d 7, 14 (9th Cir. 1965); *United States v. Righter,* 400 F.2d 344 (8th Cir. 1968); *United States v. Gordon,* 406 F.2d 332, 344, n.19 (5th Cir. 1969); *Estate of Lillian B. Gregory,* 39 T.C. 1012, 1020-22 (1963); *Estate of Howard Lee Davis,* 51 T.C. 269, 280-82 (1968); *Estate of Dora N. Marshall,* 51 T.C. 696, 703 (1968).

A proportional approach to measurement of the estate tax value of the bargain element of the lifetime transfer would be fairer and is the aim of the proposed legislation. To compare the two approaches, assume that the decedent, in contemplation of his death, sold property worth $500,000 to his son for $200,000, and that the property sold was worth $750,000 on the estate tax valuation date. The cited court decisions would require the property to be included in the gross estate to the extent of $550,000 ($750,000 less $200,000).

The legislative proposal would require inclusion of $450,000 ($750,000 multiplied by 60 percent, that having been the percentage of the transfer that was donative).

A further anomaly of the present approach is that classification of a transfer as one made for an adequate and full consideration in money or money's worth is determined by reference to values at the time of the transfer. Thus, if the decedent, during his lifetime, transferred Blackacre to his son in exchange for Whiteacre, no amount would be includable in his gross estate under present law if the values of the two properties were equal at the time of the exchange (thus disregarding any subsequent increase in the value of Blackacre). However, if Blackacre exceeded Whiteacre in value by $100 at the time of the exchange, any increase in the value of Blackacre up to the estate tax valuation date would form a part of the gross estate. The legislative proposal would eliminate this notch feature of the present law.

The legislative proposal may either decrease or increase the extent of inclusion in the gross estate of a lifetime transfer for a partial consideration, depending upon whether the transferred interest rises or falls in value between the date of transfer and the estate tax valuation date.

Although the legislative proposal will apply only to estates of decedents dying after the date of its enactment, it will apply to lifetime transfers made on or before the date of enactment by an individual who dies after that date.

The legislative proposal is not intended to change present law in any way other than by substitution of the proportional formula for the formula established by the cited cases. Although the language of section 2043(a) has been recast to simplify the introduction of the proportional formula, no inference should be drawn that the categories of transactions to which section 2043(a) applies have been either broadened or narrowed. The rules for classifying wholly gratuitous transfers, exercises or releases as includable in or excludable from the gross estate must be drawn from sections 2035 to 2038, inclusive, and 2041, which are not amended by the legislative proposal. The only function of section 2043(a) is to make such rules, which are applicable *pro toto* to wholly gratuitous transfers, exercises and releases, applicable only *pro tanto* to transfers, exercises and releases for inadequate consideration.

* * *

This recommendation was prepared by the Section's Committee on Estate and Gift Taxes. The proposed legislation is of general application. To the best of the knowledge and belief of the chairman of the committee, no member of the committee has a personal interest in the proposed legislation.

EXHIBIT E

NOTE: This study paper reflects various individual views, but does not reflect the position of the task force or of a majority of its members.

Study Paper on Transfer Tax Treatment Of Life Insurance

This study paper, submitted to the task force on transfer tax restructuring, summarizes the debate over the transfer tax treatment of life insurance, presents a historical sketch, outlines the relevant rules of the present transfer tax statutes, comments on the task force proposal regarding Code section 2039, and outlines possible substitute transfer tax rules for life insurance.

The debate

The argument on one side is that life insurance is an investment and should be treated, for transfer tax purposes, like other investments. That argument was cited by Congress in 1954, in connection with its repeal of the premium-payment test for inclusion in the gross estate of proceeds of insurance on the decedent's life. This argument is for tax neutrality, so that the choice between insurance and other investments would be made solely with regard to factors other than taxes.

The argument on the other side is that life insurance is inherently testamentary and, as such, fair game for the estate tax. Life insurance differs from other investments because the event of death directly affects the nature and value of the insurance. That and other peculiarities make unrealistic the argument that the transfer tax rules applicable to other investments should apply to life insurance. Present law recognizes that fact in prescribing special estate tax rules for life insurance. Moreover, if, as some assert, one purpose of the estate tax is to reach accumulations of property that have escaped income taxation, the income tax exclusion of life insurance proceeds provided by Code section 101 is a further reason for subjecting such proceeds to estate tax.

Proponents of the first argument point to whole-life policies, which combine savings and insurance elements. Proponents of the second argument point to term policies, which are pure insurance.

Other points have been made by advocates of the first side of the argument. Citing the view of some that life insurance is not a relatively attractive investment as a financial matter, they give that as an added reason why it should not be discriminated against for transfer tax purposes. They cite also the social value of encouraging the carrying of life insurance for the protection of widows and orphans. The advocates of the second side of the argument say that the first point is irrelevant and that the second has little significance for a system of estate taxation that reaches only estates of more than $600,000.

The debate is a stand-off, at least in the sense that neither side has accepted as persuasive the arguments of the other.

History

The original version of the modern estate tax law, enacted in 1916, did not specifically mention life insurance. The 1918 amendment defined the gross estate to include the proceeds of insurance "taken out" by the decedent upon his own life, but exempted the first $40,000 of such proceeds receivable by beneficiaries other than the executor.

The statute did not explain what was meant by insurance "taken out" by the insured decedent. The regulations focused at times on premium payment and at others on incidents of ownership in the policy as the relevant test. That administrative vacillation received uncertain judicial support.

In 1942 the $40,000 insurance exemption and the "taken out" approach were eliminated. The gross estate was redefined to include proceeds of insurance on the decedent's life:

1. Receivable by his executor, without further qualification; and
2. Receivable by other beneficiaries, but only if —
   a. Attributable to premium payments made by the decedent (with an exemption where he had transferred the policy during life for consideration), or
   b. The decedent possessed any incident of ownership (not including a reversionary interest) in the policy, exercisable alone or with another.

In 1954 the premium-payment test for inclusion was eliminated, and the incidents-of-ownership test was enlarged to include a five-percent or greater reversionary interest.

In 1978, and again in 1981, Code ssection 2035 was amended to address specifically the payment of premiums or transfer of a life insurance policy within three years preceding death.

The gift tax statute has never prescribed special rules for life insurance.

Present Law

As indicated immediately above, the gift tax statute does not attempt to treat life insurance differently from other property. Depending on the circumstances, premium payments, policy assignments, or irrevocable designations of beneficiary may be gifts, either by the insured or by someone else. The test, as for other property, is whether the donor has relinquished dominion and control.

The estate tax statute contains several rules relating to life insurance proceeds:

1. Under Code section 2042(1), proceeds of insurance on the decedent's life are includible in his gross estate if they are receivable by his executor.

2. Under Code section 2042(2), proceeds of insurance on the decedent's life receivable by persons other than his executor are includible in the decedent's gross estate if the decedent had at his death any incident of ownership (including a five-percent or greater reversionary interest) in the policy, exercisable either alone or with another.

3. Code section 2035 contains some references to transfers with respect to life insurance policies made within three years of death. The current rules for such transfers are not clear.

4. Code section 2039 specifically excludes life insurance from its amoit, thus precluding any dominance of section 2039 over section 2042.

5. Code sections 2033, 2036, 2037, 2038, 2040, and 2041 do not contain any specific exclusion for life insurance. It may be argued that sections 2035 and 2042, which refer specifically to life insurance, are exclusive, but the validity of that argument is uncertain.

6. Insurance proceeds includible in the insured's gross estate and passing to his surviving spouse qualify for the estate tax marital deduction. Code section 2056(b)(6) qualifies for that deduction certain insurance proceeds held by the insurer for the benefit of the surviving spouse and her appointees.

7. Insurance proceeds qualifying for the marital deduction are, to the extent not consumed by the surviving spouse, taxable at her subsequent death or her lifetime gift thereof. That tax is, in effect, a surrogate for the tax eliminated by the marital deduction. The result is to tax the insurance proceeds in that situation.

Task force recommendation regarding section 2039

Tested by their titles, at least, section 2039 applies to annuities and section 2042 to life insurance. Those two types of life insurance company products differ in that annuities reward long life and life insurance compensates for early death.

However, the task force proposal for amendment of section 2039 would bring within that section pure death or survivor benefits that serve purposes similar to those of life insurance, and would apply to those benefits tests stricter than those supplied by section 2042 for life insurance proceeds. Specifically, section 2039 would apply even though the decedent had at his death no incident of ownership in the contract providing the death or survivor benefits.

Proposals

It cannot seriously be argued that the above estate tax rules treat life insurance like other investments. Those rules look in part to destination of proceeds, in part to the decedent's rights in the policy, and in part to time of transfer. In some respects they are tighter than the rules applicable to other investments and in others more liberal.

The proposals below, without attempting to resolve the policy disagreement summarized earlier, outline for consideration other possible transfer tax rules.

Proposal A

1. The present section 2042(1) would be retained and the present section 2042(2) repealed.

2. Section 2042 would be amended to provide that proceeds of insurance on the life of the decedent would be included in his gross estate if the proceeds are receivable by his spouse, his ancestors, his descendants, the spouse of any such descendant, or the estate of any such individual. For that purpose, relationship by adoption would not be distinguished from relationship by birth. The identity of the payor of the premiums would be irrelevant.

3. Proceeds of insurance on the life of the decedent receivable by entities other than estates (corporations, partnerships, and trusts) would be treated as follows:

> (a) For the purpose of valuing the decedent's interest, for estate tax purposes, in any such entity, effect would be given to the decedent's death, i.e., the value of the proceeds would be counted. (To avoid duplication in values, that portion of the insurance proceeds would not, as such, be included in the gross estate.)
>
> (b) With respect to any interst in any such entity of any individual or estate described in paragraph 2, a corresponding portion of the proceeds of the insurance would be included in the insured's gross estate. (This rule is necessary to prevent abuse by creation of entities.)

4. During the insured's life, premium payments or policy assignments would not be gifts, but the surrender of a policy for cash by an owner described in paragraph 2 would be deemed to be a gift of the cash so received. That gift would be deemed to have been made by the insured to the recipient.

5. Proceeds of insurance on the life of the decedent payable in installments to his surviving spouse for life and then to others would be brought within the QTIP marital deduction.

Examples illustrating application of the above rules are given below (in each case the insured individual is *I*):

Example (1). Insurance on the life of *I* was taken out by his daughter (*D*). *D* received the proceeds on *I*'s death. The proceeds would be includible in *I*'s gross estate.

Example (2). *I* is the chief executive of a large, publicly-owned corporation (*C*). *C* has taken out a "key-man" insurance policy on *I*'s life. *I* owns three percent of the outstanding stock of *C*. Upon *I*'s death, (a) no part of the insurance proceeds, as such, is includible in his gross estate, and (b) his *C* stock is valued in the usual manner (mean between high and low sales prices on the date of death or alternate valuation date). (No adjustment to date-of-death value for the receipt of the insurance proceeds would be appropriate, because the effect on stock market price would not be significant.)

Example (3). *I* was one of four equal shareholders of a corporation (*C*). *C* has a "key-man" insurance policy on *I*'s life. The other three shareholders were individuals, none of whom was related to *I* as described in paragraph 2. On *I*'s death, (a) none of the insurance proceeds, as such, would be includible in his gross estate and (b) his 25 percent stock interest in *C* would be valued by counting the insurance proceeds as a part of *C*'s assets.

Example (4). The facts are the same as in Example (3) except that one of the three other equal shareholders of *C* was *I*'s son (*S*). The results are the same as in Example (3) except that one-fourth of the insurance proceeds (corresponding to *S*'s interest in *C*), is includible, as such, in *I*'s gross estate.

One consequence of enactment of Proposal A would be that the gross estate could include the proceeds of insurance neither owned nor purchased by the decedent. The apportionment rules of Code section 2206 would, unless made inapplicable by the will of the insured decedent, prevent the resulting estate tax burden from falling on persons other than the recipient of the insurance proceeds. If the rules outlined above were adopted, consideration might be given to making section 2206 mandatory.

Variations on Proposal A

Critics of Proposal A note that it (1) would subject to estate tax the proceeds of insurance on the decedent's life purchased by a child of the decedent (or other member of the decedent's family) with money never received from the decedent and (2) would fail so to tax proceeds of insurance purchased by the decedent for the benefit of his mistress. That criticism might be met, in whole or in part, by one of the following approaches:

(1) The incidents-of-ownership test of Code section 2042(2) might be retained as an alternative test for inclusion. If so, insurance proceeds payable to the insured decedent's mistress or other nonmember of his immediate family would be taxed unless the decedent parted irrevocably with the policy during life.

(2) An exception to Proposal A could be created for insurance purchased by an individual other than the insured with consideration shown to have originally belonged to such person and never to have been received donatively from the insured. (This language is similar to that of Code section 2040(a), relating to joint interests.) To avoid tracing, there would be a conclusive presumption that consideration for the policy comes first out of donative transfers from the insured. Such a rule would ease the criticism described above regarding insurance purchased by members of the decedent's family, but would not permit escape of insurance economically traceable to the insured (including insurance held by an irrevocable insurance trust funded by him).

(3) The most far-reaching rule would be to extend Proposal A to insurance held by, or for the benefit of, any individual other than the insured, whether related to him or not. (There is probably relatively little such insurance held by nonrelatives.) Commercially-grounded insurance, such as a policy held by a lender, would be excepted.

Proposal B

To the extent that concern centers on the increase in the value of insurance resulting from death, the gross estate could be redefined to include that element of the insurance. The includible element, if it is not caught by Code section 2042(1) or (2) (which would be retained), would be the excess of the insurance proceeds over the value of the policy immediately preceding death.

Problems presented

Problems that would have to be resolved under the above or other proposals include:

(1) Death of the policy owner during the insured's life. (Logically, under Proposal A, the policy might be exempted from estate tax at the owner's death.)

(2) Insurance owned by the insured's former spouse, perhaps as part of the marital settlement.

(3) Whether policy loans should be distinguished from policy surrenders.

(4) The handling of insurance held by a discretionary trust where some of the beneficiaries are individuals described in Proposal A and others are not.

EXHIBIT F
ABA LEGISLATIVE RECOMMENDATION NO. 1986-0

BE IT RESOLVED, That the American Bar Association supports enactment by Congress of amendments to Sections 2035 and 2038 of the Internal Revenue Code of 1954 along the lines set forth in Exhibit [1], attached, to conform to the provisions of the Economic Recovery Tax Act of 1981 and the Technical Corrections Act of 1982.

REPORT

The Section of Real Property, Probate and Trust Law has joint jurisdiction with the Section on Taxation over matters relating to the United States estate tax. This recommendation was approved by the Council of the Section of Real Property, Probate and Trust Law, having authority to act for the Section, at its regularly-scheduled meeting on April 24, 1983, at Point Clear, Alabama. This recommendation was approved by the Estate and Gift Tax Committee of the Section on Taxation at its meeting in Washington, D.C. on May 20, 1983, and will be considered by the Council of the Section on Taxation as an expedited matter before the August, 1983 meeting of the House of Delegates of the American Bar Association.

In the Economic Recovery Tax Act of 1981 (ERTA) Congress amended I.R.C. § 2035 by adding a new subsection (d). This new subsection eliminates most intervivos transfers from a decedent's gross estate. I.R.C. § 2035 as amended by ERTA and the Technical Corrections Act of 1982 now provides:

1. The gross estate includes any gift taxes paid by a decedent or his estate on any taxable gifts made within 3 years prior to death.

2. Except for transfers for full consideration, the gross estate includes any interest in property transferred within 3 years prior to death if such interest would have been included in the decedent's gross estate under I.R.C. §§ 2036, 2037, 2038 or 2042 had it been retained by the decedent.

3. For purposes of I.R.C. § 303(b) (distributions in redemption of stock to pay death taxes), § 2032A (special valuation of certain farms, etc., real property), § 6166(a) (extension of time to pay estate tax), and subchapter C of Chapter 64 (lien for estate tax), the old rules of I.R.C. § 2035 apply, i.e., all transfers within 3 years of death are includible in the gross estate except those for full consideration and those small enough to come within the annual gift tax exclusion so that no gift tax return was required to be filed.

However, as presently drafted I.R.C. § 2035(a) states the former general rule: the value of a decedent's gross estate includes the value of all property to the extent of any interest therein which the decedent transferred during the

3-year period ending on his death. Subsections (b) and (d) now set forth exceptions that render the former general rule meaningless, except for transfers under (b)(2) (with respect to a life insurance policy), (d)(2) (within the scope of I.R.C. §§ 2036, 2037, 2038 and 2042), and except for the special rules of I.R.C. §§ 303(b), 2032A, 6166, and subchapter C of Chapter 64 that are referred to in subsections (d)(3) and (4).

The proposed rewrite of I.R.C. § 2035 is not intended to change existing law but to be a nonsubstantive rewrite making the section more comprehensible. However, the last sentence of proposed subsection (a) has been added to correct a potential but unintended trap in the present statutory language: All gifts from a revocable trust, made by or on behalf of its settlor, may technically be includable under I.R.C. § 2035(d)(2) since any such transferred property would otherwise have been included in the settlor's gross estate under I.R.C. §§ 2036, 2037 or 2038, and not under I.R.C. § 2033. However, such a transaction is analytically a distribution by the trustee to the settlor, followed by a gift by the settlor to the donee, and should be subject to the same rules as apply to the settlor's donations as an individual.

As a corollary, all gifts from a revocable trust within 3 years of the settlor's death would apparently also be caught by I.R.C. § 2038(a)(1) and (2), as any such transfer could be construed as a relinquishment of a power to "alter, amend or revoke" during "the 3 year period ending on the date of the decedent's death." *See* Cremer, *The 1981 Act and Section 2035: Problems and Possibilities*. 35 The Tax Lawyer 389, 393-4 (1982). In order to cure this problem and to let Section 2035 set the operative rules, it is recommended that I.R.C. § 2038 be amended by adding at the end of I.R.C. § 2038(a)(1) and at the end of the first sentence of I.R.C. § 2038(a)(2) the following: "(except when such relinquishment results from a transfer from a trust as to which trust the settlor has reserved a right of revocation)."

EXHIBIT [1]
PROPOSED REVISION OF INTERNAL REVENUE CODE § 2035

SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

(a) INCLUSION OF CERTAIN TRANSFERS IN GROSS ESTATE — The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death, if such transferred interest would have been included in the decedent's gross estate under Sections 2036, 2037, 2038 or 2042, had such transferred interest been retained by the decedent on the date of his death. The provisions of this subsection (a) shall not apply to any transfer from a trust as to which trust the settlor has

reserved a right of revocation unless such transfer, if made directly by the settlor, would be a transfer to which this subsection (a) would apply.

(b) INCLUSION OF GIFT TAX ON GIFTS MADE DURING 3 YEARS BEFORE DECEDENT'S DEATH — The amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse after December 31, 1976, and during the 3-year period ending on the date of the decedent's death.

(c) INCLUSION OF TRANSFERS WITHIN THREE YEARS OF DEATH FOR CERTAIN PURPOSES.

(1) For purposes of Section 303(b) (relating to distributions in redemption of stock to pay death taxes), Section 2032A (relating to special valuation of certain farms, etc., real property), and subchapter C of Chapter 64 (relating to lien for taxes), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(2) An estate shall be treated as meeting the 35-percent of adjusted gross estate requirement of Section 6166(a)(1) only if the estate meets the requirement both with and without including in the value of the gross estate the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

(3) The provisions of (1) and (2) above of this subsection (c) shall not apply to any transfer (other than any transfer with respect to a life insurance policy) made during a calendar year if the decedent was not required by Section 6019 (other than by reason of Section 6019(a)(2)) to file any gift tax return for such year with respect to such transfer.

(d) DEFINITION — For purposes of this section, the term "transfer" shall not apply to any bona fide sale for an adequate and full consideration in money or money's worth.

PROPOSED REVISION OF INTERNAL REVENUE CODE § 2038

SEC. 2038. REVOCABLE TRANSFERS.

(a) IN GENERAL. — The value of the gross estate shall include the value of all property —

(1) TRANSFERS AFTER JUNE 22, 1936. — To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the

date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death *(except when such relinquishment results from a transfer from a trust as to which trust the settlor has reserved a right of revocation).*

(2) TRANSFERS ON OR BEFORE JUNE 22, 1936. — To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death *(except when such relinquishment results from a transfer from a trust as to which trust the settlor has reserved a right of revocation).* Except in the case of transfers made after June 22, 1936, no interest of the decedent of which he has made a transfer shall be included in the gross estate under paragraph (1) unless it is includible under this paragraph.

EXHIBIT G

NOTE: This study paper reflects various individual views, but does not reflect the position of the task force or of a majority of its members.

Study Paper on Estate Tax Treatment of Unrealized Appreciation in Value at Death

This study paper, submitted to the task force on transfer tax restructuring, proposes a possible solution to the problem of unrealized appreciation in the value of property at death.

1. *Introduction*

Assume (1) a flat estate tax rate of 50 percent, (2) an estate tax exemption of $600,000, and (3) a top income tax rate of 28 percent. Identify unrealized appreciation in value of property at death by the acronym UAVPAD. Finally, assume a desire to subject UAVPAD to a rate of estate tax that would more nearly equalize the tax treatment of those who sell during life and those who hold until death.

The tax treatment of the seller and the holder could be equalized by subjecting UAVPAD to an additional 14 points of estate tax, i.e., to a rate of 64 percent.

Proof: A and *B* each has invested $2 million, which has increased in value to $10 million. *A* sells during life, pays income tax of $2,240,000, has $7,760,000 left, incurs an estate tax of $3,880,000 and has $3,880,000 to bequeath. *B* incurs estate tax of $6,120,000 (50% of $2 million plus 64% of $8 million), and has $3,880,000 to bequeath.

An alternative would be to subject UAVPAD to a 50 percent estate tax and the rest of the taxable estate to a lower rate. To equalize, the lower rate would have to be 39.06 percent (50 percent divided by 1.28). For convenience, assume rounding of the lower rate to 40 percent.

2. *Proposal*

The proposal is for a 10-point credit against the estate tax for the non-UAVPAD element. More precisely, the base for computation of the 10-point credit would be the amount "X" in the following equation:

$$\frac{\text{X}}{\text{Taxable estate}} = \frac{\text{Non-UAVPAD portion of gross estate}}{\text{Gross estate}}$$

To prevent loss of credit where there are minor or unquestionable amounts of UAVPAD, there would be a full credit unless UAVPAD exceeded $25,000. (That figure could be larger.) Basis, in the absence of records, would be permitted to be established by economic analysis, reasonable estimate, etc.

If desired, all property other than stocks, bonds, and property used in trade or business or held for production of income would be non-UAVPAD property. Examples of non-UAVPAD property would be personal residences, personal effects, personal stamps or coin collections, etc. The need for such an exception is questionable.

To avoid the complex "floating basis" problem and to free from tax consequences the earmarking of UAVPAD property for the marital or nonmarital share of the estate, the credit in such situations would be computed as shown in example (7) below. Normally, where the tax is charged to the nonmarital share, the benefit of the credit would inure to that share. The same would be true of the charitable deduction.

3. *Examples of Operation of Proposal*

Example (1): Gross estate of $5 million; non-UAVPAD of $3 million; debts and charges of $400,000; exemption of $600,000; taxable estate of $4 million. Computation:

Estate tax at 50%	$2,000,000
Credit (10% of X [$2.4 million])	240,000
	$1,760,000

Example (2): Same as example (1) except that there is a charitable deduction of $1 million, reducing the taxable estate to $3 million. Computation:

Estate tax at 50%	$1,500,000
Credit (10% of X [1.8 million])	180,000
	$1,320,000

Example (3): Same as example (1) except that UAVPAD does not exceed $25,000. Computation:

Estate tax at 50%	$2,000,000
Credit (10% of X [$4 million])	400,000
	$1,600,000

Example (4): Same as example (1) except that everything is UAVPAD. Computation:

Estate tax at 50%	$2,000,000
Credit	-0-
	$2,000,000

Example (5): Same as example (1) except that there is a marital deduction of $4 million, reducing the taxable estate to zero. Computation:

Estate tax at 50%	-0-
Credit	-0-
	-0-

Example (6): Same as example (1) except that there is a marital bequest of $2 million (a fractional share of the general estate), making the taxable estate $2 million. Computation:

Estate tax at 50%	$1,000,000
Credit (10% of x [$1.2 million])	120,000
	$ 880,000

Example (7): Same as example (1) except that there is a specific bequest to the surviving spouse of an asset having a basis of zero and a value of $2 million (so that the surviving spouse succeeds to all the UAVPAD). Computation:

Estate tax at 50%	$1,000,000
Credit (10% of X [$1.2 million])	120,000
	$ 880,000

4. *Basis Adjustment*

The basis of property in the gross estate with elements of UAVPAD would be increased by the amount of "X." The increase would be allocated among such property in proportion to the amounts of UAVPAD involved.

EXHIBIT H

ABA LEGISLATIVE RECOMMENDATION NO. 1980-5

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO MAKE IT CLEAR THAT THE EXISTING RULE FOR ESTABLISHING THE VALUE OF PRIOR GIFTS FOR GIFT TAX PURPOSES EXTENDS TO ESTATE TAX AND GENERATION-SKIPPING TRANSFER TAX COMPUTATIONS AND TO PROVIDE THAT USE OF THE UNIFIED CREDIT FOR GIFT TAX PURPOSES BE OPTIONAL RATHER THAN MANDATORY.

RESOLVED that the following Resolutions be submitted by the Section of Taxation to the House of Delegates of the American Bar Association:

RESOLUTIONS

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to make it clear that the existing rule for establishing values for gift tax purposes (by which the question of the value of donated property is settled if a gift tax return has been filed reporting the gift, a gift tax has been assessed or paid, and the time for assessment of a gift tax deficiency has expired) extends to estate tax computations and to the tax on generation-skipping transfers and to provide that use of the unified credit for gift tax purposes be optional rather than mandatory, thereby allowing a donor to pay a gift tax and activate the existing rule;

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments that will achieve the foregoing results.

REPORT

Summary

Under section 2505, enacted by the Tax Reform Act of 1976, the unified credit is required to be applied, to the extent available, to offset tax on lifetime transfers. The statute requires use of the unified credit "allowable" (section 2505(a)(2)). This is a change from prior law under which use of part or all of the lifetime exemption was optional. Gift tax due is computed with respect to each transfer by reducing the gift tax generated from the transfer by the amount of unified tax credit allowable at the time of the transfer.

The change made by the Tax Reform Act of 1976 prevents a donor-taxpayer from resolving issues of valuation if the value of the gift does not exceed, in the judgment of the taxpayer, an amount which would incur a gift tax beyond that covered by the available unified credit. Payment or assessment of some gift tax is necessary to trigger the statute (section 2504(c)) which is designed

to settle valuation questions. When a donor-taxpayer cannot activate section 2504(c), the Service may question the value of the gifts for the purpose of determining the amount of gift tax owed with respect to later gifts.Moreover, under the unified transfer system, such questions may arise many years later in determining the estate tax bracket applicable to the donor's estate.

It is not clear whether the Service can question the value of lifetime transfers where a gift tax was paid or assessed for estate or generation-skipping transfer tax purposes. Section 2504(c) expressly applies to gift tax computations, and the Code contains no counterpart for the estate tax or for the tax on generation-skipping transfers.

It is recommended that a donor be permitted to use less than the full amount of the allowable unified credit provided for in section 2505 and thereby pay a gift tax which would start the running of the period specified in section 2504(c), after which the Service would not be able to challenge the valuation of such gift for future gift tax purposes.

It is further recommended that the Code be amended to make clear that the provision for making the value of a gift conclusive for gift tax purposes would extend as well to the computation of the estate and generation-skipping transfer taxes.

Discussion

The Tax Reform Act of 1976 enacted a rule that prevents some donors from using the procedure already in the Code for fixing the value of gifts in computing the amount of tax on subsequent gifts. Under section 2505, added by the Tax Reform Act of 1976, the unified credit is required to be applied to reduce or eliminate the gift tax otherwise generated by a transfer. See Rev. Rul. 79-160, 1979-1 C.B. 313.

Present law governing computation of the estate tax or the generation-skipping transfer tax requires that post-1976 lifetime gifts made by a decedent or a deemed transferor be taken into account in determining the amount of each of those taxes as well. The Code does not contain a provision to settle questions of value of such gifts for estate or generation-skipping transfer tax purposes.

The effect of requiring a donor to use the unified credit "allowable" for gift tax purposes is to prevent a donor-taxpayer from setting at rest issues of valuation for transfers that do not exceed an amount which would generate a gift tax beyond that covered by the credit. While the usual three-year statute of limitations bars the service from assessing a deficiency in gift tax as to transfers reported on a gift tax return, it does not bar the Service from increasing the value of gifts reported on prior returns for purposes of computing the gift tax payable in respect of later gifts. Section 2504(c) was enacted to remove this

uncertainty from the tax system. Under section 2504(c), if the service does not increase the value of a gift during the statutory assessment period, the service is thereafter bound by the value reflected on the return for the purpose of computing the amount of gift tax payable on subsequent transfers. Section 2504(c) applies, however, only if a gift tax is assessed or paid. When no gift tax is assessed or paid, a later adjustment in value may be made.

Prior to the Tax Reform Act of 1976, under former section 2521, a donor was not required to use his $30,000 lifetime exemption and could thereby incur and pay a gift tax and activate section 2504(c). The applicability of section 2504(c) was significantly limited when Congress, in section 2505(a), required use of the allowable unified credit to reduce or eliminate the gift tax otherwise owed.

Another effect of the required use of the credit is that a gift wherein the donee agrees to pay the gift tax, called a "net gift," is not possible unless the donor's credit has been used in full. In Rev Rul. 79-398, 1979-49 I.R.B. 12, the Service, focusing on the language of section 2505(a), held that in computing gift tax a donor cannot elect to defer the use of the unified credit where the donee undertakes to pay the tax. Consequently, net gifts cannot effectively be made by a donor to the extent of his unused credit even though he may desire not to use the credit.

Valuation questions should be settled when the evidence is fresh. The service should not be permitted to adjust values many years after the transfer at issue was made. This was the legislative purpose behind section 2504(c). After the statute of limitations has run, the value of a gift for a prior year with respect to which a gift tax was assessed or paid should be conclusive in determining the tax rate to be applied to subsequent gifts. Similarly, where a gift tax was assessed or paid, and the statute of limitations has run, the value of a gift for a prior year should be conclusive in determining the rate of tax to be applied to the donor's estate and in determining the rate of tax to be applied to a generation-skipping transfer as to which the donor is the deemed transferor.

Under the Recommendation the change would be accomplished for gift tax purposes by deleting the word "allowable" in section 2505(a)(2) and substituting "claimed and allowed," as in former section 2521. A further change would be made in section 2505(a) to make it clear that a part or all of the unified credit must be claimed. It is intended that the administrative interpretation, in the regulations and elsewhere, of these changes would be the same in principle as that under former section 2521.

For estate tax purposes the change would be accomplished by making section 2504(c) expressly applicable for "purposes of computing the estate tax under chapter 11" as well as the gift tax under chapter 12. Though an argument can be made that section 2503 incorporates the provisions of section 2504,

thereby making available for estate tax purposes the existing provision for establishing values for gift tax purposes where a gift tax is assessed or paid, that result is not clear. Section 2001(b) refers only to section 2503, and section 2503 does not specifically incorporate section 2504(c). Moreover, section 2504(c) expressly applies for purposes of computing the tax under "this chapter" (the gift tax).

Also for estate tax purposes, section 2001(b) would be amended by changing "payable" to "assessed or paid." Computation of the estate tax involves determination of a tentative estate tax on the aggregate value of the taxable estate plus "adjusted taxable gifts." From this tentative estate tax a deduction is taken for the amount of gift tax "payable" in respect of gifts made by the decedent after December 31, 1976. If the question whether the deduction for the gift tax is the amount of gift tax actually assessed or paid or the amount of gift tax "payable" is left open in an estate tax computation, the result could be unnecessary controversies over value questions in respect of prior gifts. This opening for the Service, or for the taxpayer, to argue about what gift tax should have been "payable," should be closed. The change of "payable" to "assessed or paid" would mean that the gift tax actually assessed or paid would be subtracted in determining the estate tax (section 2001(b)). The words "assessed or paid" are the same as in section 2504(c).

Computation of the tax on certain generation-skipping transfers under chapter 13 also requires a determination of the amount of the "adjusted taxable gifts" of the deemed transferor. For that purpose, section 2602(a)(1)(C) incorporates into chapter 13 section 2001(b) from the estate tax rules of chapter 11. As noted above, section 2001(b) refers to "adjusted taxable gifts" as determined under section 2503 of the gift tax rules in chapter 12. The Recommendation would broaden section 2001(b) to include a specific reference to section 2504(c); hence, that provision would automatically extend to computation of the tax on generation-skipping transfers under chapter 13. For ease of reference, section 2504(c) would also be expanded to make clear that it would apply to the tax on generation-skipping transfers.

Although the proposed amendments are likely to generate revenues at times earlier than under present law, the extra revenues to be anticipated from the early payment of gift taxes may be relatively small when compared to the administrative burden placed on the Service either to audit or to be bound by values as reported on a taxable gift tax return. However, when a donor-taxpayer files a return he has the initial duty to establish correct values, under penalties of perjury. When a donor makes a full disclosure to the Service and pays a gift tax, the onus of questioning that value in a timely manner should shift to the Service. Certainty in the administration of the tax laws should override the desire of the Service to be rid of administrative pressure. The Service may ease its burden by including on the face of the gift tax return a box to be checked

by the donor-taxpayer if any of the reported gifts are of a property other than those (such as cash and listed securities) as to which there is generally no dispute over value.

The Recommendation would return to principles applicable under pre-1977 law. It is anticipated that, as under pre-1977 gift tax principles, a donor who desires to fix the valuation of transferred property for future transfer tax purposes would defer a part of the available unified credit so as to incur a tax. Though a sophisticated taxpayer may use these principles to his advantage, that was possible (and widely accepted) under pre-1977 law; the need for machinery to fix values is deemed to outweigh this concern.

The amendments would apply to transfers made after the date of enactment. A gift made after the date of enactment may have the benefit of the rules of section 2504(c) in the determination of any gift tax generated by any subsequent gift, in the determination of the donor's estate tax and also, if the donor becomes a deemed transferor, in the determination of the tax on generation-skipping transfers. Also a transfer at the death of a person dying after the date of enactment would have the benefit of the rules of section 2504(c) to determine, for estate tax purposes and for the tax on generation-skipping transfers, the amount of "adjusted taxable gifts" during decedent's lifetime and the amount of gift tax "assessed or paid" in respect thereof.

A gift made between December 31, 1976, and the date of enactment would not have the benefit of the new rules; however, if a gift tax were assessed or paid, such a gift could have the benefit of the existing provisions of section 2504(c). A transfer at death which occurred between December 31, 1976, and the date of enactment would not have the benefit of the new rules for estate tax or generation-skipping tax purposes; the value of prior "adjusted taxable gifts" would be conclusive for estate or generation-skipping tax purposes, only if existing rules so provide.

The changes would not be made applicable to any transfers, by gift or at death, made between December 31, 1976, and the date of enactment, to avoid obvious retroactivity problems.

Tax Section Recommendation No. 1970-4, proposed in August 1970, 23 TAX LAWYER 999 (1970), and adopted by the Association in 1971, 96 A.B.A. REP. 445 (1971), provides for related, but not inconsistent, changes in section 2504(c). Specifically, that Recommendation provides that if a gift tax has been assessed or paid and the statute has run, (i) the Service would not be able to adjust the amounts of exclusions and deductions, *e.g.*, charitable and marital deductions reported on a gift tax return (in addition to the existing prohibition against adjustments in values) and (ii) the bar to adjustments would apply to value, exclusion and deduction items reported on prior returns which enter into the computation of the gift tax owed on the return at issue. It is recommended that Recommendation No. 1970-4 be retained.

No member of the originating committee or of the Council of the Section of Taxation is known to have material interest in the Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. It is recommended that the amendment be given only prospective application. In that case, clients would not be affected in any pending matter.

PROPOSED STATUTORY LANGUAGE

RESOLVED that the Section of Taxation implement the foregoing by urging the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:

Sec. 1. Subsection (b) of section 2001 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(b) COMPUTATION OF TAX. — The tax imposed by this section shall be the amount equal to the excess (if any) of —

(1) a tentative tax computed in accordance with the rate schedule set forth in subsection (c) on the sum of —

(A) the amount of the taxable estate, and

(B) the amount of the adjusted taxable gifts, over

(2) the aggregate amount of tax **[payable]** *assessed or paid* under chapter 12 with respect to gifts made by the decedent after December 31, 1976.

For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503 *and as determined under section 2504(c)*) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

Sec. 2. Subsection (c) of section 2504 is amended to read as follows (insert new matter in italics):

(c) VALUATION OF CERTAIN GIFTS FOR PRECEDING CALENDAR YEARS AND QUARTERS — If the time has expired within which a tax may be assessed under this chapter or under corresponding provisions of prior laws on the transfer of property by gift made during a preceding calendar year or calendar quarter, as defined in section 2502(c), and if a tax under this chapter or under corresponding provisions of prior laws has been assessed or paid for such preceding calendar year or calendar quarter, the value of such gift made in such preceding calendar year or calendar quarter shall, for purposes of computing the tax under this chapter for any calendar quarter *and for purposes of computing the estate tax under chapter 11 and the generation-skipping transfer tax under chapter 13,* be the value of such gift which was used in computing the tax for the last preceding calendar year or calendar quarter for which a tax under

this chapter or under corresponding provisions of prior laws was assessed or paid.

Sec. 3. Subsection (a) of section 2505 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(a) GENERAL RULE. — In the case of a citizen or resident of the United States, *if claimed* there shall be allowed as a credit against the tax imposed by section 2501 for each calendar quarter an amount equal to —

(1) $47,000, reduced by

(2) the sum of the amounts **[allowable]** *claimed and allowed* as a credit to the individual under this section for all preceding calendar quarters.

Sec. 4. The amendments made by sections 1, 2, and 3 shall apply to transfers made after the date of enactment thereof.

EXPLANATION OF PROPOSED STATUTORY LANGUAGE

The effect of the Recommendation is to extend to gift, estate, and generation-skipping tax computations the valuation principles applicable to gift tax computations under pre-1977 law. Other substantive approaches have been considered and rejected. Use of the unified credit itself, without payment of a gift tax, might trigger the statute on valuation issues, but that was deemed too favorable to the taxpayer and would place too great an administrative burden on the Service. On the other hand, suggestions (i) requiring a donor to claim all or none (not a part) of his available unified credit and (ii) prohibiting use of any remaining credit after adjustments in audit were thought too great a burden on the taxpayer, for the purpose of having two parties come together to fix value would be accomplished and use at any time of any part of the unified credit is a valuable "payment" by the taxpayer. Changing the evidentiary presumption in favor of values reported by a donor-taxpayer for future transfer tax purposes after a specified period of time or establishing a procedure for requesting rulings on value questions were thought too radical a departure from prior concepts and too complicated.

Conforming and clerical amendments have not been made.