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Federal Estate and Gift Tax Reform Act of 1976 and Estate Planning Implications†

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The Estate and Gift Tax Reform Act of 1976 was approved by President Ford on October 4, 1976. It makes significant changes in the Estate and Gift Tax provisions of the Internal Revenue Code, enacted in 1954, by material amendments to existing sections and by introducing new concepts in and added sections to this area of the tax laws. This article analyzes in depth the substantive changes in the law and their impact on existing and future estate plans.

I. Unified Transfer Tax and Rate Schedule (Amending Section 2001 of I.R.C.)

A. *Citizens or Residents of the United States*

1. *Prior Law.*—Prior law provided for a gift tax on lifetime transfers of property and an estate tax on transfers at death. The gift tax rate was three-fourths of the estate tax rate for corresponding brackets. Exemptions were allowed for both taxes, as well as an annual exclusion for the gift tax. The rates of tax were separately stated for each tax, beginning with the lowest rate and moving upward progressively. If a lifetime transfer was included in the decedent's gross estate, due to retained interests, rights, powers, or because transfers made within three years of death were made "in contemplation of death," the amount of the gift tax paid on the transfer was excluded from the gross estate and was allowed as a credit against the estate tax.

The new unified rate schedule[1] of the 1976 Tax Reform Act is aimed

1.

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $10,000	18% of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20% of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22% of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24% of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26% of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28% of the excess of such amount over $80,000.

at eliminating the preferential treatment given lifetime transfers. Congress believed that this preference principally benefited only the wealthy, who were able to afford lifetime transfers.[2] In addition, Congress desired to eliminate the great amount of litigation in the "contemplation of death" area.[3]

2. *1976 Tax Reform Act*.—The proposal for a unified transfer tax to take the place of the separate estate and gift taxes[4] has been advanced for many years.[5] The new Act provides for the adoption of a single unified estate and gift tax rate schedule of progressive rates based on cumulative lifetime and death-time transfers, the latter being deemed the last transfer. The effect of this provision is to treat transfers the same whether made during life or death. The unified schedule eliminates the preferential rates provided under the present Code for lifetime transfers, which are three-fourths of the estate tax rates at each corresponding bracket. The annual gift tax exclusion of $3,000 for each donee is continued. Except for the last three years prior to death, the amount of gift tax paid during lifetime will not be added to the transfer base at death. The annual exclusion and the

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Over $100,000 but not over $150,000	$23,800, plus 30% of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32% of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34% of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37% of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39% of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41% of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43% of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53% of the excess of such amount over $2,500,000.
Over $3,000,000 but not over $3,500,000	$1,290,800, plus 57% of the excess of such amount over $3,000,000.
Over $3,500,000 but not over $4,000,000	$1,575,800, plus 61% of the excess of such amount over $3,500,000.
Over $4,000,000 but not over $4,500,000	$1,880,800, plus 65% of the excess of such amount over $4,000,000.
Over $4,500,000 but not over $5,000,000	$2,205,800, plus 69% of the excess of such amount over $4,500,000.
Over $5,000,000	$2,550,800, plus 70% of the excess of such amount over $5,000,000.

Under this rate schedule, the rates range from 18% for the first $10,000 in taxable transfers to 70% of taxable transfers in excess of $5,000,000. There will, however, be a unified credit that will be phased in over a five-year period—$30,000 in 1977, $34,000 in 1978, $38,000 in 1979, $42,500 in 1980, and $47,000 in 1981 and thereafter. In 1977 the credit will be equivalent to an exemption of $120,667; in 1978 $134,000; in 1979 $147,000; in 1980 $161,000; and in 1981 and thereafter, the fully phased-in unified credit will be equivalent to an exemption of $175,625.

2. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 11 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 460-542 [hereinafter cited as H.R. REP.].

3. *Id.* at 12.

4. The Federal Estate Tax was first imposed by the Act of September 8, 1916 and has been continuously in effect since. The present gift tax dates from the Revenue Act of 1932.

5. *See* Altman, *Continuing the Gift and Estate Taxes*, 16 TAXES 219 (1938). *See generally* E. POLISHER, ESTATE PLANNING & ESTATE TAX SAVING 489-601 (1948).

disregard of the gift tax paid during lifetime create incentives for lifetime giving. The present rules for determining when a gift is to be considered completed for the gift tax will be retained, as well as the gift splitting provisions now available to husband and wife for gifts to third persons.

Under the 1976 Tax Reform Act, the estate tax bracket of the decedent is computed by adding the total of his taxable estate to all post-1976 taxable gifts other than those includable in his gross estate, such as gifts made within 3 years prior to death, and those includable in the estate although made beyond the 3 year period, because of sections 2036 and 2038. The taxable estate is treated as the final transfer of the decedent and is superimposed upon the total taxable gifts made during the decedent's lifetime after December 31, 1976. If the decedent was a donor of any gift, one-half of which was considered as made by the decedent's spouse, and the amount of such gift is includable in the decedent's gross estate, any tax payable by the spouse is to be treated as tax paid by the decedent.

It is, however, important to note that the actual gift tax payable on gifts made after 1976 is based upon a rate determined by reference to all of the transferor's prior gifts, whenever made. In computing cumulative taxable gifts for preceding taxable periods, the donor's taxable gifts for periods preceding January 1, 1977, are to be taken into account. At the same time, in computing the tax payable, the reduction for taxes previously paid is to be based upon the new unified rate schedule, even though the gift tax imposed under prior law may have been less than this amount. Thus, a donor's previously taxable gifts only affect the starting point in determining the applicable rate and net tax on gifts made after December 31, 1976. Moreover, the amount of credit for pre-1977 gifts includable in the gross estate is not determined by the actual gift tax paid on such gifts, but rather by treating the total amount of such taxable gifts as having been paid under the rate schedule of the 1976 Tax Reform Act. The credit allowed will be that amount which the total of such taxable gifts would reach under the new schedule.

The Act also provides for the inclusion in the decedent's gross estate of all gifts made during the three-year period ending on the date of the decedent's death, except amounts of $3,000 or less which qualify for the annual exclusion. As a result, contemplation of death problems have been eliminated. Moreover, the amount of gift tax paid in respect to such transfers made within three years of death are to be included in the decedent's gross estate as a gross up.[6] Such "gross up," however, does not include any gift tax paid by the spouse on a gift made by the decedent within three years of death which is treated as made one-half by the spouse, since the spouse's payment of such tax would not reduce the decedent's estate at the time of death.

3. Credit for State Death Taxes.—The credit for state death taxes

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6. New section 2035, added to the Code by the 1976 Act.

paid is continued as under present law. Since the limitation on the credit against the estate tax for state death taxes is determined by reference to the taxable estate, a conforming change is made to reflect the fact that the credit does not enter into the computation of the taxable estate. For this purpose, the taxable estate is reduced by $60,000 and the credit is computed as under prior law, utilizing the table in section 2011(b) of the Internal Revenue Code.[7]

The effective date of the unification will apply to estates of decedents dying after December 31, 1976. The amendments relating to estate tax treatment of transfers made within three years of death, however, do not apply to transfers made before January 1, 1977; the rules controlling transfers in contemplation of death will continue to apply to such transfers.[8]

B. *Estates of Non-Resident Aliens and Residents of U.S. Possessions*

The estate of a non-resident alien[9] is allowed a credit of $3,600 against

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7. The following examples illustrate the computation of estate and gift taxes using the new unified credit:

Example: Computation of Gift Tax

A donor makes the following taxable gifts:

(a) First quarter 1974	$ 10,000.00
(b) Second quarter 1975	20,000.00
(c) Third quarter 1976	100,000.00
(d) Fourth quarter 1977	50,000.00

The gift tax for the fourth quarter of 1977 is computed as follows:

(a) Taxable gifts for the current quarter	$ 50,000.00
(b) Taxable gifts for previous quarters	130,000.00
(c) Total taxable gifts	$180,000.00
(d) Tax on amount in line (c)	48,400.00
(e) Tax on amount in line (b)	32,800.00
(f) Gift tax before credit line (d) minus (e)	15,600.00
(g) Less unified credit	15,600.00
(h) Gift tax payable	-0-

Example: Computation of Estate Tax

The same decedent dies in 1981 with a taxable estate of $1,000,000. In addition to the gifts made previously, as computed above, he made one further gift in 1979 of an additional $200,000 on which he paid a gift tax of $35,200.

(a) Taxable estate	$1,000,000.00
Plus 1979 gift	200,000.00
Plus gift tax paid	35,200.00
Total	$1,235,200.00
(b) 1977 gift	50,000.00
(c) Total of (a) and (b)	$1,285,200.00
(d) Tentative tax on (c)	413,436.00*
(e) Less gift tax on 1977 gift	—0—
(f) Estate tax before unified credit	$ 413,436.00
(g) Less unified credit	47,000.00
(h) Estate tax payable	$ 366,436.00

* After credit for state death taxes.

8. H.R. Rep., *supra* note 2, at 10-15; H.R. Conf. Rep. No. 94-1515, 94th Cong., 2d Sess. 608 (1976), *reprinted in* [1976] U.S. Code & Ad. News 1222-1388. [hereinafter cited as Conf. Rep.].

9. A separate rate schedule for such estates is provided by section 2101(d) of the Act, as follows:

the estate tax imposed upon the taxable estate (determined as provided in section 2106). Included are the adjusted taxable gifts made by the decedent after December 31, 1976, other than gifts brought back into the gross estate.

For the estate of a resident of a possession of the United States, the credit allowable is to be the greater of $3,600 or the proportion of $15,075 which the value of the property situated in United States bears to the value of the entire gross estate, wherever situated. This credit is phased in over a period of five years, beginning in 1977 when the credit is to be $8,480 and ending in 1980, when the full credit of $15,075 will be allowed. The credit cannot exceed the amount of tax imposed by section 2101(d). In the case of the estate tax provisions relating to expatriation to avoid estate tax, the credit allowable is to be $13,000.

C. Estate Planning Comments

1. The Annual Exclusion.—The annual exclusion, as presently defined, remains intact and is unaffected by the 1976 Act.[10] Gifts up to the amount of the $3,000 annual exclusion for each donee made within 3 years of death will not be grossed up in the decedent's estate. Thus, where the donor's spouse consents to a gift to a third person, making a total gift by both for the year of $6,000, the additional $3,000 consented to by the spouse will not escape gross up.

Although all gifts and the taxes payable thereon made by the decedent within 3 years prior to his death will be thrown back into his estate, the annual exclusion of $3,000 allowable to any number of donees each year is disregarded, even though made within the 3 year period. Thus, the decedent could utilize such annual exclusions to an unlimited number of donees up to the moment of death, without sacrificing any tax benefits. When, however, the donor's spouse consents to such gifts within the 3 year period, so as to increase the allowable amount of exclusions to $6,000, the excess over $3,000, attributed to her joinder, will be grossed up and become part of the decedent's estate at death. Therefore, it would be advisable to avoid utilizing the consent of the spouse for such gifts to third parties but have the decedent make a gift of an extra $3,000 to the spouse, who in turn could utilize the same for the extra $3,000 gift to the third party

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If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $100,000	6% of such amount.
Over $100,000 but not over $500,000	$6,000, plus 12% of excess over $100,000.
Over $500,000 but not over $1,000,000	$54,000, plus 18% of excess over $500,000.
Over $1,000,000 but not over $2,000,000	$144,000, plus 24% of excess over $1,000,000.
Over $2,000,000	$384,000, plus 30% of excess over $2,000,000.

10. *See* Polisher & Kapustin, *The Federal Gift Tax: How Does it Work and What Gifts Are Taxable?*, 1 TAXATION FOR LAWYERS 12 (July-August 1972).

in lieu of consent. Where more than one third party donee is involved, this technique will only be available as to the first donee. Her gift would likewise be disregarded in valuing the decedent's estate, although made within the 3 year period prior to his death.

2. *Split Gifts by Spouses to Third Parties*.—Split gifts to third parties by spouses under section 2513 of the Code are not affected by the 1976 Act. Therefore, only 50% of post-1976 gifts will be taken into account in computing the unified transfer tax and its effect on the allowable credit, if the gifts were made more than three years prior to the decedent's death. Where, however, the joint gift is thrown back into the decedent's estate because of sections 2036 and 2038, or because made within three years prior to the decedent's death, the entire gift becomes part of the decedent's gross estate.

3. *Computing the Unified Transfer Tax for Gifts Under the 1976 Act*.—The computation of the gift tax for gifts made after 1976 takes into account all prior taxable gifts made by the donor during his lifetime. The effect of this is to cause the post-1976 gifts to be subject to the unified transfer tax at the higher rates attained by combining all taxable gifts. This is true even though the donor is allowed a deduction from the total tax thus computed. This deduction is based upon the transfer tax he would have paid on the pre-1977 gifts, had they actually been made after January 1, 1977.

4. *Gift Programs*.—There will continue to be an advantage to making lifetime gifts of relatively low value assets that are likely to appreciate in value during the balance of the donor's lifetime, since all of the post-gift appreciation will escape both gift tax and estate taxation in the donor's estate. Under prior law, there was often a hesitancy to give away assets, even if they were likely to appreciate in value. If the donor had retained the assets until his death, and they were sold by the estate, income tax on appreciation would be avoided due to the step-up in basis, but the fair market value would be subject to estate tax. Conversely, a gift would have removed the assets from the estate, but the donee would have to pay income tax on any appreciation when he sold the assets. Now that obtaining a step-up in basis is no longer possible for assets acquired after 1976, however, shifting future appreciation to others can only be an advantage. For this reason, there would also appear to be excellent reasons for making new investments that require nominal amounts of capital through trusts for members of the family, so that all of the appreciation will be deflected from the decedent. At the same time, thought should be given to the retention of low basis assets in the estate in order to get the benefit of the December 31, 1976 "fresh start" basis.

5. *Life Insurance*.—Vesting the incidents of ownership in life insurance policies outside of the insured continues to be beneficial under the 1976 Act. An important unresolved question is whether the proceeds of

insurance policies gifted within three years of death, if the cash values at the date of the gift fall within the annual gift tax exclusion allowable, will be included in the estate. Under the 1976 Act, gifts in amounts within the annual exclusion are conclusively removed from the estate, even though made within three years of death. This is particularly applicable in the case of term or group term life insurance. The regulations to be promulgated will most likely provide the answer. In addition, it may be that the previous concern that the payment of premiums by the insured up to the date of death would be treated as transfers in contemplation of death will no longer be a problem, provided the premiums fall within the amounts of the allowable annual exclusion.

II. Unified Credit in Lieu of Specific Exemptions (Sections 2010 and 2505 Added to I.R.C.)

A. Prior Law

Prior law provided for separate gift and estate tax exemptions. The gift tax gave a specific lifetime exemption of $30,000 per donor[11] and an annual exclusion of $3,000 per donee.[12] The estate tax exemption was $60,000.[13]

Congress recognized that the present estate tax exemption had not been increased since 1942, in spite of inflation which has reduced the value of the dollar by more than two-thirds over that period. Because the gift tax exemption was not available to those who could not afford to make lifetime gifts in the first place, Congress believed it more equitable to create a unified credit in lieu of the former exemptions. A tax credit was chosen because it gives more savings to small and medium sized estates, since it is applied as a dollar for dollar reduction. An exemption, on the other hand, confers more savings on larger estates.[14]

B. 1976 Tax Reform Act

Under the new unified tax a credit is allowed in place of the present gift and estate tax exemptions. As stated previously, there is to be a phased-in unified credit, which during 1977 is $30,000 and in 1981 and thereafter $47,000. As a transitional rule, the credit is to be reduced by an amount equal to 20% of the amount allowed as a specific exemption on gifts made after September 8, 1976, and before January 1, 1977. Further, only $6,000 of the unified credit can be applied to gifts made after December 31, 1976, and prior to July 1, 1977.

The gift tax paid by a decedent's spouse on a lifetime transfer made by the decedent to a third person and included in his gross estate, which was considered as being made in part by the surviving spouse under the

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11. I.R.C. § 2521.
12. *Id.* § 2503(b).
13. *Id.* § 2052.
14. H.R. REP., *supra* note 2, at 17.

gift-splitting provisions of the present law, is to be an offset in computing the estate tax to be imposed.

Consistent with the new credits, an estate tax return, after the credit is fully phased in, will be required only if the decedent's estate exceeds $175,000. During the phase-in period for the unified credit, the filing requirements are to be $120,000 for 1977, $134,000 for 1978, $147,000 for 1979, $161,000 for 1980 and $175,000 for 1981 and thereafter. The applicable amounts would be reduced, however, by the sum of the adjusted taxable gifts made by the decedent after December 31, 1976, and the amount of the specific gift tax exemption under present law utilized by the decedent with respect to gifts made by the decedent after September 8, 1976, and before January 1, 1977.

The effective date of this Amendment is to apply to estates of decedents dying after December 31, 1976, and to gifts made after December 31, 1976.[15]

C. *Estate Planning Comment*

The unified transfer tax credit must be taken and cannot be waived. This differs from the specific exemption under the former gift tax, which could be utilized at the election of the donor. In view of the reduced credit ($6,000) allowed for gifts made between January 1 and June 30, 1977, substantial gifts should be avoided during this period. For gifts made after the latter date, the full credit allowable in the year of the gift will be available.[16]

III. Increase in the Marital Deduction (Amending Sections 2056(c) and 2523 of I.R.C.)

A. *Prior Law*

The maximum marital deduction for estate tax purposes under prior law was 50% of the adjusted gross estate.[17] The gift tax marital deduction was 50% of the value of the gift to the spouse.[18] Believing that the prior limits were too restrictive and that they interfered with normal transfers between spouses,[19] Congress made the changes discussed below.

B. *1976 Tax Reform Act*

The Act increases the maximum estate tax marital deduction for property passing from a decedent to a surviving spouse to the greater of $250,000, or one-half of the decedent's adjusted gross estate. The gift tax marital deduction provides for an unlimited deduction for transfers be-

15. H.R. REP., *supra* note 2, at 15-17; S. REP. No. 94-938, Part II, 94th Cong., 2d Sess. 13 (1976) [hereinafter cited as S. REP.]; CONF. REP., *supra* note 8, at 607-08.
16. See table on following page.
17. I.R.C. § 2056(c).
18. *Id.* § 2523(a).
19. H.R. REP., *supra* note 2, at 17.

This table compares the estate tax results in estates between $150,000 and $500,000, with and without use of the marital deduction, under 1976 Tax Reform Act (TRA) and prior law.

	ESTATE TAX BEFORE 1976 TRA		ESTATE TAX AFTER 1976 TRA									
			1977		1978		1979		1980		1981	
ESTATE SIZE	FULL M.D.*	NO M.D.	FULL M.D.	NO M.D.	FULL M.D.	NO M.D.	FULL M.D.	NO M.D.	FULL M.D.	NO M.D.	FULL M.D.	NO M.D.
150,000	555	17,500	—0—	8,800	—0—	4,800	—0—	800	—0—	—0—	—0—	—0—
200,000	4,800	31,500	—0—	23,600	—0—	19,600	—0—	15,600	—0—	11,100	—0—	6,600
250,000	10,700	45,300	—0—	38,400	—0—	34,400	—0—	30,400	—0—	25,900	—0—	21,400
300,000	17,500	59,100	—0—	54,200	—0—	50,200	—0—	46,200	—0—	41,700	—0—	37,200
350,000	24,400	73,300	—0—	69,600	—0—	65,600	—0—	61,600	—0—	57,100	—0—	52,600
400,000	31,000	87,700	8,400	85,000	4,400	81,000	400	77,000	—0—	72,500	—0—	68,000
450,000	38,400	102,100	23,600	100,400	19,600	96,400	15,600	92,400	11,100	87,900	6,600	83,400
500,000	45,300	116,500	38,400	115,800	34,400	111,800	30,400	107,800	25,900	103,300	21,400	98,800

* M.D. = Marital Deduction

tween spouses for the first $100,000 in gifts. Thereafter, the deduction allowed will be 50% of the inter-spousal lifetime transfers in excess of $200,000. It should be noted that the estate tax marital deduction is to be reduced by the amount of the marital deduction allowed for lifetime transfers in excess of 50% of the value of the transfers, where the lifetime gifts eligible for the marital deduction are less than $200,000. These provisions are effective with respect to estates of decedents dying after December 31, 1976, and to gifts transferred after December 31, 1976.

A transitional rule is included in the Act to provide that the increased estate tax marital deduction will not apply to a transfer resulting from a will or trust executed before January 1, 1977, which contains a maximum marital deduction clause, provided that:

> (a) The formula clause is not amended after December 31, 1976, and before the decedent's death; and
>
> (b) There is not enacted a State law, applicable to the estate, which would construe the formula clause as referring to the increased marital deduction, as amended by this Act.

This transitional rule will be effective for decedents dying after December 31, 1976, and before January 1, 1979. The reason for this rule is that under prior law the maximum marital deduction was limited to one-half the adjusted gross estate and many wills and trusts utilized a maximum marital deduction formula clause. The concern is that many testators using the formula clause may not have wanted to pass more than one-half the estate to the spouse.[20]

C. *Estate Planning Comments*

Under the transitional rule applying to the marital deduction, wills and trusts executed prior to 1977 that contain a maximum marital deduction clause will not be interpreted to take advantage of the new maximum deduction allowable under the 1976 Act unless the will or trust is amended after December 31, 1976, or the testator dies after January 1, 1979. It would be advisable to utilize a codicil to change the marital deduction formula, if it is sought to take advantage of the larger marital deduction allowable under the 1976 Tax Reform Act, so as not to affect other transitional provisions of the Act.

Under the 1976 Act, a new minimum marital deduction of $250,000 is allowed. In estates under $500,000 the decedent spouse may leave to the surviving spouse up to $250,000 tax free. The $250,000 minimum marital deduction should only be used, however, if the adjusted gross estate, after January 1, 1981, is between $425,000 and $500,000. If, for example, the adjusted gross estate is $300,000, the decedent could pass to the surviving spouse the minimum marital deduction of $250,000, which, when combined with the unified credit of $47,000, would eliminate all tax at his death. At the subsequent death of the surviving spouse, however, there

20. *Id.* at 17-18; S. REP., *supra* note 15, at 14.

would be an estate of $250,000 which would be taxed at $70,800, less a credit of $47,000 or a federal estate tax of $23,800. This tax can be entirely eliminated if in the estate of the first decedent, the surviving spouse is left that amount which, after application of the unified credit, will reduce the federal estate tax to zero. Under the suggested plan, the marital deduction in the estate of the first spouse to die would be $125,000, resulting in no tax, and later, no federal estate tax in the surviving spouse's estate.

The marital deduction formula should be integrated with the new unified credit, so that the amount passing to the surviving spouse will be that amount which, after utilization of the unified credit, will reduce the federal estate tax to its lowest possible amount.[21]

IV. Fractional Interest of Spouse (Amending Sections 2040 and 2515 of I.R.C.)

A. Prior Law

Under prior law, on the death of a joint tenant, the entire value of the jointly owned property was included in a decedent's gross estate for estate tax purposes, unless the survivor could prove contribution of part of the purchase price.[22] The gift tax consequences of creating a joint tenancy under prior gift tax law depended on whether the donor had made a completed transfer under local law. Even though a completed gift of an interest in the joint tenancy was deemed to have been made to the non-contributing spouse, the surviving spouse continued to labor under the burden of proving her contribution to its acquisition.

The provisions of the new act are intended to reduce the complexity of the provisions relating to jointly owned property. Congress desired to eliminate the difficult determination of which spouse is responsible for the acquisition of jointly owned property, and to eliminate the possibility of double taxation of the same property under the gift and estate taxes.[23]

B. 1976 Tax Reform Act

This provision applies to property owned jointly by husband and wife. Under the Act, one-half of the value of a qualified joint interest is included

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21. Here is an example of the new marital deduction provisions at work:
A decedent has made lifetime gifts to his spouse after 1977, totaling $150,000. He had allowed a gift tax marital deduction of $100,000. He dies leaving an adjusted gross estate of $400,000. The maximum estate tax marital deduction is $175,000, computed as follows:

(a)	50% of adjusted gross estate	$200,000.00
(b)	New minimum marital deduction	250,000.00
(c)	Maximum marital deduction allowable (greater of (a) or (b))	250,000.00
(d)	Gift tax marital deduction	100,000.00
(e)	Gifts to spouse	150,000.00
(f)	50% of (e)	75,000.00
(g)	Excess of (d) over (f)	25,000.00
(h)	Maximum estate tax marital deduction (c) minus (g)	225,000.00

22. I.R.C. § 2040.
23. H.R. REP., *supra* note 2, at 19.

in the gross estate of decedent at the date of death, regardless of which joint tenant furnished the consideration. The definition of a "qualified joint interest" requires the following:

> The interest must have been created by the decedent or his spouse, or both. As to personal property, the creation of the joint interest must have been a completed gift for purposes of the gift tax provisions. In the case of real property, the donor must have elected to treat the joint tenancy as a gift at the time of the creation of joint tenancy. The joint tenancy cannot be between other than the decedent and his spouse.

This provision applies to joint interests created after December 31, 1976. The chain of title of the property before the creation of the joint tenancy is immaterial. Thus, if a severance or a partition of an existing joint tenancy is made after December 31, 1976, and the joint tenancy between the spouses in that property is then re-created, the creation of the new joint tenancy would be eligible for election, so long as the other requirements are satisfied and the creation of the new tenancy is valid under local law. The amount of the gift resulting from the re-creation of the joint tenancy would be determined under the principles of prior law. They provide, in section 2515 for gift tax purposes, that the creation of a joint tenancy in real property between spouses, when one of the joint tenants furnishes all of the consideration for the creation of the tenancy, will not be deemed to be a completed transfer unless the joint tenant furnishing the consideration elects to do so, or unless the joint tenancy is terminated for any reasons other than death.[24]

Section 2515 applies only to jointly held real estate and not personal property. Once the election is made with regard to the creation of the joint tenancy in real property, it applies to all subsequent additions in value. This would include mortgage payments or debts against the property, as well as improvements made to the property. An appreciation in the value of the property will not constitute an additional gift. The donor is to make the election by including the transfer in a gift tax return for the calendar quarter in which the joint tenancy was created.

A completed transfer is a prerequisite to the imposition of the gift tax. As to personal property, for example stocks and bonds, there is deemed to be a gift when such property is placed in joint names. The creation of a joint tenancy will not, however, be a completed transfer for gift tax purposes, at the creation of a joint bank account in which either party is entitled to withdraw the entire account, until the funds in the account are withdrawn by the joint tenant whose money was not deposited into the account. In the case of a U.S. Savings Bond, the gift is not complete until the bond is surrendered by the joint tenant who did not furnish the consideration. In such cases, the new rules added by this section will not apply and upon the death of either co-tenant, the property will be includable in the gross estate at full value, subject to the contribution-furnished test.

24. I.R.C. § 2515.

The effect of including only one-half of the value of the property in the gross estate in these situations is to recognize implicitly the services furnished by a spouse toward the accumulation of jointly owned property. If the donor does not elect to treat the transfer as a gift at the time of the creation of the interest then, on the death of a spouse, the jointly held real estate is to be subject to inclusion in the gross estate at the full value of the property, less the value attributable to any contribution that can be traced to the survivor.[25]

C. Estate Planning Comments

In reviewing a client's estate plan, careful attention must be paid to the treatment of jointly owned assets if the joint tenancy was created before 1977. If a husband and wife have accumulated a portfolio of securities over a period of years as a result of regular investments from funds supplied by one of them, the tax effect would be that a gift was made at the date of each purchase. Thus, a division of the securities between the spouses after 1976 will not be an additional gift. This can be utilized as a technique for building a wife's estate up to the level of $175,000 which will be the exemption equivalent to the credit available by 1981. The wife's will can then be revised to provide that her estate be left in a lifetime trust for her husband, so that should she predecease him, the $175,000 of assets owned by the wife will not be taxable in either the estate of the husband or that of the wife.

In making this decision, especially in Pennsylvania, the impact of the Pennsylvania inheritance tax cannot be ignored, since the conversion of jointly owned property into separate ownerships by each spouse will increase the inheritance tax on the portion held by each spouse. In more modest estates, it may be advisable to terminate the joint ownerships of securities and then recreate the joint tenancy. This will have the effect of removing one-half of the value of the securities from the husband's estate, for federal estate tax purposes, while at the same time preserving the exemption from Pennsylvania inheritance tax. Under these circumstances, care must be taken to make certain that the wife's estate, at her subsequent death, is not disproportionately large because of her receipt of the jointly owned assets.

If real estate was acquired by husband and wife after 1954 with consideration furnished by one of them, and a gift was not elected under section 2515 to have been made upon the acquisition of the property, a division of the real estate into a tenancy in common after 1976 must be accompanied by an election to treat the one-half passing to the wife as a gift; or, as an alternative, the title should be transferred to the spouse who furnished the consideration. Thereafter, if a joint tenancy between the spouses is re-created in the property, the estate of the first spouse to die

25. H.R. REP., *supra* note 2, at 18-21.

could rely upon this post-1976 joint tenancy for excluding one-half of its value from federal estate tax. Here, too, the Pennsylvania inheritance tax implications cannot be ignored.

This suggestion does not apply to situations in which the property acquired in joint names by the spouses stemmed from their joint efforts and resources, as in the case of "Mom and Pop" businesses, since the surviving spouse could prove her contribution.[26] Nor does it apply to joint bank accounts, joint U.S. Bonds and joint brokerage accounts of securities held in street names, because these are not gifts ab initio. They will only become so when the spouse who did not furnish the consideration withdraws the funds or securities from the account. Thereafter, the filing of a gift tax return in the year the withdrawal occurs will secure for the spouses the benefits of this section of the 1976 Act.[27]

V. Valuation of Real Property Devoted to Farming or Closely Held Business Use (New Section 2032A Added to I.R.C.)

A. *Prior Law*

Prior law valued all property in the gross estate at fair market value, the price that a willing buyer would pay to a willing seller. It was presumed that a willing buyer of real estate would pay a price based on the highest and best use of the land, rather than the actual use at the time of transfer. Because the greater estate taxes based on highest and best use valuation could force the heirs to sell the property for development, the 1976 Act included a special use valuation provision intended to encourage the continued use of property for farming and small business purposes.[28]

B. *1976 Tax Reform Act*

1. Eligibility for Special Valuation.—This section provides that if certain conditions are met, the executor may elect to value real property included in the decedent's estate, which is devoted to farming or closely held business use, on the basis of that property's value as a farm or closely held business, rather than its fair market value determined on the basis of its highest and best use. The special valuation cannot, however, reduce the gross estate by more than $500,000.

To qualify for the special use valuation:

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26. *See, e.g.*, Trafton v. Commissioner, 27 T.C. 610 (1956). *But see* Ehret v. Commissioner, 35 T.C.M. 1432 (1976).

27. The following example illustrates the new provisions relating to jointly owned property. Decedent placed property in the joint names of his wife and himself. The property consists of stocks and bonds in the amount of $100,000 and real estate valued at $100,000. The donor filed a gift tax return reporting the gift of the stocks and bonds, but elected not to consider the real estate as a gift in that year. At his death, the stocks and bonds are still in joint names and are now valued at $200,000. The real estate is similarly in joint names and is valued at $200,000. The assets includable in his estate are (assuming he died more than three years thereafter) as follows: As to the stocks and bonds, $100,000 is includable even though the decedent put up all the consideration for the stocks. As to the real estate, the entire property, $200,000, is includable in his gross estate, because the decedent did not elect to treat the placing of the real estate in joint names as a gift in the year when such joint tenancy was created.

28. H.R. REP., *supra* note 2, at 22.

(1) Decedent must be a citizen or resident of the United States;

(2) The value of the farm or closely held business asset in a decedent's estate, including both real and personal property, must be at least 50% of decedent's gross estate (reduced by debts and expenses);

(3) At least 25% of the adjusted value of the gross estate must be a qualified farm or closely held business real property;

Note: For purposes of (2) and (3) above, the value of property is determined without regard to its special use value.

(4) The real property qualifying for special use valuation must pass to a qualified heir;

(5) Such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely held business for five of the last eight years prior to the decedent's death;

(6) There must have been material participation in the operation of the farm or closely held business by the decedent or member of his family in five years out of the eight years immediately preceding the decedent's death. The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents and aunts or uncles of the decedent and their descendants;

(7) The property will cease to have a "qualified use" for purposes of this section if during any period of eight years ending after the date of the decedent's death and before the date of the death of the qualified heir there had been a period or periods aggregating three years or more during which there was no material participation by such qualified heir or any member of his family in the operation of the farm or closely held business; and

(8) Such property is designated in the agreement, referred to in sub-section (d)(2) of this section, setting forth the tax treatment of dispositions and failures to use the property for qualified use.

The Act provides for two valuation methods: the farm method and the multiple factor method, if the executor so elects. The elements to be considered in utilizing either of these methods are set forth in detail in sub-section (e)(7) and (e)(8) of this section, as amended by the 1976 Act.

The mere passive rental of property will not qualify. When, however, a related party leases the property and conducts farming or closely held business activities on the property, the real property may qualify for special use valuation.

The decedent's estate should be able to utilize the benefits of the special use valuation if he holds the qualifying real property indirectly, as through his interest in a partnership or corporation, but only if the business in which such property is used constitutes a closely held business (as defined in section 6166 as amended) and the real property would qualify for special use valuation if it were held directly be decedent.

2. Definitions—Farm, Farm Purposes, Trade or Business Use.— In general a "farm" includes stock, dairy, poultry, fruit, furbearing animal

and truck farms; plantations, ranches, nurseries, ranges, greenhouses and other similar structures used primarily for the raising of agricultural or horticultural commodities; and orchards and woodlands. In addition, cultivation of the soil and the raising and harvesting of agricultural commodities and preparing them for market are included in the term "farming purposes," which also embraces the planting and cultivating, caring for or cutting of trees and the preparation (other than milling) of trees for market.

Real property used in a trade or business other than farming may also qualify for special use valuation, so long as the property was utilized in a trade or business in which the decedent or a member of his family materially participated prior to the decedent's death. The term "real property" for these purposes covers a farmhouse, other residential buildings, and related improvements located on qualifying real property, if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purposes of operating or maintaining the real property or business conducted on the property. On the other hand, elements of value not related to farm or business, such as mineral rights, are not to be eligible for special valuation.

3. Recapture of Tax Benefits.—If, within 15 years after death of the decedent (but before the death of the qualified heir), the property is disposed of to non-family members or ceases to be used for farming or other closely held business purposes, all or a portion of the federal estate tax benefits obtained by the reduced valuation are to be recaptured. This recapture provision will apply not only if the qualified real property is sold (or exchanged in a taxable transaction) to non-family members, but also when it is disposed of to non-family members in a tax free exchange under section 1031, or if the property is disposed of under an involuntary conversion, rollover or similar transaction which is non-taxable under Code sections 1033 and 1034. Excepted from this latter rule is an involuntary conversion or condemnation, if the proceeds are reinvested in real property which originally qualified for special use valuation.

The amount of tax benefit potentially subject to recapture is the excess of the estate tax liability that would have been incurred had the special use valuation provision not been utilized, over the actual estate tax liability based on the special valuation provisions. If a recapture event occurs within 10 years of the decedent's death, the amount of the recapture tax is the lesser of the adjusted tax difference attributable to this interest, or the excess of the amount realized with respect to the interest over the value of the interest determined with the special use valuation. If the recapture event occurs more than 10 but less than 15 years after decedent's death, the amount subject to recapture is phased out on a ratable monthly basis. The qualified heir is expressly made personally liable for the recapture tax imposed hereunder. After 15 years, the recapture tax is no longer due.

There are certain exceptions to the recapture rules:

(1) If the qualified heir dies without having disposed of the property or converted it to a non-qualified use, the potential liability for recapture will cease.

(2) If the decedent leaves the qualified real property for which special use valuation was allocated to two or more heirs with successive interests in the property, none of the property is to be released from potential liability for recapture until the death of the last qualified heirs, or if earlier, upon the expiration of 15 years from the date of the decedent's death.

(3) A sale, exchange or other disposition (such as a gift) by one qualified heir to another qualified heir is not treated as a recapture event.

While the recapture tax is generally deemed a separate estate tax, it is treated as a tax on the estate of the decedent for the purposes of previously taxed property credit and is regarded as having been imposed as of the date of the decedent's death, rather than at the time the actual recapture event occurred. The Act provides a special lien on all qualified farm or closely held business real property. This lien remains on such property until the potential liability for recapture tax ceases.

4. *Election for Special Use Valuation.*—The election for this special use valuation must be made not later than the time for filing the estate tax return, plus extensions. One of the requirements for making a valid election is the filing with the estate tax return of a written agreement signed by each person in being who has an interest (whether or not in possession) in any qualified real property, which must include the consent of each of these parties to the application of the recapture tax provisions to the property.

5. *Effective Date and Extension of Statute of Limitations.*—These provisions apply to estates of decedents dying after December 31, 1976. The Act provides for an extension of the statutory period for assessment and collection of the recapture tax until three years after the Internal Revenue Service is notified that an event has occurred which results in the imposition of the tax.[29]

C. *Estate Planning Comments*

The limitations on the use of the special valuation formula, including the restriction that the value of such property may not be reduced by more than $500,000, should give pause to consider the alternative. Whenever the special valuation for such property nevertheless results in a substantial amount to be included in the estate because of the $500,000 limitation, it is advisable to decide whether it might be better to forego electing the special valuation and negotiate the valuation of the property through the normal audit procedure. The recapture provisions of the special valuation section,

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29. *Id.* at 21-28; CONF. REP., *supra* note 8, at 610.

if they become operative because of failure to meet the conditions of the section, can be so detrimental that the relief intended by this section may prove to be burdensome.[30]

D. Conservation Easements

One permissible method of reducing the valuation of real property for tax purposes is through the grant of conservation easements for public use. Section 2124(e) of the 1976 Act, dealing with transfers of partial interests in property for conservation purposes, amends sections 170(f) (3)(B)(iii), 2055(e)(2) and 2522(c)(2). It permits the charitable deduction for income, gift and estate tax purposes of a lease, option to purchase, or an easement with respect to real property for a term not less than 30 years, granted to a public charity (section 170(b)(1)(A) organization) exclusively for conservation purposes.

The new provision applies to contributions made after June 13, 1976, and before June 14, 1977, and can be used in lieu of the grant of permanent easements if the objective is to preserve land for agricultural purposes or to protect the environment. The value of the land would be depressed for estate tax purposes by excluding industrial or residential use and might also allow the property to remain in the family unit. For example, under the standard 6% tables, an easement of 30 years has a value equal to 82% of the value compared with a permanent easement. An easement for 50 years would be over 94% of the value.

VI. Automatic Extension of Time for Payment of Estate Tax (Amending Section 6166 of I.R.C.)

A. Prior Law

Under prior law, the IRS could grant an extension of time for payment of estate tax of up to ten years in the case of "undue hardship."[31] In addition, an estate consisting in large part of a closely held business could elect to pay the estate tax in installments extending up to ten years.[32] Congress noted that the IRS granted extensions on the grounds of undue hardship only rarely. In addition, it felt that these provisions have not adequately alleviated the liquidity problems of estates that consist in large part of a closely held business.[33]

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30. *Example*: Decedent owned a 250 acre farm which has been a family farm for the last 30 years. Under his will, the farm is devised to his son, who will continue to use the farm in a similar manner. The property is located near housing developments, which have been spreading throughout the area. At the date of death, the farm is valued as farm land at $1,000 per acre or a total of $250,000. The property could be sold to a housing developer at $4,000 an acre or a total of $1,000,000. The executor elects to use the new special valuation procedure. The land is to be valued at $500,000. This is accomplished because even though the land as farm land is worth only $250,000, the Act provides that the special valuation cannot reduce the gross estate by more than $500,000. Therefore, since the difference in valuation is $750,000, the reduction is limited to a $500,000 figure.

31. I.R.C. § 6161(a)(2).

32. *Id.* § 6166.

33. H.R. REP., *supra* note 2, at 30.

B. 1976 Tax Reform Act

1. Introduction.—Under the conference agreement, the present 10 year extension for payment of estate tax (section 6166) is retained if the value of a closely held business exceeds 35% of the value of the gross estate or 50% of the taxable estate of the decedent. The Act provides a new 15-year period for payment of the estate tax attributable to the decedent's interest in a farm or other closely held business, with the entire principal being deferred for five years and then payable in equal annual installments over the next 10 years. Interest is computed at the rate of 4% on the tax attributable to the first $1,000,000 in value of a farm or other closely held business property, with the standard rate of interest on valuations above the $1,000,000 figure. The five-year deferral is only for the tax. The interest on the tax must be paid annually.

2. Requirements for Installment Payment of Tax.—To qualify for deferral and installment payment treatment, the value of the closely held business in a decedent's estate must be at least 65% of the value of gross estate, reduced by expenses, indebtedness and losses. An interest in a closely held business is defined as one in which the decedent had a 20% or more interest in the capital of a partnership or 20% or more in the value of the voting stock of a corporation, or one in which such partnership or corporation had fiften or fewer partners or shareholders. This section also liberalizes the rule as to when two or more businesses may be aggregated for purposes of determining whether the estate qualifies under the 65% rule and the amount of tax to be deferred. The new provision permits interests to be aggregated if each of them represents more than 20% of the total value of each such business included in the gross estate. For this purpose, property that is held by husband and wife as joint tenants, tenants by the entirety or tenants in common is treated as though it were owned by one shareholder or one partner. Property (including stock or partnership interest) owned directly or indirectly by or for a corporation, partnership, estate or trust is considered as being owned proportionately for its shareholders, partners or beneficiaries. Beneficiaries are counted for apportionment only if they have a present interest in the trust.

This section essentially continues the current provisions that provide for acceleration of the deferred tax when amounts equal to or in excess of one-third of the value of the closely held business are distributed, sold, exchanged or otherwise disposed of, or upon failure to pay an installment when due. Redemption of stock under sections 303 and 304, however, will not cause an acceleration, but the interest in the closely held business will be considered to be such interest reduced by the value of the stock redeemed.

3. Installment Payment of Deficiencies.—This Act allows the executor to pay any estate tax deficiencies in installments, if the estate qualifies for the election but the executor has not made the election. This

will apply both (1) to situations in which on the basis of the estate tax return as filed the estate was eligible to make the election but did not do so, and (2) to situations in which the adjustments on the return on audit increase the valuation of the closely held business or businesses to the point at which the estate is eligible for the automatic election. Interest thereon is to be paid in the manner prescribed by the Secretary, consistent with the provisions of section 6166(f).

4. Special Lien for Deferred Tax Discharge of Executor's Liability.—Under the prior law an executor remained personally liable for payment of the tax for which an extension was granted, unless he furnished a bond. Congress recognized that because bonds are difficult and expensive to obtain, many executors would not elect the extended payment provisions.[34]

A special lien is created under this Act for the payment of the deferred taxes that are attributable to the closely held business, under either of the two extensions available, in situations in which the executor has made an election under the extended payment provision rules relating to the payment of interest, section 6166(f). This new lien provision is elective. An executor and all parties who have an interest in the property subject to the lien must file an agreement consenting to the creation of the lien and designating a responsible person to be the agent for the beneficiaries of the estate and the other consenting persons for the purpose of dealing with the IRS. This lien is in lieu of the regular estate tax lien under section 6324. The new Act requires that it be filed to be valid as against any purchaser, holder of a security interest, mechanics' lienor, or judgment lien creditor. Once filed, it need not be refiled every six years as is required of tax liens generally. Whenever this lien procedure is followed the executor is to be discharged from personal liability.

The lien is inferior to certain other priorities which are essentially the same as those under present law relating to most other liens under section 6323(b). Thus, when a notice of lien has been filed, the lien is not valid against real property tax and special assessment liens (even those which come into existence after the date upon which thenotice of lien is filed). It is also inferior to a mechanics lien for repairs or improvements, or real property construction or improvement financing agreements, if the security interest came into existence before the tax lien was filed. If, however, the Internal Revenue Service files a notice that the payment of the deferred amount has been accelerated, tax liens shall take priority over subsequent mechanics' liens, or real property or construction financing agreements, but not real property tax or special assessment liens.

In addition, the Act allows discretionary extensions of up to ten years to pay the estate tax and deficiencies for "reasonable cause", rather than for "undue hardship" as under present law. The amendments made by this

34. *Id.* at 31.

section apply to estates of decedents dying after December 31, 1976.[35]

VII. Distributions and Redemption of Stock to Pay Death Taxes under Section 303 (Amending Section 303(b) of I.R.C.)

A. *Prior Law*

Prior law taxed a qualified redemption of stock to pay estate taxes, funeral costs and administration expenses as capital gain rather than as a dividend.[36] Congress desired to restrict the benefit of these provisions to the parties who actually bear the burden of payment of debts and taxes, and to restrict use of the provisions to situations in which the closely held business comprised a larger percentage of the estate.[37]

B. *1976 Tax Reform Act*

This section increases the percentage of stock that must be owned by an estate in order to redeem stock to obtain the benefits of section 303. The new test is that the value of the corporate stock included in the gross estate must exceed 50% of the value of the adjusted gross estate. Under existing Code provisions, the requirements for utilizing the advantages of this section are that the stock owned by the estate must exceed 35% of the gross estate or 50% of the taxable estate of the decedent. The time for such redemption is also extended until the due date of the last installment in cases in which an election has been made under section 6166.

Section 303 is further amended to require the capital gains treatment under this section to apply to the distribution made by a corporation in redemption of the stock only to the extent that the interest of a shareholder is reduced directly either by or through a binding obligation to contribute toward such payments. This section will apply to estates of the decedents dying after December 31, 1976.[38]

C. *Estate Planning Comments*

1. *Technical Amendments*.—It is to be hoped that the Technical Amendments Bill, which Congress will most likely enact at its 1977 session to correct errors and adjust inequities resulting from the passage of the 1976 Act, will consider amendments to the revised provisions of section 303. These should include the right of the estate to redeem from the corporation sufficient stock to pay not only the federal estate taxes and state inheritance taxes, but also any income taxes attributable to the redemption of the stock. In addition, Congress should consider restoring to section 303 the previous percentages of stock ownership required to qualify the estate for the favorable tax treatment of such redemptions, *i.e.*, 35% of the gross estate or 50% of the taxable estate.

35. H.R. REP., *supra* note 2, at 28-35; S. REP., *supra* note 15, at 17-19; CONF. REP., *supra* note 8, at 611.
36. I.R.C. § 303.
37. H.R. REP., *supra* note 2, at 31.
38. *Id.* at 35-36; CONF. REP., *supra* note 8, at 621.

2. Meeting the 50% Requirement.—To meet the requirement that the decedent's stock sought to be redeemed by the corporation under this amended section must equal 50% of the decedent's adjusted gross estate, the decedent's individually owned stock and that of the same corporation owned by a generation-skipping trust of which the decedent is the "deemed transferor" should be permitted to be aggregated. This would appear to be consistent with the pattern and rationale of the generation-skipping transfer tax concept.

3. Shareholder Agreements.—It is common practice for close corporations and their shareholders to enter into agreements placing restrictions on the transferability of their stock. These usually provide that upon the death of a shareholder his stock must be sold at a price established by the agreement. The option or obligation to purchase is usually granted to or imposed upon the corporation whenever such a redemption, because of the rules of attribution, will not result in ordinary income to the estate. Prior to the 1976 Act, the deceased shareholder's estate would obtain a step-up in basis equal to the estate tax value, so that the sale of shares would not result in any capital gain to the estate. Under section 303, the corporation would then redeem stock in an amount equal to the federal estate and state inheritance taxes and funeral and administration expenses, without the estate incurring any income tax. With the elimination of the step-up in basis benefit by the carry-over basis provisions of the 1976 Act, estates will now incur an additional expense equal to the capital gains tax. It will, therefore, be necessary to consider in every case whether or not the sale from the estate should qualify as an installment sale, with 30% or less of the purchase price to be received in the year of sale. If the estate selects a short fiscal year that will end immediately after the initial payment is made, the second installment can be received quite promptly by being made payable in the succeeding fiscal year of the estate. If corporation-owned life insurance is being utilized to fund part of the purchase price, with the balance to be paid over a term of years, the estate could easily fall into the trap of collecting and paying out all the insurance proceeds in the year of sale, which would frequently exceed 30% of the sale price and cause the entire gain on the transaction to be subject to immediate taxation.

In situations in which the purchase was made by the corporation, the remaining shareholders did not receive any increase in basis for their stock equal to the purchase price of the redeemed stock. This usually was not a concern, since it was assumed that the surviving shareholders would retain their shares until death, at which time they would obtain the benefit of some step up in basis. It may now be advantageous, however, to give careful consideration to cross-purchase life insurance arrangements that will provide the remaining shareholders with a stepped up basis on the acquired stock, to the extent of the purchase price paid to the decedent's estate by utilizing the life insurance proceeds received by them. Of course, this imposes the burden of paying the premiums on the surviving shareholders,

rather than the corporation. This would invite consideration of the practicality of fully insuring the cross-purchase arrangement. Where the price is substantial and the shareholders are older, the cost of paying these premiums directly by the shareholders may be prohibitive, since they would be using funds on which they have already paid income tax.

It should be noted that if there is a subchapter S corporation involved, with the shareholders already paying tax on all of the corporation income, the cross-purchase arrangement is clearly called for. It should be pointed out that if the life insurance is owned by the corporation, which is the beneficiary, and the premiums are paid from corporate funds, they are not income tax deductible. But at least the premiums are not being paid by the shareholders with their own after-tax dollars.

4. Corporate-Owned Insurance on Shareholder's Life to Redeem Stock at Death.—As a result of the more restrictive provisions of amended section 303, many shareholder agreements, which assumed this section to be available and had corporate-owned insurance to fund part of the purchase price, must be re-examined, since such redemptions may no longer be feasible. Even in circumstances in which the value of the decedent's shares qualify for redemption by the corporation under section 303, but the stock to be redeemed is section 306 stock, such stock no longer will lose its "taint" as a result of the shareholder's death. The redemption of such stock will, in many cases, result in ordinary income to the estate to the extent that the corporation had earnings and profits at the date the preferred shares were issued. A re-examination of all shareholder agreements is imperative in these situations. Reversing the recapitalization, following death, may be the only available solution.

The regulations, when issued, should prevent this disastrous result by recognizing this situation as one which was not devised to avoid income tax under the exceptions of section 306(b)(4), but rather is a common business practice to ensure the continuity of the enterprise.

5. Tax Consequences of Redemption of Section 306 Stock Under Section 303.—As a result of the enactment of the "carry-over basis" provision of the 1976 Act, significant problems and uncertainty now exist with respect to redemptions or sales of section 306 stock by a decedent's estate. Since the step-up in basis on death under section 1014 is no longer applicable after December 31, 1976, a sale of stock pursuant to a buy-sell agreement or redemption under section 303 at a gain will generally give rise to the recognition of capital gain. In the case of section 306 stock, however, ordinary income may be recognized in the same manner as if the stock had been sold or redeemed prior to the death of the holder.

Prior to the enactment of the carry-over basis provision, it was clear that death removed the "taint" of section 306 stock. Section 306(c)(1)(C) provides that, with certain exceptions, when the basis of stock in the hands of the shareholder selling or otherwise disposing of the stock is determined

by reference to the basis in the hands of that shareholder or any other person of section 306 stock, the stock sold or otherwise disposed of is section 306 stock. Section 1.306-3(e) of the regulations provides that section 306 stock "ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death or the optional valuation date under section 1014." Since under section 1023 of the Code, the basis of property acquired from a decedent dying after December 31, 1976, is the adjusted basis of the property immediately before the death of the decedent, as further adjusted by section 1023, section 306 stock would not lose its taint on the death of the holder and ordinary income would be realized.

Exceptions exist to the recognition of ordinary income when a shareholder's interest is completely terminated. Section 306(b)(1) provides that when the disposition is in redemption and section 302(b)(3) applies, ordinary income will not be recognized. When the disposition is not in redemption and there is a complete termination of interest, and the disposition is not directly or indirectly to a person whose stock ownership would be attributable under section 318(a) to the "disposing" shareholder, ordinary income will not be recognized.[38a] A further exception, under section 306(b)(4), deals with transactions not having a tax avoidance purpose and will be discussed later.

In a section 303 redemption, a distribution of property in redemption falling within the limitations of section 303 is treated as a distribution in full payment in exchange for the stock redeemed. Section 1.303-3(a) of the regulations provides, however, that, while the sole effect of section 303 is to exempt from tax as a dividend a distribution to which section 303 applies, that section does not "in any other manner affect the principles set forth" in sections 302 and 306. The regulation continues with an example of two individuals and an estate, each owning one-third of the stock of a corporation, with the corporation redeeming one-half of the stock of each shareholder. In such a case, it explains, the determination whether the distributions to the two individuals are "essentially equivalent to dividends" is made without regard to the effect section 303 may have upon the taxability of the distribution to the estate. The language of the regulation does not make clear whether sections 302 and 306 remain in full force only with respect to redemptions of stock owned by the individuals but do not

38a. If a redemption of section 306 stock qualifies under section 302(b)(3) as a complete termination of interest, no ordinary income will result from the disposition of the section 306 stock. Traditionally, only family attribution could be waived under section 302(c), permitting a shareholder to have all directly owned stock redeemed and still qualify under section 302(b)(3), despite ownership of stock by family members whose ownership could be attributable to the redeeming shareholders. Estates could not similarly waive attribution from beneficiaries. Two recent cases, Crawford v. Commissioner, 59 T.C. 830 (1973), and Rickey v. United States (D. La., Nov. 16, 1976), have held that a redemption of stock held by an estate could qualify under section 302(b)(3) despite ownership of stock by beneficiaries of the estate—in effect allowing the estate to waive attribution. While it is anticipated that the IRS will contest any such attempted waiver by an estate, if these cases are generally followed, estates owning section 306 stock will be able to have such stock redeemed without ordinary income consequences, since the redemption will meet the requirements of section 302(b)(3).

apply to stock redeemed under section 303. Section 303(a) merely states that a redemption of stock under section 303 will result in a distribution and redemption being considered as full payment in exchange for the stock redeemed. It does not state that any gain recognized will be treated as capital gain, since the provision that the distribution would be treated as an exchange necessarily meant, prior to the 1976 Act, that any gain would be capital gain.[39]

While a strict reading of the Code, as revised by the Tax Reform Act of 1976, leads to the conclusion that the sale or redemption of section 306 stock after the death of the holder of such stock would result in ordinary income, the most apparent resolution of the problems caused by the 1976 Act in this area is to be found in section 306(b)(4). This section provides that, if it is established to the satisfaction of the Secretary that the disposition or redemption was not pursuant to a plan having as one of its principal purposes income tax avoidance, the ordinary income consequences of section 306(a) will not arise. Arguably, a disposition of section 306 stock pursuant to a section 303 redemption or a buy-sell agreement has as its principal motive either the payment of estate taxes and administration expenses or, in the case of a buy-sell agreement, a desire to eliminate from ownership in a corporation the estate of a deceased shareholder or family members who will not be participating in the business of the corporation. It is perhaps in this framework that the regulations that will deal with the effect of section 306 on the disposition of "carry-over basis" property should provide for an exception to ordinary income in the case of a section 306 redemption or a disposition pursuant to a buy-sell agreement.

It is imperative that a liberal interpretation of this section be adopted by the Treasury. Otherwise, the common practice of recapitalizing close corporations to provide incentives to younger management and to secure the investments of senior shareholders by conversion of common to preferred stock will be frustrated. Moreover, this procedure has been recognized by the courts as being without tax avoidance motivation. When we consider that one strength of the American economy has been the encouragement of closely-held business enterprises through a government policy of providing relief from payment of burdensome estate taxes, the imposition of an additional income tax burden to the decedent-owner's estate would work at cross-purposes with this government policy

39. A further complication arises from the fact that section 306(a)(1) refers to the "amount realized," rather than gain realized, being taxed as ordinary income to the extent of earnings and profits (computed in varying manners depending upon whether the section 306 stock is redeemed or otherwise disposed of). A problem of "lost basis" arises since, if the amount realized is treated as a dividend, the basis of the section 306 stock would then be attributed to other stock owned by the taxpayer making the disposition. If there is a complete termination of interest, there is, of course, no problem. If, however, there is not a complete termination of interest due to the attribution rules, the issue of what happens to the basis of the stock redeemed becomes far more complex. Generally, the "lost basis" will be added back to the common stock with respect to which the section 306 stock was originally issued. It is conceivable that the basis of the common stock owned by other shareholders would be increased by virtue of the sale or redemption of the section 306 stock.

objective.[40]

6. *Installment Sales and Private Annuities*.—These techniques continue to be as attractive under the 1976 Act as they were under the prior law. In many instances, they are even more attractive. For example, under prior law use of the installment sale technique between family members in order to provide an immediate step-up in basis in anticipation of the disposition of the transferred assets locked in a capital gain that otherwise would have been eliminated if the transferor had retained the assets until death. Under the 1976 Act, since this step-up in basis will not be available in any event for post-1976 appreciation, the disadvantage of locking in the capital gain is less. The same is true as it relates to the basis problems of the transferee on transfers made in exchange for a private annuity.

7. *Formation of Corporations*.—If a new corporation is to be organized after 1976, careful consideration should be given to the establishment of several classes of stock. The principal management of the corporation should own the voting common stock, while the non-voting common stock authorized to receive all or part of the future profits of the corporation should be vested in trusts for other family members. Thus, all or some of the appreciation in the value of the corporate stock will be deflected away from the estate of the principals. The shareholder agreements will, therefore, have to restrict the transferability of the shares issued to the principals, as well as to the trusts for other family members who would be obliged to sell their stock at their principal's death. The fact that shares sold at death are not owned by the decedent will not result in any additional capital gains tax, since retention of these shares would not result in any step-up in basis at the date of death.

8. *Conclusion*.—The amendments made to section 303 by the 1976 Act have converted what was initially intended to be a relief provision to shield a small business from forced liquidation at the death of its owner into a spear that will accomplish its destruction in many situations. The increase to 50% in value of the adjusted gross estate for making such business interest eligible to utilize this section, and the restrictions on the amount of stock that may be redeemed at death without income tax implication, will impose burdensome tax liabilities upon the estate, since corporate funds used to repurchase stock will no longer be available to the same extent.

VIII. Carry-Over Basis (Amending Section 1014(b) and Adding New Section 1023 to I.R.C.)

A. *Carry-Over Basis from Decedent, Its Limitations and Adjustments*

1. *Prior Law*.—Under prior law, the basis of property acquired

40. There is some reason to believe that the regulations that will be proposed in this area will confirm that section 306 stock will not lose its taint at death. Rather, it appears that a capital gain may be allowed for all stock redeemed under section 303. This will, of course, only partially solve the problem but will leave unaltered the consequences of a redemption in excess of the amount allowable under section 303 or a sale pursuant to a shareholder's agreement.

from a decedent was stepped up to its fair market value on the date of death, or on the alternate valuation date, if elected.[41] In the case of lifetime gifts, the donor's basis in the transferred property was carried over and became the basis of the donee, increased by any gift taxes paid on the transfer. If the fair market value of the property was less than the donor's basis, the donee would take a basis equal to fair market value.[42]

The new provision of the 1976 Act eliminates the "lock-in" effect caused by individuals who hold on to assets, which they might otherwise sell, until death, so that the gain resulting from the appreciation of the property will not be taxed. The new carryover basis provision eliminates the discrimination against individuals who sell their appreciated property prior to death.[43]

2. 1976 Tax Reform Act.—The adjusted basis of property which the decedent is treated as holding on December 31, 1976, is increased for purposes of determining gain (but not loss) by the amount by which the fair market value of property on December 31, 1976, exceeds its adjusted basis on that date. The basis cannot, however, be increased above its estate tax value. In essence, this modification continues existing law with respect to appreciation in property accruing before January 1, 1977, and provides everyone with a "fresh start."

Property acquired by the decedent as a gift or from a trust qualifies for the "fresh start" treatment if the donor or trustee held the property on December 31, 1976, or if the property held by the decedent at his death was acquired in a nontaxable exchange for property which he did own on December 31, 1976. In order to avoid the necessity of obtaining an appraisal on all property held on December 31, 1976, the Act contains a requirement that all property other than securities for which market quotations are readily available is to be valued under a special valuation method. In general, the special rule determines the adjustment by assuming that any appreciation occurring since the acquisition of the property until the date of the decedent's death occurred at the same rate over the entire time that the decedent is treated as holding the property.

Under the special valuation method, the amount of the increase in basis is equal to the sum of (1) the amount of all depreciation, amortization, or depletion allowed or allowable with respect to the property during the period the decedent is treated as holding the property prior to January 1, 1977, and (2) the excess of the fair market value of the carryover basis property on the date of the decedent's death (determined without regard to alternate date valuation) over its adjusted basis immediately before his death, reduced by the amount of all depreciation, amortization, or depletion allowed or allowable with respect to the property during the period the

41. I.R.C. § 1014(a).
42. *Id.* § 1015(a).
43. H.R. REP., *supra* note 2, at 37.

decedent is treated as holding the property, and multiplied by this fraction:

$$\frac{\text{Number of days the decedent is treated as holding the property before 1977}}{\text{Total number of days the decedent is treated as holding the property}}$$

The appreciation treated as occurring before December 31, 1976, is computed by multiplying the total amount of appreciation over the entire period during which the decedent is treated as holding the property by the fraction shown above.

The total amount of appreciation is then computed by subtracting from the fair market value of the property on the date of the decedent's death a recomputed basis that is basically equal to the purchase cost of the property. For purposes of this rule, the fair market value of property on the date of the decedent's death is to be determined under the special valuation rule for farms or other closely held businesses, if that rule is elected for estate tax purposes (section 2032A), but determined without regard to the alternate valuation rule (section 2032).

The special valuation method must be used for all property other than marketable bonds or securities. Thus, the special valuation method must be uted even though the executor or beneficiary of the decedent can establish that the fair market value of the property of December 31, 1976, is other than the value determined under the special valuation method.

If the decedent (or his predecessor) made a substantial improvement to any property, the Treasury Department is to issue regulations under which the substantial improvement is treated as a separate property for purposes of this special rule. The December 31, 1976, value of marketable bonds or securities must be determined by their market value on December 31, 1976. The value of such securities is to be computed by using the normal methods of valuation for estate and gift tax purposes.

When the "fresh start" rule applies, the amount of the increase in basis that is permitted under the "fresh start" rule is not to be reduced even though the property is subject to depreciation or depletion. Any increase in basis permitted by the "fresh start" rule is determined before any other adjustments are made to the property's basis for federal and state death taxes and minimum basis. The carry-over basis provision is effective for property acquired from, or passing from, a decedent after December 31, 1976.[44]

44. Here is an example of the fresh start basis as of January 31, 1976, other than for listed stocks and bonds: Decedent died owning a commercial building which cost $50,000 and was worth $250,000 at the time of his death. He held the real estate for 3,000 days, 2,000 of which occurred before 1977. Total depreciation allowed or allowable on the property up to the time of his death amounted to $10,000, and of this amount $7,000 was allowed or allowable before 1977. The adjusted basis for the property immediately before the decedent's death was $40,000. For purposes of determining gain, the basis is increased to December 31, 1976, value as follows:

(a) $7,000 (depreciation allowed or allowable before 1977); plus

(b) $250,000 minus $40,000 minus $10,000 times $\frac{\$2,000}{\$3,000}$ equals $133,200.

Carryover basis of the property after the fresh start adjustment is $40,000 plus $140,200, or $180,200.

(a) Minimum basis.—For smaller estates, each estate will have a minimum basis in all of its carry-over basis assets of at least $60,000. The Act allows the executor of an estate to exempt up to $10,000 worth of household and personal effects of a decedent from the carry-over basis rules by making an election designating which items are not to receive carry-over basis treatment. Thus, the items not counted towards the $60,000 limitation include personal and household effects up to a value of $10,000.

(b) Exceptions and adjustments to basis.—There are other exceptions and adjustments to the "carry-over basis rule." Life insurance on the decedent's life is excepted from the definition. There is also an exception for property when income attributable to it is already taxed to the recipient under present law, such as income in respect of a decedent under section 691.

Additional exceptions include: a joint and survivor annuity taxable under section 72; payments under certain deferred compensation plans that are taxable to the decedent's beneficiary; property includable in the decedent's gross estate under sections 2035, 2038 and 2041, that had been disposed of prior to the decedent's death in a transaction in which gain or loss is recognizable; and certain stock or stock options passing from the decedent to the extent income thereon is includable in gross income.

Further, the basis is increased by net federal and state estate taxes attributable to appreciation on the carry-over basis property, computed on an asset-for-asset basis, and not on a total asset basis. Included in the term "federal and state estate taxes" are any estate, inheritance, legacy or succession taxes imposed by a state or by the District of Columbia for which the estate is liable and which are actually paid by the estate or the recipient.

Under a special rule, a specific gift or bequest of property for which a charitable or marital deduction is allowed is not considered subject to the tax and therefore will receive no increase in basis for federal and state estate taxes paid, except for that portion of such property which exceeds the amount qualifying for the charitable or marital deduction. Regulations will be issued to determine when property is bequeathed for these purposes as distinguished from its being used to fund such bequests.

The surviving spouse's share of community property is not considered "subject to the tax," since it is not included in the deceased spouse's gross estate. For administrative convenience, property qualifying for the exclusion for transfers to orphans provided in the 1976 Act is also not treated as "subject to the tax." If property includable in the decedent's estate is encumbered by indebtedness, however, then for the purpose of measuring the property "subject to the tax," the value is determined net of any indebtedness, regardless of whether the estate is personally liable for the mortgage or owns the property subject to the mortgage. The Treasury is to

issue regulations determining the application of the "fresh start" rule to cases in which gain from the sale of property is subject to special rules taxing all or a portion of the gain as ordinary income and in which the property is held by a trust or partnership in which the decedent was a beneficiary or a partner.

(c) *Proof of basis.*—The Act recognizes that sometimes it may be impossible to know what the decedent's basis was, in order to continue the carry-over basis. A provision permits the executor and the IRS to assume that the purchase cost of the property to the decedent is the fair market value of the property on the date that it was purchased. Thus, it is presumed that the decedent paid fair market value for the property at the time he or she purchased it.

(d) *Duty of executor to provide basis information.*—There is now a requirement that the executor must furnish the information concerning carry-over basis to the IRS, as would be required by the regulations. Failure to provide this information results in the imposition of a penalty on the executor equal to $100 for each failure, with a maximum amount for all such failures equal to $5,000.

In addition, the executors must furnish each recipient of property from a decedent information on the adjusted basis of the assets in the estate. Failure to provide this information will result in the imposition of a penalty on the executor of $50 for each such failure, unless the failure is due to reasonable cause, with the maximum for all such failures being $2,500.

(e) *Amendments to section 691.*—The Act makes two amendments to section 691. First, it broadens the type of taxes for which a deduction is allowed on the items of income in respect of a decedent to all federal and state estate taxes, as defined in section 1023(f)(3). At present, the deduction is limited to federal estate taxes only.

Second, the amount of deduction for federal and state estate taxes attributable to the income in respect of a decedent is computed by multiplying the amount of those taxes by a fraction, the numerator of which is the net income in respect of a decedent and the denominator of which is the value of the gross estate. Under existing law, the deduction is determined by comparing what the actual federal estate taxes are with what they would have been had the income in respect of a decedent not been included in the gross estate.

(f) *Amendment to section 1015.*—This amendment provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift, rather than the total gift tax paid as now allowed under existing law.

(g) *Use of appreciated carry-over basis property to satisfy marital deduction formulas and pecuniary bequests.*—There are two basic types of

formulas in common use for computing the maximum marital deduction. In the first type, known as the "fractional share formula," the surviving spouse is given a fraction of each asset in the estate of the decedent. When the estate distributes this share to the surviving spouse there is no taxable transaction. The change under this Act from stepped-up basis to carry-over basis does not result in additional income tax at the time of distribution.

In the second type of formula, known as the "pecuniary bequest formula," the surviving spouse is given an amount equal to a percentage of the decedent's estate.

If the trust or estate distributes property in satisfaction of this right to receive a specified dollar amount, there is a taxable transaction resulting in recognizable gain or loss. The new section conforms the treatment of the two types of bequests by treating the distribution by an estate in satisfaction of a pecuniary bequest as a non-taxable transaction, except to the extent of the appreciation occurring from the date of death to the date of distribution. Any loss occurring between these two dates will not, however, be recognized. Whenever this section applies, the basis of the property to the distributee is the carry-over basis of the property, increased by the amount of any gain recognized on the distribution. Thus, bequests using the pecuniary bequest formula will receive substantially the same income tax treatment to the estate upon distribution as under existing law. Regulations will be issued applying this non-recognition treatment to situations in which a trust distributes property in satisfaction of a right to receive a specific dollar amount, which is the equivalent of a pecuniary bequest. This can occur if an inter vivos trust is used as a will substitute, so that the property is never held by the decedent's estate.

(h) Effective date.—The amendments are effective for decedents dying after December 31, 1976. The amendment relating to adjustments to basis for gift taxes paid is effective for gifts made after December 31, 1976.[45]

C. *Estate Planning Comments*

1. Introduction.—In view of the changes made under the 1976 Act concerning the satisfaction of pecuniary bequests by appreciated property and the limitation of the recognition of gain to the amount of appreciation after the decedent's death, it becomes important to authorize the executors to satisfy pecuniary bequests, either in cash or in kind, without regard to basis. The choice of property must, however, be equitable to the beneficiaries both as to value and to basis, since the fiduciary's obligation of fairness must be observed.

2. Carry-Over Basis—Effect on Flower Bonds.—The use of discounted United States Treasury Flower Bonds for the payment at par of federal estate taxes has been made less attractive by the carry-over basis

45. H.R. REP., *supra* note 2, at 36-46; CONF. REP., *supra* note 8, at 612-13.

provisions of the 1976 Act. Before 1977, there was a step-up in basis of such bonds to their par value at the time of the decedent's death, to the extent that they could be utilized to pay federal estate tax. The new provisions limit the basis to their market value on December 31, 1976. Thus, the capital gain realized between the basis and par value, which formerly escaped taxation in the decedent's estate, is now subject to such tax. Since the bonds must be included in the estate at their par value, up to the amount of the federal estate taxes payable, and this additional capital gains tax must now be paid, the net benefit derived from the use of Flower Bonds is substantially reduced.

3. *Holding Period of Estate Assets*—Prior to the 1976 Act, any gain from the sale by the estate of a capital asset acquired from the decedent was treated as a long term capital gain, irrespective of the length of time the asset was owned by the decedent during his lifetime or by the estate. In all other situations capital gain treatment from the sale of capital assets was available only if the asset was owned for a period of at least six months prior to the sale.

The new Act changed the holding periods for capital gain treatment to nine months during 1977, and twelve months for 1978 and thereafter.

Until January 1, 1977, an asset acquired by an estate from the decedent took as its basis the fair market value on the date of his death. The carry-over basis provision of the new Act establishes the basis for assets acquired by an estate from the decedent as its fair market value on December 31, 1976. Therefore, the estate will not obtain a step-up in basis for an asset received from the decedent to its fair market value as of the date of his death. It becomes important to determine whether the estate will enjoy the same capital gain treatment for assets acquired from the decedent as under prior law. It does not appear that it is now available to estates of decedents dying after December 31, 1976.

The estate should be entitled to tack on, as part of its holding period, the entire period of prior ownership of the assets received by the estate from the decedent, from the date he acquired it to the date of his death.

4. *Tax Free Liquidation at Death of Sole Shareholder of Corporation No Longer Available*.—Prior to the adoption of the carry-over provisions of the 1976 Act, it was often advisable to recommend the liquidation of a corporation of which the decedent was the sole shareholder in order to release liquid assets from the corporate solution if the circumstances required their use to meet obligations. The step-up in basis of the decedent's stock to its value at the date of death could be accomplished income tax free, since no gain would be recognized. Under the 1976 Act, any appreciation in the value of the stock after December 31, 1976, will create taxable gain in the event of a post-death liquidation.

IX. Generation-Skipping Transfers (Section 7, Adding Chapter 13 to the I.R.C.)

A. *Scope of the Tax*

1. Prior Law.—The termination of an interest of a beneficiary of a trust under prior law was not taxed if the beneficiary did not have a general power of appointment. Thus there would be no tax at the death of a trust beneficiary, even though he had (1) the right to receive trust income; (2) the power to invade principal, if the power was subject to ascertainable standards; (3) a power to withdraw 5% of trust principal or $5,000 annually; or (4) a limited power of appointment and designation to serve as trustee.[46]

Congress recognized that the tax advantages of generation-skipping trusts are used more often by wealthier families. Congress desired to eliminate the lack of uniformity whereby some families paid transfer taxes only once every several generations while most families had to pay these taxes in every generation.[47]

2. 1976 Tax Reform Act.—The Act adds a new Chapter 13 to the Internal Revenue Code, which imposes a tax on generation-skipping transfers under a trust or similar arrangement, upon distribution of the trust assets to a generation-skipping heir or upon the termination of an intervening interest in the trust. The term "similar arrangement" includes life estates, estates for years, certain insurance and annuity contracts, and other arrangements whereby there is a splitting of beneficial enjoyment of assets between generations. Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations that are younger than the generation of the grantor of the trust.

A generation will be determined along family lines whenever possible. For example, the grantor, his spouse and his brothers and sisters would be one generation. Their children (including adopted children) would be the first "younger generation," and the grandchildren would be the second "younger generation." Husbands and wives of family members would be assigned to the same generation.

If the generation-skipping transfers are made outside the family, generations are to be measured from the grantor. Individuals not more than 12-½ years younger than the grantor would be treated as members of his generation; individuals more than 12-½ years younger than the grantor, but not more than 37-½ years younger, would be considered members of his children's generation.[48]

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46. H.R. Rep., *supra* note 2, at 46.

47. *Id.* at 47.

48. Here are some examples to define a generation-skipping transfer:

(a) Grantor in trust for spouse for life and then outright to child creates no generation-skipping transfer.

(b) Grantor in trust for spouse for life, then to child for life, and then outright to grandchild will be a generation-skipping transfer, taxable at the death of the child.

(c) Grantor in trust for spouse for life, then to son and daughter for life, and thereafter to grandchild, creates a generation-skipping transfer, but the tax is not payable until the death of the survivor of son and daughter, measured by the estate of the survivor.

For the purpose of these rules, a person is a beneficiary if he has either a present or future interest of power in the trust. An interest includes the right to receive income or corpus from the trust during the duration of the trust or the right to receive a distribution upon its termination. A person has an interest in the trust if he is the permissible recipient of income or corpus under a power exercisable by himself or another.

The term "power" means any power to establish or alter the beneficial enjoyment of the corpus or income of the trust, other than the mere right of management with respect to the trust property. A limited power of appointment generally would be treated as a power, except for an individual whose sole discretion under the power is the right to allocate income or corpus of the trust among the lineal descendants of the grantor who belong to a generation or generations younger than that of the individual holding this right of allocation.

A power to draw down annually from the principal of the trust the greater of 5% of its value or $5,000, as well as to invade the principal subject to an ascertainable standard relating to health, education, support or maintenance, are both to be treated as powers for the purposes of these rules, unless the power is exercisable for the benefit of lineal descendants of the grantor under the exception set forth above. If any beneficiary of a generation-skipping trust is an estate, trust, partnership, corporation or other entity, other than certain charities, charitable trusts and tax exempt trusts, each individual having an indirect interest in the generation-skipping trust through means of the entity is to be treated as a beneficiary of the generation-skipping trust for the purposes of this section.

This tax will not be imposed in the case of outright transfers, or if the generation-skipping heir has nothing more than a right of management over trust assets, or a limited power to appoint the trust assets among lineal descendants of the grantor.

An exception in the Act is that this tax on generation-skipping does not include a transfer to a grandchild of the grantor of the trust or testator, to the extent that total transfers from all terminations and distributions do not exceed $250,000 for each deemed transferor. This exclusion is to be available in any case in which the property vests in the grandchild as of the time of the termination or distribution, even if the property continues to be held in trust for the grandchild's benefit. The exclusion applies whether the grandchild receives his interest under the express terms of the trust, or as a result of the exercise or lapse of a power of appointment with respect to the trust.

The tax is to be imposed only once upon each generation with respect to the same trust share or interest. The amount subject to tax is the cumulative value (not in excess of 100% of the value of the trust assets, determined as of the time of the termination or alternate valuation date) subject to these interests and powers.

B. *Definitions of New Terms*

This section introduces several new terms, the understanding of which is necessary to a knowledge of the generation-skipping provisions:

(1) *Generation-skipping transfer* means either a taxable termination or a taxable distribution.

(2) A *taxable termination* is defined as a termination of an interest or power of a younger generation beneficiary. Such a termination would generally occur by reason of death (in the case of a life interest) or by lapse of time if the grantor created an estate for years). However, the taxable termination does not occur when the only interest or power that is terminated is a future interest or power; or when members of several different generations have an interest or a power in the same trust. If the interest of a member or members of a younger generation terminates first (because of an unusual order of death), the tax is postponed until the interest of the older generation terminates. The assignment with or without consideration of a beneficiary's interest in a generation-skipping trust is not to be treated as a taxable termination. However, the death of the beneficiary would constitute a taxable termination.

The taxes are postponed in the case of a discretionary or sprinkling trust because it is difficult to value the terminated interest until all members of the intervening generation have terminated their interests.

(3) *Taxable distribution*. This occurs whenever there is a distribution from the generation-skipping trust, other than a distribution out of accounting income (section 342(b)) to a younger-generation beneficiary of the trust, in cases in which there is at least one other younger-generation beneficiary who is a member of an older generation. Close examination will be made of distributions out of corpus as well as out of income to members of the oldest generation, which are to be treated as having been made out of income (to the extent of income), in which event the distributions to the younger generation are treated as having been made out of any remaining income and then out of corpus. Similarly, if the trustees are authorized to make loans to the beneficiaries of the trust, such loans, if unsecured and bearing no interest or only nominal interest, may be substantially equivalent to a distribution. The IRS will scrutinize such transactions.

The terms "taxable termination" and "taxable distribution" do not include any amounts subject to estate or gift tax. When both a termination and distribution result from the same occurrence, the transfer is to be treated as a termination.

(4) A *deemed transferor* of the generation-skipping transfer is always the parent (whether or not living at the time of the transfer) of that transferee of the trust property who is most closely related to the grantor of the trusts, except that if (a) that parent is not a younger-generation beneficiary of the trust at any time, and (b) there is another ancestor (grandparent, great grandparent) of the transferee who is related by blood or adoption (not marriage) to the grantor of the trust, who is a younger-generation beneficiary of the trust, then, if both of these conditions are

satisfied, that ancestor will be considered the deemed transferor.[49]

(5) The *transferee*, in the case of a taxable termination, is generally any person who has a present interest or power in the trust or trust property after the termination. The regulations will thwart attempts to minimize tax through the use of nominal transferees.

(6) The *tax base*, in the case of a taxable distribution, is the value of the money and property distributed as of the time of the distribution. Property in a generation-skipping trust is also to receive the benefit of the "fresh start," based on a December 31, 1976, valuation date, provided that property passing through the trust is subject to the tax on generation-skipping and the taxable transfer occurs at or after the death of the deemed transferor. The trust will not be eligible for the $60,000 minimum basis or the $10,000 exclusion for household or personal effects.

The tax base includes the transfer taxes paid under these rules with respect to the distribution, regardless of whether these taxes are paid by the beneficiary out of the proceeds of the distribution or by the trustee out of trust monies which are paid over directly to the government.

In the case of a taxable termination, the tax base equals:

(a) The value of the trust property in which an interest has terminated; and/or

(b) The value of the property that was the subject of a power that has terminated.

C. *Computations, Deductions and Adjustments to the Tax*

The tax is to be substantially equivalent to the estate or gift tax that would have been imposed if the property had actually been transferred outright to each generation. This is achieved by adding the amount subject to the tax, as a result of the generation-skipping transfer, to the other taxable transfers of the "deemed transferor." The trust would be entitled to any unused portion of the estate tax credit which the "deemed transferor" had not utilized in his own estate. If part of the property passes to charity, a charitable deduction will be allowed. The amount of any taxable termination or distribution, at the time of or within three years and nine months of the deemed transferor's death, is taken into account in determining the size of his estate. Generally, the result will be that the maximum marital deduction will be increased, the transfer tax payable with respect to his estate will be decreased, and the transferor's marginal rate bracket will also decrease. The previously taxed property credit will also be allowed if an estate tax had been imposed with respect to the creation of the trust within 10 years of the transferor's death. Trustees' fees and costs of administration, attributable to property in the trust, which are deductible under

49. Here are examples of a deemed transferor:

(a) Grantor to child for life and then outright to grandchildren. The deemed transferor is the child.

(b) Grantor to third party for life and then to grandchild. The deemed transferor is the parent of the grandchild who has the nearest affinity to the grantor.

(c) Grantor in trust for life of secretary and on her death to her issue creates a generation-skipping trust with the secretary as the deemed transferor.

sections 2053 or 2054 in the case of an estate, may be deducted from the amount of any generation-skipping transfer, to the extent such items are paid by or for the trust. The net effect is that the generation-skipping transfer is taxed at the marginal transfer tax rate of the "deemed transferor." The tax will be paid out of the proceeds of the trust property and neither the "deemed transferor" nor his estate is liable for such tax.

D. Estate and Gift Tax Benefits Available to Generation-Skipping Trusts

Property passing under a trust is now entitled to many of the benefits that are available under the estate and gift tax laws in the case of property which passes in an outright transfer (to the extent that property passing under the trust is subject to the tax on generation-skipping transfers). The alternate valuation is to be available whenever a taxable termination occurs at the death of the deemed transferor. This election is to be made by the trustee of the generation-skipping trust, who must make a timely filing of the tax return. It is not required that the executor of the deemed transferor's estate also elect the alternate valuation.

Any permitted increase in the amount of the marital deduction by reason of a generation-skipping transfer occurring after the death of the decedent is not to be treated as a terminable interest by reason of the fact that the maximum amount of the deduction is not known as of the date of the decedent's death. If certain rights to income are subject to tax on generation-skipping transfers, the income tax treatment of "income in respect of a decedent" will apply. The recipient of this income will be entitled to a deduction for the generation-skipping tax in the same way as the recipient is allowed a deduction for the estate tax under section 691(c).

When a generation-skipping transfer is subject to tax after the death of a deemed transferor, section 303 treatment is to be available. But for the qualification requirements of section 303, the trust and the estate of the deemed transferor are to be treated separately.

The death of the deemed transferor within three years after a generation-skipping transfer will cause the transfer to be brought back for the purposes of the generation-skipping tax. The transfer will be taxed at the deemed transferor's transfer tax rate taking into account his cumulative life time and death time transfers.

For the new disclaimer rules, the event that triggers the nine month period allowed for an effective disclaimer of a generation-skipping transfer will be either a taxable distribution or a taxable termination. The return is to be filed by the trustee in the case of a taxable termination, and by the distributee if there is a taxable distribution. During the lifetime of the deemed transferor, the return is not due until 90 days after the close of the taxable year of the trust. If the transfer occurs at or after the death of the deemed transferor, the return is due at the later of (1) 90 days after the estate

tax return of the deemed transferor is due, or (2) nine months after the generation-skipping transfer occurs. The IRS may, however, grant an extension of up to six months for filing a return involving a generation-skipping transfer, or may grant an extension for the payment of the tax.

Authority is granted to the Treasury Department to prescribe "separate share" rules for determining whether a trust in which there are several interests should be treated as one trust or as two or more separate trusts. The rules will be substantially similar to those used presently in income taxation of trusts under subchapter J.

E. Effective Dates and Transitional Rule

In general these provisions would apply to generation-skipping transfers occurring after April 30, 1976. The provisions are not, however, to apply to any transfers under a trust that was irrevocable on April 30, 1976 (but only to the extent that the transfer is not made from corpus added to the trust after that date). In the case of a revocable trust or will in existence on April 30, 1976, the provisions are not to apply (to transfers from corpus in the trust on that date) if the grantor dies before January 1, 1982, and the trust instrument or will is not revised after April 30, 1976.

For the purposes of this transitional rule, a change of trustee is not a change creating or increasing the amount of a generation-skipping transfer. Also, an amendment changing the beneficiaries, or a change in the size of the share used for the benefit of a particular beneficiary, does not disqualify the trust under the transition rule, so long as the number of younger generations provided for under the trust (or the potential duration of the trust in terms of younger-generation beneficiaries) is not expanded and the total value of the interests of all beneficiaries in each generation below the grantor's generation is not increased.

An amendment creating a power of appointment would disqualify the trust if there were any possibility, under the power of appointment, of increasing the number of generations that might be skipped.

The grandfather provision will apply to such an irrevocable trust on April 30, 1976, which includes a limited power of appointment, so long as the exercise of the power (including the creation of a new trust) cannot result in the creation of an interest which postpones, or a new power which can be validly exercised so as to postpone, the vesting of any estate or interest in the trust property for a period ascertainable without regard to the date of the creation of the trust. If the grantor or testator is incompetent, the grace period is to be extended for a period of two years after the disability is removed.[50]

F. Estate Planning Comments

1. Introduction.—Since a $250,000 exemption is allowed for each

50. H.R. REP, *supra* note 2, at 46-59; S. REP., *supra* note 15, at 19-22; CONF. REP., *supra* note 8, at 614-21.

of the grantor's children who will be deemed a transferor, the division of the estate passing from the grantor to his children and grandchildren should be considered, so that part of the estate will pass to or for the benefit of the children, and part will pass either directly to the grandchildren or to a trust for them. The grantor's child may be the trustee of this trust with full power to manage the trust assets and with the power to dispose of the trust assets to the lineal descendants of the grantor. Such powers in the grantor's child will not cause the trust assets to be subject to the generation-skipping transfer tax. The grantor's child, as trustee under these circumstances, may have no beneficial interest in the trust.[51]

2. *Transitional Rule*.—An irrevocable trust executed on or before April 30, 1976, is not subject to the generation-skipping transfer tax, except as to corpus added after that date. Any will or revocable trust executed before April 30, 1976, will also escape this tax, if the decedent dies before January 1, 1982, without having (1) amended the will or trust to increase the number of younger generations provided for in the instrument, or (2) expanded the total value of the interests of all beneficiaries below the grantor. An amendment creating a power of appointment whose exercise could accomplish any of the proscribed expansions would disqualify the will or trust.

A number of areas involving generation-skipping transfers are unclear. For instance, if there is an addition of corpus made to a protected irrevocable trust by a pour-over from a probate estate under a protected will executed before April 30, 1976, will the funds received by the trust after that date be protected? If there is an addition to an irrevocable trust corpus after April 30, 1976, should only the amount added be subject to the generation-skipping transfer tax at the time of a taxable distribution or taxable termination of the entire trust? It would seem that the entire trust should not be tainted but only the addition of an unprotected amount to a protected trust should be subject to the tax. And what of the appreciation in value of the trust corpus, or its increase by income accumulations or by the receipt of life insurance proceeds paid for by premiums from a protected trust? Should they be protected also?

Another problem involved under the transitional rule is the increase in the amount payable out of the trust to a beneficiary. This can result from a number of factors, such as reducing the number of executors or trustees, thus saving commissions, or the elimination of a cash legacy, thus

51. There are a number of exceptions to the generation-xkipping transfer tax:

(a) $250,000 exemption for a trust for each child of the grantor, passing to his grandchildren after the death of the grantor's child.

(b) Outright transfers to grandchildren.

(c) Trusts for grandchildren, if the parent who is the child of the grantor has only the right to manage or to distribute the trust assets among lineal descendants of a younger generation of the grantor.

(d) Death of the younger generation beneficiary before that of the older generation.

(e) Does not apply to distributions of trust income.

(f) Does not include any amounts subject to estate or gift taxes in the estate of the grantor.

increasing the residuary estate that passes to a generation-skipping trust. In these circumstances it would appear that the indirect increases in the residue should not taint the trust. Similarly, a provision dealing with tax apportionment, which changes the burden of taxes among the tax entities, would reduce the taxes otherwise payable from corpus under the protected instrument and would create an indirect benefit.

If a property is held in a protective trust before April 30, 1976, and is subject to a general power of appointment, it should be protected, if the will of the donee of the power was executed on or before April 30, 1976, and the donee dies prior to January 1, 1982, without having made any of the prohibited changes in his will.

3. Special Caution. A will or trust executed before April 30, 1976, that includes a generation-skipping trust should not be amended before January 1, 1982, in any manner which would cancel the protection afforded it under the transitional rule. If the decedent were to die before 1982, there would be no generation-skipping transfer tax. As we approach the crucial date, the estate plan should be reexamined to make the appropriate changes.

X. Orphans' Exclusion (Adding Section 2057 to I.R.C.)

A. Prior Law

There was no provision under prior law allowing an estate tax deduction for the value of an interest in property passing to an orphan child of the decedent. In order to facilitate the support of the child during minority, the 1976 Act creates the new orphans' exclusion, which applies if there is no surviving spouse to whom property to be used for the child's support has passed tax-free.[52]

B. 1976 Tax Reform Act

The orphans' exclusion introduces a new section to the Code. It allows a limited deduction from the value of the gross estate of a decedent for an amount passing to a minor orphan from the estate of his parent. The amount of the deduction may not exceed an amount equal to $5,000, multiplied by the excess of 21 over the child's attained age at the time of the decedent's death. It is available to natural as well as adopted children. The deduction is allowed only if the child has no known surviving parent and the decedent does not have a surviving spouse. It cannot exceed the amount of property passing to the minor orphan. The deduction will be allowed for any interest in property passing to a minor child, but only to the extent a deduction would be allowed for the marital deduction if the property passed to a surviving spouse under section 2056(b). An interest will not be treated as a terminable interest solely because it will pass to another person, if the child dies before the youngest child of the decedent attains 21 years of

52. H.R. REP., *supra* note 2, at 59.

age.[53] This section becomes effective for estates of decedents dying after December 31, 1976.[54]

C. Estate Planning Comments

Section 2057 of the 1976 Act created an estate tax deduction for amounts passing to a minor child with no surviving parent. It is computed by multiplying $5,000 by the number of years between the age of the minor child at the decedent's death and 21. It must, however, comply with the provisions comparable to those required for the martial deduction under section 2056(b), with the exception that the interest will not be treated as terminable solely because the property will pass to another person, if the child dies before the youngest of the decedent's children reaches 21.

To ensure the qualification of the bequest for an orphan under this provision, it would be advisable to use a trust whose provisions would comply with the requirements to qualify a marital deduction trust as set forth under section 2056(b) of the Code. Among the provisions of such a trust should be a common disaster clause, which creates the presumption that the orphan survived his parent should both die in a common disaster, so as to preserve the right of the parent's estate to the estate tax benefits of the orphan's exclusion. Further, a right of acceleration should be given the trustees to terminate the trust when the principal amount is reduced to a stated amount or less.

While such a bequest to a minor orphan can be made directly to the minor, or to a guardian for him, this approach would seem to be less desirable.

XI. Furnishing on Request a Statement Explaining Estate or Gift Valuation (Adding Section 7517 to I.R.C.)

A. Prior Law

There was no provision under prior law requiring the IRS to disclose the method or basis by which it determined the valuation of property for estate or gift tax purposes. Congress believed that by requiring the Service to furnish full information as to how it arrived at its valuation, differences between executors and the IRS would be resolved at the earliest possible time.[55]

B. 1976 Tax Reform Act

The new Act provides that if the IRS makes a determination of the value of an item of property for purposes of estate or gift tax law, the

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53. Here is an example of the new orphans' exclusion: A widow dies with three children ages 19, 15, and 7, and in her will leaves to each child that amount which will equal the new orphans' exclusion. Her estate will be entitled to an orphans' exclusion for each child as follows: for the 19 year old $15,000 ($5,000 x 3), for the 15 year old $30,000 ($5,000 x 6), and for the 7 year old $70,000 (5,000 x 14).

54. H.R. REP., *supra* note 2, at 59.

55. *Id.* at 61.

executor or donor may request the Service to furnish a written statement with respect to the value of such item of property. This statement is to be given within 45 days of the later of the date the request for the statement is made or the date of determination by the Service. The statement shall not, however, be binding on the IRS.[56]

XII. Special Rule for Filing Returns if Gifts in Calendar Quarter Total $25,000 or Less (Amending Section 6075(b) of I.R.C.)

A. Prior Law

Prior law required a gift tax return to be filed on or before the 15th day of the second month following the close of the calendar quarter in which the gift was made. The new rule of the 1976 Act is designed to ease the administrative burden brought on by the ever-increasing number of quarterly gift tax returns that have been filed. In addition, Congress desired to correct an unintended result of the change to the quarterly filing system, which made the amount and timing of gifts between spouses important in order not to lose part of the marital deduction.[57]

B. 1976 Tax Reform Act

This provision provides that a gift tax return is required to be filed on a quarterly basis only when the sum of (1) the taxable gifts made during the calendar quarter plus (2) all the taxable gifts made during the calendar year exceed $25,000. If the total taxable gifts do not exceed $25,000, then the return is only to be made after the fourth calendar quarter of the calendar year.[58] This amendment applies to gifts made after December 31, 1976.[59]

XIII. Inclusion of Stock in Decedent's Estate when Decedent Retains Voting Rights (Amending Section 2036 of the I.R.C.)

The Supreme Court in *United States v. Byrum*[60] held that the grantor-decedent's retained powers under an irrevocable trust, including the right to vote the transferred stock, did not require the stock assets to be included in his gross estate. To reverse the *Byrum* decision, this section was intended to provide that the retention by the decedent of voting rights in transferred stock, whether outright or in trust, for his life, for any period

56. *Id.* at 60-61.
57. *Id.* at 62.
58. The following example illustrates the new gift tax filing requirements. The donor has given the following gifts:

(a) First quarter 1977	$10,000.00
(b) Second quarter 1977	15,000.00
(c) Third quarter 1977	18,000.00
(d) Fourth quarter 1977	-0-

A gift tax return must be filed after the second quarter of 1977 because the donor has made gifts aggregating $25,000 or more. The return must be filed by August 15, 1977. As to the gifts made after the second quarter, since there has been no further aggregation of gifts up to the $25,000 limitation, no gift tax return is due until the due date of the fourth quarter return, which would be February 15, 1978.
59. H.R. REP., *supra* note 2, at 61-64.
60. 408 U.S. 125 (1972).

not ascertainable without reference to his death, or for any period that does not in fact end before his death, was to be treated as a retention of the enjoyment of this stock. This would have caused stock transferred with voting rights retained by the decedent to be included in his gross estate. The provision was to apply even if the stock were issued by a corporation that had not been directly or indirectly controlled by the decedent. The capacity in which the decedent exercised his voting rights was immaterial. The amendment is to apply to transfers made after June 22, 1976.[61]

In drafting this section, however, Congress inadvertently referred to the retention of voting rights by the decedent in "retained" stock, instead of "transferred" stock, rendering the provision meaningless. Unless a technical amendment to this section is enacted, the courts would be required to interpret this section contrary to its clear and literal wording, if the intended purpose were to be accomplished. Thus, the courts would be usurping the legislative functions of the Congress. In our opinion, the courts would be reluctant to rescue this relatively unimportant section by such an abuse of their powers. It is to be expected that the Congress will enact a Technical Amendments Law during the 1977 session to correct and clarify a number of errors of this type that surfaced as a result of the hurried consideration and passage of the 1976 Act. Among these corrections should be the mistaken use in this section of the words "retained stock" instead of "transferred stock."

XIV. Treatment of Disclaimers (Amending Sections 2518 and 2045 of I.R.C.)

A. *Prior Law*

An effective disclaimer was not treated under prior law as a taxable transfer by the disclaimant; nor did it provide a definition of a disclaimer or rules regarding the tax consequences of a disclaimer. The estate and gift tax consequences of disclaimers had depended upon local law of the various states. The 1976 Act establishes uniform rules regarding disclaimers for estate and gift tax purposes.[62]

B. *1976 Tax Reform Act*

The Act attempts to establish definitive rules concerning disclaimers and their effect on estate and gift taxation, and to provide a uniform standard for determining the time within which disclaimers must be made. The term "qualified disclaimer" means an irrevocable and unqualified refusal to accept an interest in property that satisfies four conditions:

> (a) The refusal must be in writing.
>
> (b) The refusal must be received by the transferor of the interest, his legal representative, or holder of the legal title to the property, not later than nine months after the day on which the

61. H.R. REP., *supra* note 2, at 64-65.
62. *Id*. at 66.

transfer creating the interest is made, or after death of the grantor, or the day on which such person attains age 21. The nine-month period for making a disclaimer is to be determined in reference to each taxable transfer.

(c) The donee must not have accepted the interest or any of its benefits before making a disclaimer.

(d) The interest must pass to a person other than the person making the disclaimer as the result of the refusal to accept the property. The person making the disclaimer cannot have the authority to direct the redistribution or transfer of the property to another person, if there is to be a qualified disclaimer.

The qualified disclaimer may be made as to an undivided portion of an interest, if the requirements are satisfied. A power with respect to property can be treated as an interest in property for the purpose of these provisions.

If a qualified disclaimer is made, the federal estate, gift and generation-skipping transfer tax provisions are to apply with respect to the property interest disclaimed, as if the interest had never been transferred to the person making the disclaimer.[63]

C. *Estate Planning Comments*

The 1976 Act provides a federal disclaimer rule, which applies to transfers made after 1976 that create the interest in the person who disclaims. A qualified disclaimer is defined as an irrevocable and unqualified refusal to accept an interest in property. When this disclaimer is properly taken advantage of, there will be no estate, gift or income tax implications to the disclaiming beneficiary.

In the absence of a special provision, however, the disclaimed property will pass to succeeding beneficiaries in accordance with state law. This may differ as to the eligible recipients. It might, therefore, be appropriate to provide specifically to whom any property interest would pass in the event a beneficiary should elect to disclaim.

XV. Estate and Gift Tax Exclusions for Qualified Retirement Benefits (Amending Sections 2039 and 2517 of I.R.C.)

A. *Prior Law*

Under prior law, an annuity or other payment received under certain qualified pension and profit sharing plans was excluded from the decedent's gross estate to the extent its value was not attributable to his contributions.[64] This exclusion did not apply to benefits paid under an H.R. 10 (Keogh) plan for a self-employed individual, or under an individual retirement account (IRA).

Congress desired to extend the exclusion to H.R. 10 plans and IRA's in order to encourage the establishment of these voluntary retirement plans. Because lump sum benefits provide enough cash to cover estate tax liability

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63. *Id.* at 65-68; CONF. REP., *supra* note 8, at 623-24.
64. I.R.C. § 2039(c).

attributable to including these benefits in the estate, however, Congress believed it was inappropriate to continue the exclusion for benefits payable in the form of lump sum distributions.[65]

A lump sum distribution is defined as (1) the distribution or payment (2) within one taxable year of the recipient (3) of the balance to the credit of an employee, (4) which becomes payable to the recipient

(i) on account of the employee's death;
(ii) after the employee attains age 59½;
(iii) on account of the employee's separation from service; or
(iv) after the employee has become disabled.[66]

B. 1976 Tax Reform Act

1. Annuity and Other Payments Under Corporate Qualified Retirement Plans.—Section 2039(c) has been amended by the 1976 Act so that the estate tax exclusion applies only to annuity or other payments, other than a lump sum distribution, not payable to an executor, from a qualified corporate pension, profit sharing or stock bonus plan.

The following tax implications will result from a post-1976 lump sum distribution of benefits. The proceeds will be

(a) eligible for 10 year income averaging;

(b) eligible for long-term capital gains tax (with respect to pre-1974 portion);

(c) excluded from minimum tax, if 10 year averaging is elected instead of utilizing captial gain treatment for pre-January 1, 1974 benefits;

(d) not eligible for 50% maximum tax;

(e) subject to federal estate tax;

(f) taxed at a higher bracket even though the annuity will not be taxed as part of the distribution, if an annuity contract is distributed as part of the distribution;[67]

(g) eligible for the $5,000 death benefit exclusion from gross income under section 101(b)(2)(B).

A post-1976 non-lump sum distribution of benefits will have the following tax implications. The proceeds will be

(a) free from federal estate tax;

(b) ineligible for 10 year income averaging;

(c) eligible for 50% maximum tax;

(d) eligible for 5 year income averaging;

(e) eligible, entirely or partially, for the $5,000 death benefit exclusion for payments under section 101(b)(2)(B).[67a]

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65. H.R. REP., *supra* note 2, at 69.

66. I.R.C. § 402(e)(4).

67. This result is forced on the taxpayer because the current value of the annuity contract is treated as part of the lump sum distribution in making the initial calculation of the tax. Then a tax is computed on the current value of the annuity as though it were the entire lump sum distribution. This second income tax figure is subtracted from the first. The difference leaves only the tax calculated at the highest tax brackets in the final computation of the tax on the ordinary income portion of the lump sum distribution.

67a. I.R.C. § 102(b)(2)(B) provides that while the $5,000 exclusion will be applicable in all cases in which a "lump sum distribution" is made, in all other cases (annuities, payments in

The amounts excluded under the $5,000 death benefit provision are treated as additional consideration paid by the employee and are pro-rated over the life expectancy of the annuitant. Thus a portion of each payment is received tax free.[68]

2. *Annuities and Other Payments Under H.R. 10 (Keogh) Plans.*—Section 2039(c) has been amended to bring within the estate tax exclusion the value of an interest other than a lump sum distribution received by a beneficiary (other than an executor) under an H.R. 10 (Keogh) plan attributable to contributions to the plan for which income tax deductions were allowable when made. Under the prior law all pension proceeds from H.R. 10 (Keogh) plans were subject to the federal estate tax. The tax implications of the receipt of benefits are, with the exception of the death benefit income tax exclusion, identical to those listed above in paragraph 1 for corporate plans.

3. *Annuities Under IRA Plans.*—A new subparagraph (e) has been added to section 2039, excluding from the gross estate of the owner of the IRA plan the value of an annuity receivable by a beneficiary from an individual retirement account, under an individual retirement annuity or under a retirement bond to the extent such value is attributable to contributions to the plan for which income tax deductions were allowable when made, or with respect to "roll over" contributions from another qualified plan. The annuity must provide a series of substantially equal payments to be made to a beneficiary for life or for a period extending at least 36 months from the date of the decedent's death. Comparable gift tax exclusions are made. Under the prior law, all proceeds from IRA plans were subject to federal estate tax.

4. *Effective Date.*—The amendments are applicable to estates of decedents dying after December 31, 1976, and to transfers by gifts after that date.[69]

C. *Estate Planning Comments*

The selection of the form of benefit to be received under a qualified retirement plan must take into account not only the needs of the family and the estate, but also the death tax and income tax costs. The 1976 Act has added new complexities to this process. Before any form of benefit is determined, the estate planner must calculate the present value of the total taxes to be paid under the various options available. Only then can he advise whether to request a lump sum distribution, an annuity contract,

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more than one year, etc.), the exclusion will be applicable only to the extent the employee did *not* possess, immediately before his death, a nonforfeitable right to receive the amounts while living. *See also* Treas. Reg. § 1.101-2(e).

68. Treas. Reg. § 1.101-2(d).

69. H.R. REP., *supra* note 2, at 68-70; S. REP., *supra* note 15, at 22-23; CONF. REP., *supra* note 8, at 624-25.

installment payments over two or more years, or any combination of these forms. Perhaps the most important step to be taken at this time is to examine all plans to ascertain whether the recipient has the right to request a method of payment that will permit the most flexible arrangement necessary to best suit the family's needs and to minimize the total estate and income tax consequences. In particular, when life insurance is payable to a trust, the insurance companies frequently permit single sum payments only. It is our understanding that most insurance companies are changing their policies in this regard.

XVI. Gift Tax Treatment of Certain Community Property (Amending Section 2517 of I.R.C.)

Congress amended the estate tax exemption in 1972 so that no part of the employer's contributions to a qualified pension plan would be includable in the gross estate of the employee's spouse if the spouse pre-deceased the employee and they resided in a community property state. No corresponding change was made in the gift tax law. Thus, the surviving spouse was treated as having made a gift of one-half of any benefits payable to other beneficiaries. The result was otherwise in a common-law state.

Section 2517 now provides a gift tax exclusion for the value of any interest of a spouse in certain employee contracts, trusts or plan payments, to the extent attributable to tax deductible contributions, if the following conditions are met:

> (1) The employer made contributions on the employee's behalf under an employees' trust forming part of the qualified plan; or (2) the employer purchased a retirement annuity contract under such a plan; or (3) the contributions were made by an employer that is a tax exempt charitable organization; or (4) a taxpayer, who is an employee for gift tax purposes, made contributions to an individual retirement account; and (5) the amount involved cannot be deemed a non-tax deductible employee contribution.

The effect of this section will be to equate the gift tax treatment that will occur in a community property state upon the lifetime transfer of qualified benefits by an employee's spouse with that in a common-law state.[70]

XVII. Income Tax Treatment of Certain Selling Expenses of Trusts and Estates (Amending Section 642(g) of I.R.C.)

This section proposes to overturn court decisions such as *Estate of V.E. Bray v. Commissioner*,[71] which allowed selling expenses to be used as an estate tax deduction, and also as off-sets against the amount realized on the sale of the property, for income tax purposes. Under this provision, there can be no such off-set against sales proceeds if the amount was also deducted for estate tax purposes. It is effective for all taxable years ending

70. H.R. REP., *supra* note 2, at 70-71.
71. 396 F.2d 452 (6th Cir. 1968).

after date of enactment.[72]

XVIII. Charitable Remainder and Annuity Trusts—Extension of Time to Amend Pre-1969 Trusts and Wills

The Tax Reform Act of 1969 changed the form of the charitable remainder trust to require the use of a charitable remainder unitrust or annuity trust, or payment to a pooled income fund in order to take advantage of the estate tax charitable deduction. As to wills that were executed or property that was irrevocably transferred in trust on or before October 9, 1969, an extension to various later dates was enacted by the Congress to permit the instrument to be amended to conform with the requirements of the 1969 Act. The last such extension was accomplished by H.R. 9889, which extends to December 31, 1977, the date by which the governing instrument of a charitable remainder trust created after July 31, 1977, must be amended in order to qualify as a charitable remainder annuity or unitrust or a pooled income fund, for the purpose of the estate tax charitable deduction, in the estate of decedents dying after December 31, 1969.[73]

XIX. The Tax Clause in Wills

The current practice of including a tax clause in wills imposing "all taxes payable by the estate" on the residuary estate now requires careful scrutiny. Generally speaking, when the beneficiaries of the estate, inter vivos trusts, and insurance proceeds on decedent's life are the same persons, it makes little difference where the burden of the taxes falls. The sources from which payment is made can be equitably adjusted among the beneficiaries. When the beneficiaries of each segment of decedent's assets are different, however, the placement of the burden of taxes becomes important to do equity among them. Changes made by the 1976 Act, as well as other common situations, point up the necessity for attention to the wording and scope of the tax clause.

The amendments made to section 303 (dealing with the redemption of the decedent's stock to pay death taxes, administration and funeral expenses) and the "carry-over basis" provisions create a potential liability for income taxes, both capital gain and ordinary income, on the redemption of such stock. No longer will the basis of the decedent's stock be stepped up to its value at death. Problems are bound to arise involving exposure to capital gains tax because the redemption price will exceed the "carry-over basis" as of December 31, 1976, as adjusted, and liability for ordinary income tax if the corporate structure was recapitalized during the lifetime of the decedent for valid business purposes by the creation of what is termed "section 306 stock." If the tax clause imposes on the residuary estate the payment of "all taxes," a serious disruption of the decedent's estate may result.

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72. H.R. REP., *supra* note 2, at 71-72.
73. CONF. REP., *supra* note 8, at 522.

The 1976 Act has introduced the new generation-skipping transfer tax. While the burden of the tax is imposed upon the transferee if there is a taxable distribution and upon the trust assets if there is a termination distribution, care should be taken to make clear that a broad tax clause is not construed as intending to relieve the recipients of the generation-skipping transfer assets of the burden of such taxes and impose the payment on the residuary estate.

The 1976 Act includes a section for "special use valuation" of real property devoted to farming and closely-held business purposes. The failure of the recipient of such property to continue to use the property for the prescribed purpose, as defined in the section, will invoke substantial recapture tax burdens, for which the estate will become liable. The impact of such taxes should be imposed upon the devisees of such property, rather than on the residuary estate. Similar care must be taken in framing the "tax clause," so as not to relieve the beneficiaries of life insurance proceeds and the donee of a general power of appointment of their tax responsibilities, whenever appropriate.

Questions also arise as to transfers made before December 31, 1976, which are forced back into the estate of a decedent dying after that date, under sections 2035, 2036 and 2038. With the higher rates of the unified transfer tax applicable under the 1976 rate schedule, should a tax clause leave any doubt as to who should bear the burden of taxation on such transfers?

Frequently, insurance on the decedent's life is transferred to or made payable to an inter vivos or testamentary trust, which will receive the proceeds at death. This may constitute a significant part of the liquid assets stemming from the decedent and may be important to assist the executors in paying the administration expenses and taxes due by the estate. It is important that such trust instruments contain authority to the trustees to loan to the estate funds necessary to meet these charges, if necessary, or to purchase assets from the estate, thus making available to it the cash required by the executors for these purposes.

XX. A Summary of the 1976 Tax Reform Act

The effect of the changes made by the estate and gift tax provisions of the Tax Reform Act of 1976 will be to reduce the number of estates currently subject to tax each year—150,000—by two-thirds. The outstanding features of the new Act are as follows:

(1) The integration of the federal estate and gift tax into a unified transfer tax, with the property passing at death being deemed the final transfer;

(2) The adoption of a new rate schedule effective generally for gifts made after December 31, 1976, and for the estates of decedents dying after December 31, 1976;

(3) The repeal of the estate and gift tax exemptions and the substitution therefor of credits against the unified transfer tax to be phased in over a period of five years;

(4) The increase in the marital deduction for lifetime gifts and bequests to spouses;

(5) Special valuation treatment for farms and closely held businesses;

(6) The extension of time for the payment of the tax in certain instances up to 15 years;

(7) A step-up in basis for property passing at death equal to its value on December 31, 1976, which will become its carry-over basis for decedents dying after that date, subject to certain adjustments;

(8) The introduction of a generation-skipping tax with an exemption of $250,000 for each deemed transferor with respect to gifts to each grandchild;

(9) The elimination of the concept of transfers in contemplation of death;

(10) The removal of the exclusion from federal estate tax of lump sum payments made to a beneficiary of a qualified pension or profit sharing plan and the exclusion of certain benefits under H.R.10 and IRA plans from estate tax;

(11) The exclusion from estate taxation of the surviving spouse's one-half of property held jointly by husband and wife, when the decedent spouse, who furnished the consideration, treated the creation of the joint tenancy as a taxable event at that time;

(12) The clarification of the requirements of an effective disclaimer to escape federal estate, gift and generation-skipping transfer taxes;

(13) The provision that retention by a decedent of voting rights over transferred stock will cause the stock to be included in his gross estate.

The effect of these changes is to relieve from estate and gift taxes estates of approximately $370,000 in 1977, to $425,000 in 1981 and thereafter, that utilize the maximum marital deduction, when the allowable credit is fully phased in. Moreover, estates will be excused from filing estate tax returns if the gross estate is $120,000 in 1977, or up to $175,000 in 1981 and thereafter.

XXI. Authors' Lament

The statistics reflecting the effect of the estate and gift tax provisions of the 1976 Tax Reform Act on projected receipts of the U.S. Treasury indicate that for the year 1977 there will be a reduction of receipts of $726 Million, this reduction increasing each year until in 1981 it reaches $1.449 Billion.[74] No figures beyond the latter date have been made public.

The estate and gift tax revenues generated in the fiscal year ended June 30, 1974, amounted to approximately $5.1 Billion, representing 1.9% of the total receipts.

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74. *See id.*, App. B.

A thinking person, sophisticated in this area of the federal tax system, is constrained to wonder what real objectives the officials of our government hoped to accomplish by the sweeping changes made in the estate and gift tax patterns. The 1976 Act repealed a federal estate tax system that had been in effect for 60 years, and a gift tax system in effect for 44 years, with which the tax experts had been working and were familiar, and whose provisions had been interpreted by the courts, the Treasury and the Congress. It introduced new concepts that will create chaos until their full interpretation is developed in the years to come, without any increase to the Treasury's receipts. If all that was sought was to relieve estates under $425,000 of the burden of federal estate taxes and to impose heavier taxes on larger estates, the same could have been accomplished by increasing the existing estate and gift tax exemptions and adjusting the rates, without doing such violence to established concepts.

Some of the loss of tax receipts to the Treasury is projected to be recovered in later years through other provisions of the 1976 Act. Among them is the "carry-over basis" section, which is expected to provide substantial capital gain taxes in later years because of the "fresh start" valuation of estate assets as of December 31, 1976.

The authors predict that before the harvest of this section is reaped and the anticipated lost revenues are recovered through increased capital gains tax on carry-over basis property, even normal inflation will raise values of carry-over basis property to such a degree that Congress will be compelled to enact relief measures.