FEDERAL ESTATE AND GIFT TAXES

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PUBLIC HEARINGS

AND

PANEL DISCUSSIONS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-FOURTH CONGRESS

SECOND SESSION

ON THE GENERAL SUBJECT OF

FEDERAL ESTATE AND GIFT TAXES

MARCH 15, 16, 17, 18, 19, 22, AND 23, 1976

PART 1 OF 2

March 15, 16, and 17, 1976

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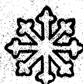
d for the use of the Committee on Ways and Means



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FEDERAL ESTATE AND GIFT TAXES

MONDAY, MARCH 15, 1976

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 9:35 a.m., pursuant to notice, in the committee hearing room, Longworth House Office Building, Hon. Al Ullman (chairman of the committee) presiding.

The CHAIRMAN. The committee will be in order, please.

Today the committee begins a series of public hearings on the very important subject of estate and gift taxes. Estate and gift taxes have not been substantially revised for some 40 years. This series of hearings will bring to the committee information that will be useful to the committee in developing changes for estate and gift taxation at the Federal level. We will also, of course, have available to us the data on this subject which was presented to the committee in recent hearings in the past.

Without objection, I would like to include at this point in the record the press release announcing these hearings.

[The press release follows:]

[Press release of Friday, Feb. 20, 1976]

CHAIRMAN AL ULLMAN (D., OREGON), COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES PANEL DISCUSSIONS AND PUBLIC HEARINGS ON THE GENERAL SUBJECT OF FEDERAL ESTATE AND GIFT TAXES FOR THE WEEK OF MARCH 15, 1976

The Honorable Al Ullman (D., Oregon), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee on Ways and Means would conduct panel discussions and public hearings beginning on Monday, March 15, 1976, on the general subject of Federal estate and gift taxes. These hearings will include the recent proposals made by the President, all estate and gift tax proposals which are presently pending before the Committee on Ways and Means, as well as any other suggestions which witnesses may care to make on the general subject of estate and gift taxes.

The hearings will be conducted in the Main Committee Hearing Room, across from Room 1102, Longworth House Office Building, beginning at either 9:00 or 10:00 a.m. each scheduled day, depending upon the requirements of the Committee. Witnesses desiring to be heard should submit their requests to John M. Martin Jr., Chief Counsel, Committee on Ways and Means, Room 1102, Longworth House Office Building, Washington, D.C. 20515, not later than the *close of business Friday March 5, 1976.*

It is anticipated that, either at the beginning of the hearing or before completion of the hearing, the Committee will receive testimony from the Secretary of the Treasury, and that during the course of the hearing certain specifically invited witnesses will testify, either in panels or individually. Panel arrangements will be made by the staff. It is the intention of the Committee to make every effort to complete this hearing by not later than Friday, March 19.

In view of the limited time available for the hearing, and in anticipation of the

large number of requests to be heard, it will be required that all persons and organizations having a common position exert a maximum effort to designate one spokesman to represent them, making the oral presentation as brief as possible in order to enable the Committee to receive the widest expression of views, with the understanding that a more detailed statement can be submitted for review and for inclusion in the printed record of the hearing. Any person or organization, instead of presenting an oral statement, may file a written statement for the Committee's consideration and for printing in the record of the hearing.

DETAILS CONCERNING THE SUBJECTS TO BE HEARD

Testimony will be admitted on amendments to all aspects of the present estate and gift tax laws. Thus, there will be included (1) the proposals of the Administration; (2) proposals pending before the Committee in bill form (for example, such amendments as those embodied in H.R. 1793 (Congressman Omar Burleson of Texas), to increase the exemption for purposes of the Federal estate tax marital deduction, and to provide an alternative method of valuing certain real property for estate tax purposes); and (3) any other proposals on estate and gift taxes which witnesses may care to present.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Cutoff Date for Requests to be Heard—Requests to be heard must be received by the Committee no later than the *close of business Friday, March 5.* Requests should be addressed to John Martin, Jr., Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515 (telephone: (202) 225-3625). Notification as to the witnesses's date of appearance will be made as promptly as possible after the cutoff date, setting out details as to the format to be used by the Committee for the presentation of testimony. *Once the witness has been advised of his date of appearance, it is not possible for this date to be changed.* If a witness finds that he cannot appear on that day, he may wish to either substitute another spokesman in his place or file a written statement for the record of the hearing instead of appearing in person.

Due to the limited time available to the Committee for this hearing, it may be necessary to allocate the amount of time available to each witness for the presentation of his direct oral testimony. If so, it will be mandatory upon all witnesses not to exceed the time allocated for this purpose. If the witness wishes to submit a more detailed statement, it will be reviewed and included in the record of the hearing.

Requests to be heard must contain the following information:

1. The name, address, telephone number, and capacity in which the witness will appear.
2. The list of organizations and/or persons the witness represents, and in the case of associations and organizations, their address and, where possible, a membership list.
3. If a witness wishes to make a statement on his own behalf, he must still nevertheless indicate whether he has any specific clients who have an interest in the subject, or in the alternative, he must indicate that he does not represent any clients having an interest in the subject he will be discussing.
4. The provisions of the estate and gift tax laws on which the witness will be testifying, including a topical outline or summary of the comments and recommendations to be presented.

If it is necessary to allocate time to each witness, this amount of time will be strictly enforced. Witnesses are urged to verbally summarize their statements; the complete statements will be carefully considered by the members of the Committee and included in the printed record of the hearing.

It is requested that persons scheduled to appear before the Committee submit 75 copies of their prepared statements to the Committee Office no later than 24 hours prior to their scheduled appearance. An additional 75 copies may be furnished for distribution to the press and the interested public on the date of appearance.

Any interested person or organization may, instead of a personal appearance, file a written statement for inclusion in the printed record of the hearing. For this purpose, five copies should be submitted by the close of business Friday, March 19. Additional copies may be furnished for distribution to the members of the Committee, the staff, press and interested public if submitted to the Committee during the course of the public hearing.

The CHAIRMAN. We are going to begin at 9:30 each morning this week and hear a series of public witnesses arranged in panels. On next Monday, March 22, we will hear from the Treasury Department. On Tuesday, March 23, we will hear two panels of experts especially invited by the committee.

Our first witness this morning is our very distinguished colleague in the House, the Honorable George Mahon, chairman of the Appropriations Committee.

Mr. Mahon, we are pleased to have you here to give testimony on this important subject.

I yield to our distinguished colleague, Mr. Burleson.

Mr. BURLESON. Thank you very much, Mr. Chairman, for giving me the opportunity of welcoming my colleague from Texas who is chairman of the Appropriations Committee but who is now the dean, not only of the Texas delegation, but also of the entire Congress. I take personal pleasure in presenting him to the committee.

He doesn't need introduction, but it is my pleasure to welcome my colleague to this hearing.

The CHAIRMAN. I yield to our other distinguished colleague from Texas, Mr. Pickle.

Mr. PICKLE. Mr. Chairman, I thank you for yielding.

I also want to welcome one of the most distinguished men who ever served in this Congress. I am glad to see him here. I would like consent to have my remarks made a part of the record immediately following those of Mr. Mahon.

As you may know, Mr. Burleson and I both have introduced a companion bill on this subject. I would like my remarks to follow those of this distinguished gentleman.

The CHAIRMAN. Without objection, it will be so ordered. I am very glad, Mr. Burleson, that you pointed out that our distinguished witness this morning is now the dean of the House and we commend him. The gentleman is certainly one of the most distinguished of all Americans.

We will be pleased to hear you.

STATEMENT OF HON. GEORGE H. MAHON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. MAHON. Thank you very much, Mr. Chairman. Thank you very much, Mr. Burleson and Mr. Pickle for the commercial. I don't know just how advantageous it is to be the dean of the House of Representatives and of the Congress. I think we look more these days to the quality of performance rather than to the length of service.

The CHAIRMAN. The gentleman excels in that, too.

Mr. MAHON. Thank you so much. The gentleman from Texas, Mr. Burleson, introduced a bill involving Federal estate taxes some time ago. We discussed this matter and I was delighted to become also a cosponsor of this legislation because, in my opinion, it is legislation of a very great urgency. I am not a student of Federal estate taxes. I am here because many of my constituents of relatively moderate means have expressed to me the view, which I fully share, that the present $60,000 exemption which was written into the law about 34 years ago is inadequate in the context of existing conditions.

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In my opinion it is much too low and should be increased, and so I have joined with Mr. Burleson and Mr. Pickle and others to try to give impetus to the idea of raising the $60,000 limit. I hope the Ways and Means Committee will find a way to provide an appropriate increase.

Mr. Chairman, I want to commend the Ways and Means Committee for scheduling this hearing because this matter is more important than it may appear to be on the surface. I realize that, of course, there are many complexities in our estate tax laws. I know you will be receiving testimony from the experts in this field.

I represent a great farming area and what inflation has done to my great farming area is really something to behold. It costs money, money, money to engage in the farming business. Many pieces of farm equipment will cost you as much as $25,000. It isn't unusual to have a $50,000 or $100,000 or more investment in equipment and machinery alone.

Then land values have skyrocketed far beyond their productive potential. In other words, speculation in real estate ventures and otherwise has caused the land to increase very significantly in market value.

So the $60,000 limit even for people of moderate means is now entirely too low and I would hope that we can find a way to deal with this subject. If we can't deal with it adequately, it is going to have a very adverse effect, in my opinion, on agricultural production.

Therefore, it is not only important to farmers—to agriculture—but it is important to city dwellers, to people in the urban areas, to the rank and file workers of the country.

That is about all I would say, Mr. Chairman, because I want you to hear the witnesses who are experts in the field.

The CHAIRMAN. Thank you very much. Wouldn't you agree with us that a Presidential year is a difficult year to handle this matter, but we came to the conclusion that the problem was so serious that we couldn't afford to delay it any longer. Would you agree with that?

Mr. MAHON. I fully agree. I have been rather surprised and pleased, and yet I understand it, that there has been so much interest in this by the farm organizations and others whose problem it is and whose duty it is to be responsive to the needs of agriculture.

Mr. SCHNEEBELI. Mr. Chairman.

The CHAIRMAN. Mr. Schneebeli.

Mr. SCHNEEBELI. Mr. Chairman. We all have great respect for the chairman of the Appropriations Committee. The House Members, of course, are guided by the thoughts of their seniors and certainly Mr. Mahon has the respect of everybody in the House and I am sure that his thoughts will be weighed very carefully.

I support the position you maintain. I think you are absolutely correct, Mr. Mahon.

Thank you very much for coming.

Mr. MAHON. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Burke.

Mr. BURKE. I wish to commend the chairman for his appearance here this morning. I am surprised to hear that he is the dean of the House. He has such a youthful way about him. I thought he was one of the new Members.

Mr. MAHON. Thank you very much for your partiality. That brightens up my day, Mr. Burke.

The CHAIRMAN. Are there further questions?

We appreciate your coming.

[The remarks of Congressman Pickle, previously referred to, follow:]

STATEMENT ON ESTATE TAX BY HON. J. J. PICKLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, Members, I am in strong support of the bill HR 1973 by Mr. Burleson and the companion bill HR 6179, which I have introduced. Both bills would increase the estate inheritance tax from the present amount of $60,000 to $200,000.

This committee and this Congress has a chance to breathe new life into one of our greatest institutions which has been gradually eroding in the last few years—the family farm. Few institutions in this country have been more valuable—Surveys by widely divergent economists have stated that the family farm is the most productive unit of food and fiber production. And the farmers and ranchers of this country have asked little in return. But now they are pleading that this present, badly outdated law be updated so that the family farm can be passed from generation to generation.

Whenever I talked with the people of the 10th District of Texas about agriculture, there is one subject which dominates those conversations. It is the estate tax. When Congress established the $60,000 exemption the year was 1942. I do not have the precise figures estimating the increase in land values during the last 34 years but we all know that it has been significant—a four or five times increase in value in most instances.

There has been a downhill slide in the number of farms during the last two decades. In 1955, there were 165 Congressional Districts where at least 20 percent of the folks lived on ranches or farms. Today there are only 14 such districts. Since 1970, the Census Bureau tells us a very slight reverse of the urban migration has begun. I think that such a move is encouraging. America will continue to enjoy the finest food production system in the world only as long as the family farm remains the basic unit. By passing legislation which will increase the exemption to $200,000, we will be ensuring that more farms stay in the hands of the family. Under the present system, many landowners' heirs are forced to sell out to developers, or to the government, so that they can pay the inheritance tax. I believe that this is counter-productive to our economy in the long run. If you support the family-farm and do not want our food production controlled by a handful of multinational corporations, I think this committee will support the Burleson-Pickle bill.

Some may say this is an extra tax advantage for the rich. I suppose it would help the rich slightly—but the rich (whoever the journalists classify as "rich") are not the object for relief in this bill. The bill is designed to help those average home-farm-ranch estates—300–600 acres in size. Unless we give relief to those groups—few farmers will be able to pass along their estate, or part of their estate, to their children. All that most farmers and ranchers have is their land. If that must be sold, then the farm is automatically broken up. The average farmer just keeps ahead of the bill collector anyway. Few farmers can accumulate $50,0000–$100,000 in cash to pay the federal government.

I must add that I am glad that the President has come around to our way of thinking, although he advocates an increase to only $150,000. His proposal is firm evidence, though, that there is broad-based support for reforming this antiquated law.

The CHAIRMAN. Our next witnesses this morning are a very distinguished panel that we will call to the witness stand, Mr. Allan Grant, president of the American Farm Bureau Federation; we have Barbara Brookshire from the Associated Milk Producers (Mid-State Region) Women's Auxiliary; Albert E. Geiss, International Association of Ice Cream Manufacturers, Milk Industry Foundation; L. C. Carpenter, vice president of the Midcontinent Farmers Association; Mr. W. B. Criswell, president, Plains Cotton Growers Association; and Mr.

Don Woodward, who is the president of the National Association of Wheat Growers, the ad hoc agricultural tax committee.

I want to welcome all of you to the committee. I take special note of Mr. Don Woodward, who has been a friend of mine for many years. We were in college together. He is from my district and is the very distinguished president of the National Association of Wheat Growers.

A PANEL CONSISTING OF L. C. CARPENTER, VICE PRESIDENT, MID-CONTINENT FARMERS ASSOCIATION; ALLAN GRANT, PRESIDENT, AMERICAN FARM BUREAU FEDERATION; DON WOODWARD, NATIONAL ASSOCIATION OF WHEAT GROWERS AND AD HOC AGRICULTURAL TAX COMMITTEE; BARBARA BROOKSHIRE, ASSOCIATED MILK PRODUCERS (MID-STATE REGION) WOMEN'S AUXILIARY; ALBERT E. GEISS, INTERNATIONAL ASSOCIATION OF ICE CREAM MANUFACTURERS, AND MILK INDUSTRY FOUNDATION; AND W. B. CRISWELL, PRESIDENT, PLAINS COTTON GROWERS ASSOCIATION

The CHAIRMAN. We will leave it to your judgment as to who shall lead off.

Mr. Carpenter, would you like to lead off this morning?

STATEMENT OF L. C. CARPENTER

Mr. CARPENTER. Mr. Chairman and members of the committee, I am delighted to have this opportunity. I appreciate the courtesy of leading off because I do have another meeting at 10:30.

Mr. Chairman, may I say from the standpoint of farmers probably their No. 1 worry today is prices, but their No. 2 worry is the fact that they know they are going to pass on and they are wondering what is going to happen to their relatives in the way of tax payment when that happens. So I will brief my statement if it might be placed in the record.

The CHAIRMAN. Without objection, we will place it in the record in full. Thank you, Mr. Carpenter.

[The prepared statement follows:]

STATEMENT OF L. C. "CLELL" CARPENTER, MIDCONTINENT FARMERS ASSOCIATION, COLUMBIA, MISSOURI

Mr. Chairman and members of the committee, I am L. C. "Clell" Carpenter, Vice President of Midcontinent Farmers Association, headquartered in Columbia, Missouri. MFA is a farm organization representing over 160,000 farmers in the mid-central United States.

Mr. Chairman, this committee is to be commended for holding these hearings on the vital subject of estate taxes. The American dream has always been that an individual should be able to build an estate for his own enrichment and which he can pass on to his children. It is this building up of one generation after the next which has made our country great—whether economic, social or political.

But economic growth cannot continue at past rates under the current estate tax situation. The present $60,000 exemption which was realistic 40 years ago now results in an estate tax which is confiscatory. It is important that future progress not be inhibited by tax policies of the past. It is essential that the bulk of our nation's farm land not pass into the hands of large corporations because estate laws force the heirs to sell their family farm to pay the taxes.

Quite frankly, Mr. Chairman, I believe your dynamic speech a few weeks ago did much to convince the President that a higher estate tax exemption is necessary. Your promise "that the average family farmer will get relief from the revisions" to be written by this committee, plus the lack of enthusiasm for the President's proposal, must have pursuaded the President that a higher exemption is needed. His original proposal called only for extending the time over which estate taxes could be paid.

Now the President is calling for a substantial, although inadequate increase in the estate tax exemption.

In 1942 when the $60,000 estate tax exemption was established, the average equity per farm was about $10,000. If farm equities continue to grow as they have in the past, in five years the average farm equity will rise to about $285,000 per farm.

Mr. Chairman, in order to enhance continuation of the family farm and other small businesses, we favor the following legislative proposals:

1. Increase the estate tax exemption from the present $60,000 to $200,000

The combined influence of inflation in general, and speculation in farm land in particular have caused farm-land prices to increase at a higher rate than general prices. Therefore, the present exemption established 34 years ago is no longer adequate.

We do not propose perpetuating large fortunes, and are against the development of a feudal system based upon a hereditary land-owning class. We do strongly favor continuation of family farms and small businesses. A realistic exemption of $200,000 will enhance continuation of family-sized farms and businesses. A progressive inheritance tax on that portion not exempted will limit the growth of large estates.

We favor making the $200,000 exemption apply to all estates—both farm and non-farm. Although farming requires greater capitalization than other businesses (making it more difficult for young families to enter farming than other businesses) farmers do not desire preferential treatment.

2. Increase the marital deduction by a flat sum of $100,000 beyond the present one-half deduction now allowed

It is impossible to measure the inputs contributed by a farm wife to the total increase in the value of a farm. The same is true of family businesses. The $100,000 marital deduction would reflect contributions made by the wife. In addition, it would help to overcome another problem related to the surviving wife of a family farm or business. Often a bank will not loan a widow funds necessary to carry on the business until she is able to demonstrate her ability to manage it.

3. Evaluate real property including farming, woodland, and scenic open space, on the basis of current use rather than potential use

Land adjacent to municipalities is often value on its potential development value. Likewise, speculators drive up the price of land beyond its productive value because of tax-loss considerations. Those who have owned and operated land for farming rather than holding it for speculation should not be penalized by having their estate valued and taxed at a level other than its productive value.

4. Delay estate taxes for the first 5 years following the death of the owner, with no interest due on the taxes during that period

This delay would provide the heirs ample time to assume operation of the farm or business, establish credit, and make the necessary management decisions before the added burden of estate taxes would become a factor.

5. Require payment of estate taxes during the sixth through twenty-fifth years, with an interest of 4% during this period on the unpaid balance

6. Repeal the provision that makes the executor of an estate liable for the estate taxes, when the stretched-out payment plan is being used

Repealing this liability provision would enhance the securing of professional help in administering estates.

Mr. Chairman, the role of the family farm in assuring adequate supplies of food and fiber for both domestic use and export is such that we must have bipartisan support for its survival. Equitable estate taxes can do much to provide such assurance. Tax revision plans now before the Congress have merit, and deserve your fullest consideration.

The CHAIRMAN. I will recognize Mr. Allan Grant, president of the American Farm Bureau Federation.

When I appeared before your national convention this subject matter was raised as one of the most important of all the matters in which you felt the Congress should take action. We are pleased to have you here before us, Mr. Grant.

STATEMENT OF ALLAN GRANT

Mr. GRANT. Thank you, Mr. Chairman and members of the committee, we appreciate the opportunity to present Farm Bureau's views on amendments to update and reform the provisions of the Federal estate tax law.

Farm Bureau is the largest general farm organization in the United States with a membership of 2,505,258 families in 49 States and Puerto Rico. It is a voluntary, nongovernmental organization representing farmers and ranchers who produce virtually every agricultural commodity that is produced on a commercial basis in this country. As a consequence, we have a deep interest in all Federal taxes, including estate taxes, that affect our farmers and ranchers.

Estate taxes have been a matter of increasing concern to Farm Bureau members for several years. Farming and ranching are predominantly family enterprises, and farmers and ranchers are deeply interested in the orderly transfer of their businesses to succeeding generations.

The Federal estate tax is essentially the same today as it was in the 1940's. The last significant change, the addition of the marital deduction, was made in 1948. The present rates and schedules were adopted in 1941 and the present specific exemption went into effect in 1942.

Since the basic provisions of the present estate tax were adopted, the purchasing power of the dollar has been eroded by inflation, and the size and the value of an economic farming unit have undergone drastic changes.

In 1942 the U.S. average value of land and buildings per operating farm unit was only $6,100, and very few farmers were affected by the Federal estate tax. In March 1975 the average value of land and buildings per operating farm unit was $143,000, and the amount of machinery and equipment required to operate a farm was much greater than in 1942.

As a result, estate taxes have become a matter of deep concern to a great many farmers.

The impact of the estate tax on farmers is greatest on the estates that consist primarily of efficient, productive commercial farming operations and thus do not have large amounts of liquid assets that can be used to pay estate taxes.

These are the farms that produce the bulk of the farm products that have made American agriculture the envy of most of the rest of the world. Higher estate taxes brought on by inflation and estate appraisals based on the market value of farmland for nonfarm uses are making it increasingly difficult for farmers to transfer family farming businesses to succeeding generations and are threatening to eliminate farming and desirable privately owned open space from many populous areas.

When a farmer or rancher dies, his heirs often find themselves faced with such high estate taxes that they are forced to sell the farm or ranch regardless of their desire to keep it in the family. Unfortunately, many families are not aware of their potential Federal estate tax liability until after an unexpected death.

Thus, farm families often fail to take advantage of the numerous provisions of the estate and gift tax laws that can be used—with the help of proper legal advice—to reduce, or postpone, estate taxes.

Our policy with respect to estate and gift taxes was summarized in a policy resolution, which was adopted by the voting delegates of the member State farm bureaus at the 1976 annual meeting of the American Farm Bureau Federation in St. Louis, Mo., last January, as follows:

> Laws covering the taxation of estates and gifts have not been changed materially since 1942.
>
> We place a high priority on major amendments to the estate and gift tax provisions of the Internal Revenue Code. At a minimum, these amendments should include (1) an increase in the standard estate tax exemption to reflect the effects of inflation since the present $60,000 exemption was set in 1942; (2) a substantial increase in the marital deduction to minimize the problem of the so-called "widow's tax"; and (3) provisions for basing the value of farmland and open spaces at levels reflecting their current use rather than their highest possible use.
>
> Immediate passage of such legislation is necessary if we are to allow farms and small businesses to be passed from one generation to another if we are to relieve unnecessary hardships on widows and widowers, and if, at the same time, we are to maintain open spaces in urban areas.

To offset the cumulative effect of more than 30 years of inflation and to help check the adverse effects of estate taxes on congestion and urban sprawl in populous areas, Farm Bureau recommends three changes in the present Federal estate tax law as follows:

One: Raise the specific estate tax exemption from $60,000 to $200,000. This would adjust the estate exemption for the inflation which has occurred since 1942, when the $60,000 exemption went into effect. The Consumer Price Index—1967=100—was 48.8 in 1942 and 161.2 in 1975. This means the purchasing power of $1 in 1975 was about equal to the purchasing power of 30 cents in 1942, and $60,000 divided by 30 cents equals $200,000.

Two: Raise the maximum marital deduction from 50 percent of the value of the adjusted gross estate passed to a surviving spouse to $100,000 plus 50 percent of the total value of the adjusted gross estate. This would recognize the importance of partnerships between husbands and wives, and the special problems of wives who are widowed at an early age.

Three: Establish a procedure which would permit the executor of an estate to elect to have land used for farming, woodland or scenic open space assessed for estate tax purposes on the basis of its current use rather than higher potential uses.

We are grateful to Congressman Burleson and the approximately 100 other Members of the House who have introduced, or cosponsored, bills to carry out these recommendations.

We are well aware that our proposals will be opened by some people on the grounds of cost to the Treasury. We do not think this is a valid

argument. Estate and gift taxes are a relatively minor source of Federal revenue.

In the fiscal year 1975—the last year for which final figures are available—Federal revenues from estate and gift taxes amounted to only $4.6 billion, or 2.5 percent of the $187.5 billion the Federal Government received in general revenues—that is, Federal revenues from all sources except trust funds.

The fact of the matter is that the basic purpose of the Federal estate tax is to redistribute wealth rather than to raise revenue.

Our proposal with respect to the specific estate tax exemption would apply to all estates. If a specific estate tax exemption of $60,000 was justified in 1942, an increase in this exemption to $200,000 is fully justified to adjust for the inflation that has occurred since 1942.

Our proposal with respect to the marital deduction also would apply to all estates. This deduction is essentially a device for deferring estate taxes until the death of a surviving spouse. As a matter of equity, we do not think that a tax should be levied on the transfer of property between spouses on the death of a husband or wife; however, we are not recommending a 100-percent marital deduction. The increase which we are proposing is designed to provide a measure of relief for the estates that most need it.

Our proposal with respect to the valuation of farmland, woodland, and open space would apply only to estates that own such land; however, we believe that it would serve the public interest by helping to maintain open space in urban areas without extensive public expenditures for land acquisition and maintenance.

We would like to stress the fact that this proposal would be optional rather than mandatory. If an executor elected to have an estate assessed at its value for farming purposes, the land in the estate would be required to remain in farming or ranching for a period of 5 years. If such land is sold for a nonfarm use in less than 5 years an additional tax based on the higher use value would be assessed and collected.

We are recommending that the recapture period be limited to 5 years because a longer period could create a hardship by clouding title to the land in an estate and thereby impairing its collateral value.

We also would like to point out that one effect of having land valued on the basis of its current use—rather than a higher market value—would be to increase the amount of capital gains that would be realized and subject to taxation if the property should subsequently be sold for more than its current use value.

We appreciate the opportunity to present our views on this important matter, and we urge that you take prompt and favorable action on our proposals, so that remedial legislation can be passed by the 94th Congress.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Grant, for a very concise statement. We will next hear from Mr. Don Woodward, president of the National Association of Wheat Growers.

Welcome to the committee, Don.

STATEMENT OF DON WOODWARD

Mr. WOODWARD. Thank you, Mr. Chairman.

A good many years ago when you and I were college students back in the late thirties we never would have thought we would meet here today. Things were real carefree in those days.

Now we have problems and we are glad that we have you where you are so that you can help with all of the major problems that face the Ways and Means Committee.

Mr. SCHNEEBELI. If the gentleman would yield, Mr. Woodward, we also are very happy that we have Mr. Ullman for a chairman.

The CHAIRMAN. I appreciate that very much. Sometimes I wish someone else were shouldering some of these responsibilities.

You may proceed, sir.

Mr. WOODWARD. Nevertheless we have a job to do so that we will proceed.

Members of the committee and Chairman Ullman, let me first take this opportunity to thank you for allowing me to appear before you today. I should first say that I am appearing not only on behalf of the National Association of Wheat Growers, but also on behalf of an ad hoc agricultural tax committee. This committee includes the American Horse Council, Inc., American National Cattlemen's Association, American Seed Trade Association, American Sugar Cane League, Cotton Warehouse Association, Florida Sugar Cane League, National Association of Wheat Growers, National Cotton Council of America, National Milk Producers Federation, National Wool Growers Association, and the Rio Grande Valley Sugar Cane Growers Cooperative.

In this regard you have already heard testimony from some of these people that we have here today and in the interests of time we realize that our remarks should be made briefly and we ask that all our testimony in the written text be included in the record.

The CHAIRMAN. Without objection, your statement will appear in full as though read and the same is true of all of the statements.

Mr. WOODWARD. Thank you.

There are two primary factors that have contributed to the need for updating the estate tax laws for agricultural estates—inflation and increasing farm size. Along with increased farm size has come an improved technology in which specialized equipment is being substituted for farm labor.

Based on U.S. Department of Agriculture figures the average farm in 1942 had 182 acres and its value, including buildings, was $6,100. There are no records of the average value invested in farm equipment and other personal property at that time, but even when the value of personal property is added to the real estate value, the total was far below the $60,000 estate tax exemption.

It is our conclusion that a farm had to be five or six times larger than the average farm in 1942 before it even began to pay an estate tax.

The 1975 situation is far different. The average farm now has 385 acres and, with buildings, is worth about $131,000.

In view of this, we believe it reasonable to project that the investment in farm personal property is equal to that invested in real estate.

For the average farm cited above this means another $131,000 or a

total farm investment of $262,000. Subtract the $60,000 estate tax exemption and there is a taxable estate—in round figures—of $200,000.

The estate tax on such an estate is $50,700 on a direct inheritance. In the case of a surviving spouse, who in most instances has been directly involved in operating the farm along with her husband, there is a tax of about $9,000.

It is the impact of these levies which we find alarming. The income potential of farming operations does not have within it a tolerance which can pick up a $50,000 estate tax bill. And if the property is valued at other than agricultural values, the tax burden becomes even greater.

There is an alternative to family farming, but it is one we do not like and we believe the Congress will like no better. It is total corporate farming financed solely by outside capital. We do not believe the Congress prefers this type of farm ownership to the present family farm structure. Yet, unless action is taken, the family farm will go down the drain.

It is imperative that we do something about this today as well as in the future.

Fortunately, many Members of Congress, as well as the President, have come to recognize the problem. President Ford expressed concern about the situation in his state of the Union message and advanced one type of relief.

The legislative branch of Government has shown an equal interest. Numerous bills have been introduced in the Senate to adjust the estate tax laws to maintain the family farm.

Here in the House the record is even more impressive. A very large number of bills has been introduced to rectify this situation. Among the proposed estate tax relief measures there are four main categories which I feel are imperative to the interests of the farmers.

No. 1 would be that if there is one measure which has almost universal support within the farm community it is the proposal to allow farmland to be valued on the basis of its use for farming purposes rather than the value on the basis of fair market value. This is the type of relief proposed by Mr. Burleson's legislation—H.R. 1793 and other identical bills—which at last count has 63 cosponsors.

Under the Burleson bill, land must continue to be held and used by the estate beneficiaries as farmland for at least 5 years following the death of the decedent in order to qualify.

The law now requires that property held at death, including farmland, must be included in the estate at fair market value. A large estate tax liability resulting from the valuation of farmland on the basis of its fair market value has caused in the past and continues to cause severe financial problems for the surviving members of a family.

These people are forced to sell all or part of the land in order to meet the estate tax bill, or they are forced to abandon the use of the land for farming purposes and convert it to nonagricultural uses.

By limiting the factors to be used in the valuation of farmland held by an estate to the use of the land for farming purposes, this clearly eliminates inflated values due to urban development or due to valuation on the basis of a more profitable use of the land.

It is noteworthy to take notice that 31 States already have laws

allowing property tax valuations of farmland to be made on the basis of use of the land.

Mr. Chairman, for reasons I have discussed and also in our written testimony we strongly urge the committee to adopt a provision to allow alternative valuation of farmland based on its use for farming.

No. 2: Next let me turn to the proposal to increase the current $60,000 estate tax exemption to some higher amount.

Most sponsors have suggested a rise to $200,000 in order to fully take into account the rate of inflation since the $60,000 exemption was enacted. Our organization has recommended a $300,000 exemption. The President, on the other hand, recently called for an increase to $150,000 to be phased out over a 5-year period.

Regardless of the figure, some substantial increase in the present exemption is clearly warranted. Because updating the exemption is long overdue, we favor adjusting it immediately, rather than phasing it out over a period of years.

I say this from the farmer's point of view because, as mentioned earlier, the amount of capital invested by the average farm in such things as farm equipment, livestock, and other assets necessary for farming has risen dramatically over recent years.

The proposal to value farmland on the basis of farm use does not provide any estate tax relief for the substantially higher value of farm property other than land. And we believe this problem should also be dealt with. If farm equipment or other essential assets have to be sold to pay estate taxes, the effect is the same as having to sell or convert the farmland itself.

Before turning to the next proposal, let me make it clear that we are suggesting an increase in the exemption in addition to valuation of farmland based on use—not in lieu of this latter proposal.

Next, I would like to briefly comment on the President's proposal to allow a 5-year moratorium on estate tax liability attributable to family farms or small businesses followed by a 20-year installment payment period at an interest rate of 4 percent rather than the current 7 percent.

As with other proposals, this would be quite helpful to many farmers. However, we do not believe standing alone it provides sufficient relief. Consequently, it necessarily must be coupled with some or all of the other proposals I have mentioned.

The fourth proposal is that others will no doubt discuss in great detail an increase in the 50 percent marital deduction. For that reason, I will limit my comments by stating that such an increase would obviously be helpful to everyone—farmers included—from at least two standpoints. It could eliminate estate taxes on the farm property left the surviving spouse and could also eliminate the complicated and often expensive estate planning now required to minimize taxes on the estate of the first spouse to die.

Finally, we want the committee record to clearly show that our group opposes a capital gains tax on appreciated property held at death. In the case of farmers, the farmland help at death has often appreciated greatly over the cost when originally purchased or when inherited. A large capital gains tax on this appreciation would again force the sale of the land in order to meet the tax liability.

In closing, I would like the committee to know that by commenting on the problems of farmers, we do not mean to imply there are not

many other citizens who encounter serious problems because of the present estate tax law. We realize that you must deal with the problems of the farmer within the context of small business owners and other taxpayers, and also within budgetary restrictions.

Nonetheless, within this context, we hope that the committee understands the plight of the farmer when considering estate tax changes. We urge you to adopt relief provisions along the lines suggested.

Thank you again for allowing me to present our views.

[The prepared statement follows:]

STATEMENT OF DON WOODWARD, PRESIDENT, NATIONAL ASSOCIATION OF WHEAT GROWERS, AND ON BEHALF OF THE AD HOC AGRICULTURAL TAX COMMITTEE

Chairman Ullman and members of the Committee, let me first take this opportunity to thank you for allowing me to appear before you today. I should first say that I am appearing not only on behalf of the National Association of Wheat Growers, but also on behalf of an Ad Hoc Agricultural Tax Committee. This Committee includes the American Horse Council, Inc., American National Cattlemen's Association, American Seed Trade Association, American Sugar Cane League, Cotton Warehouse Association, Florida Sugar Cane League, National Association of Wheat Growers, National Cotton Council of America, National Milk Producers Federation, National Wool Growers Association, and the Rio Grande Valley Sugar Cane Growers Cooperative.

In this regard, I should mention that some of the members of the Ad Hoc Committee are also presenting their views individually to emphasize the most important areas of concern to their particular segment of the farm community.

The Ways and Means Committee is to be commended for calling these hearings to review the estate tax laws. Such a review, particularly as it relates to estates in which the principal assets are a family-type farm and the personal property needed for its operation, is, in our opinion, long overdue. It is probably not an overstatement to say that estate tax reform for family farms is one of the most important of all farm issues now pending before Congress.

Two primary factors have contributed to the need for updating the estate tax laws for agricultural estates—inflation and increasing farm size. Along with increased farm size has come an improved technology in which specialized equipment is being substituted for farm labor.

The inflationary spiral, common to all of us, seems to have impacted more on agricultural than on the general economy. Since 1942, when the present $60,000 exemption was established for estates, farm real estate values have gone up some 1000%. Values today are three times higher than they were in 1960.

Compound this increase in value by the fact that farm size on the average has more than doubled since 1942 and we find an entirely different situation today than we had in 1942 or even in 1960.

Based on U.S. Department of Agriculture figures the average farm in 1942 had 182 acres and its value, including buildings was $6,100. There are no records of the average value invested in farm equipment and other personal property at that time, but even when the value of personal property is added to the real estate value, the total was far below the $60,000 estate tax exemption. It is our conclusion that a farm had to be five or six times larger than the average farm in 1942 before it even began to pay an estate tax.

The 1975 situation is far different. The average farm now has 385 acres and, with buildings, is worth about $131,000.

Because of the great variety of farming in the United States (and within the group presenting this statement) it is difficult to place an "average" figure on farm equipment and other personal property. However, we do know that every type of agriculture today has costly highly specialized equipment, whether it be a tractor, a combine, a mechanical cotton harvester, self-propelled picker-sheller used in harvesting corn or a stainless steel pipeline milker and storage tank on the dairy farm. In the case of livestock farms, large sums are invested in breeding animals and other livestock. In view of this, we believe it reasonable to project that the investment in farm personal property is equal to that invested in real estate.

For the average farm cited above this means another $131,000 or a total farm investment of $262,000. Subtract the $60,000 estate tax exemption and there is a taxable estate (in round figures) of $200,000.

The estate tax on such an estate is $50,700 on a direct inheritance. In the case of a surviving spouse, who in most instances has been directly involved in operating the farm along with her husband there is a tax of about $9,000.

It is the impact of these levies which we find alarming. The income potential of farming operations does not have within it a tolerance which can pick up a $50,000 estate tax bill. And if the property is valued at other than agricultural values the tax burden becomes even greater.

Unless some changes are made in the method of dealing with the estate tax law as it now applies to family farms especially since technology requires increasingly large amounts of capital investment, we will continue to witness a trend which could ultimately bring about the demise of the family farm structure as we now know it.

There is an alternative to family farming, but it is one we do not like and we believe the Congress will like no better. It is total corporate farming financed solely by outside capital. We do not believe the Congress prefers this type of farm ownership to the present family farm structure. Yet unless action is taken this will most likely occur.

Fortunately, many members of Congress, as well as the President have come to recognize the problem. President Ford expressed concern about the situation in his State of the Union message and advanced one type of relief. We fully concur with his statement to the American Farm Bureau Federation Convention in St. Louis early this year when he said: "The continuity of our farm families is vital. I want this continuity preserved, so farms can be handed down generation to generation, without the forced liquidation of family enterprises."

The legislative branch of government has shown an equal interest. Numerous bills have been introduced in the Senate to adjust the estate tax laws to maintain the family farm.

Here in the House the record is even more impressive. A check of the January 14, 1976 Legislative Calendar of your Ways and Means Committee shows three different categories under "Estate Taxes" which deal with "family farms", "rural property" or "real property which is farmland, woodland, etc." We are pleased to note that under those three headings there are 69 bills which have been introduced by 206 authors from 46 states. Since then more bills have been introduced on these subjects. These are bills directed specifically toward farming and the list does not include bills dealing with an increase in the basic exemption or the marital deduction—proposals which we also endorse but which we have not listed because they cover more than agriculture or rural areas.

PROPOSED ESTATE TAX RELIEF MEASURES

Most of the numerous estate tax proposals which I have mentioned call for one or more of the following changes to the estate tax law: (1) valuation of farmland and certain other lands on the basis of the "use" of the land rather than on the basis of "fair market value," (2) an increase in the $60,000 estate tax exemption to some higher amount, (3) an increase in the 50% marital deduction, and (4) a five-year deferral of estate tax liability attributable to family farms and small businesses followed by a 20-year installment payment period at a 4% interest rate. This last proposal is the one offered by the President in his State of the Union address.

The various estate tax relief measures being proposed are not mutually exclusive and there is something to be said about the merits of each one. In view of this, we would hope that the Committee will adopt a combination of these proposed changes. However, because our time is limited today, the emphasis of my remarks will be directed toward those proposals dealing directly with relief for family farms.

VALUATION OF FARMLAND ON USE RATHER THAN FAIR MARKET VALUE

If there is one measure which has almost universal support within the farm community it is the proposal to allow farmland to be valued on the basis of its use for farming purposes rather than valuation on the basis of fair market value. This is a type of relief proposed by Mr. Burleson's legislation (H.R. 1793 and other identical bills) which at last count has 63 co-sponsors. Under the Burleson bill, land must continue to be held and used by the estate beneficiaries as farmland for at least five years following the death of the decedent in order to qualify.

The law now requires that property held at death, including farmland, must be included in the estate at fair market value. A large estate tax liability resulting from the valuation of farmland on the basis of its fair market value has caused in the past and continues to cause severe financial problems for the surviving members of a family. These people are forced to sell all or part of the land in order to meet the estate tax bill, or they are forced to abandon the use of the land for farming purposes and convert it to non-agricultural uses.

In determining fair market value under the present law, a variety of factors are required to be considered including the highest and best use of the property, sales of nearby or similar land, the location of the land, the size of the land, and other similar facts and circumstances. This means that farmland situated near urban areas may be valued on the basis of its use as a residential development or maybe on its use as an industrial park. This value can be many times greater than the value of the land when used for farming since the rate of return on farmland and other farm assests is generally much lower than in the case of other business uses.

By limiting the factors to be used in the valuation of farmland held by an estate to the use of the land for farming purposes, this clearly eliminates inflated values due to urban development or due to valuation on the basis of a more profitable use of the land.

It is noteworthy that 31 states already have laws allowing property tax valuations of farmland to be made on the basis of use of the land.

Mr. Chairman, for the reasons I have discussed, we strongly urge the Committee to adopt a provision to allow alternative valuation of farmland based on its use for farming. In this regard, it is probably worth pointing out that the alternative valuation proposal involves a smaller drain on the Federal Treasury than the other estate tax proposals. According to Treasury Department estimates released by the Library of Congress, valuation of farmland based on use would only reduce estate tax collection by about $20 million based on 1974 levels.*

INCREASE THE $60,000 EXEMPTION

Next, let me turn to the proposal to increase the current $60,000 estate tax exemption to some higher amount. Most sponsors have suggested a rise to $200,000 in order to fully take into account he rate of inflation since the $60,000 exemption was enacted. Our organization has recommended a $300,000 exemption. The President on the other hand recently called for an increase to $150,000 to be phased-in over a five-year period. Regardless of the figure, some substantial increase in the present exemption is clearly warranted. Because updating the exemption is long overdue, we favor adjusting it immediately rather than phasing it in over a period of years.

I say this from the farmer's point of view because, as mentioned earlier, the amount of capital invested by the average farm in such things as farm equipment, livestock, and other assets necessary for farming has risen dramatically over recent years. The proposal to value farmland on the basis of farm use does not provide any estate tax relief for the substantially higher value of farm property other than land. And, we believe this problem should also be dealt with. If farm equipment or other essential assets have to be sold to pay estate taxes, the effect is the same as having to sell or convert the farmland itself.

If the Committee finds that from a budgetary standpoint it is not possible to increase the exemption across the board by an amount large enough to solve the problem caused by the higher values of farm equipment and other non-real property, there is another way to treat the problem. This alternative would allow an additional exemption for the first $200,000 of the value of a family farm. This is an exemption in addition to the basic $60,000 exemption. If the Committee raises the $60,000 exemption for all taxpayers, the additional $200,000 exemption for family farms could be lowered accordingly. As you are no doubt aware, the Senate in 1974 adopted an additional $200,000 exemption for family farms, but no action was taken on the measure in the House.

Before turning to the next proposal, let me make it clear that we are suggesting an increase in the exemption in addition to valuation of farmland based on use—not in lieu of this latter proposal.

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*"Analysis of Estate and Gift Tax Proposals Introduced in the Senate in 1975," Congressional Record, January 23, 1976, p. S-435.

FIVE-YEAR DEFERRAL FOLLOWED BY 20 YEAR INSTALLMENT PAYMENT OF ESTATE TAXES

Next, I would like to briefly comment on the President's proposal to allow a five-year moratorium on estate tax liability attributable to family farms or small businesses followed by a 20-year installment payment period at an interest rate of 4% rather than the current 7% rate. As with other proposals, this would be quite helpful to many farmers. However, we do not believe standing alone it provides sufficient relief. Consequently, it necessarily must be coupled with some or all of the other proposals. In addition, there are some technical problems with the proposal which we will be happy to discuss with the Committee staff.

INCREASE THE 50 PERCENT MARITAL DEDUCTION

Others will no doubt discuss in great detail an increase in the 50% marital deduction. For that reason, I will limit my comments by stating that such an increase would obviously be helpful to everyone—farmers included—from at least two standpoints. It could eliminate estate taxes on the farm property left the surviving spouse and could also eliminate the complicated and often expensive estate planning now required to minimize taxes on the estate of the first spouse to die.

CAPITAL GAINS TAX ON PROPERTY HELD AT DEATH

Finally, we want the Committee record to clearly show that our group opposes a capital gains tax on appreciated property held at death. The effect of imposing such a tax would be to recreate most, if not all, of the estate tax problems which you are so diligently trying to solve through the various constructive provisions being considered. In the case of farmers, the farmland held at death has often appreciated greatly over the cost when originally purchased or when inherited. A large capital gains tax on this appreciation would again force the sale of the land in order to meet the tax liability.

In closing, I would like the Committee to know that by commenting on the problems of farmers, we do not mean to imply there are not many other citizens who encounter serious problems because of the present estate tax law. We realize that you must deal with the problems of the farmer within the context of small business owners and other taxpayers, and also within budgetary restrictions. Nonetheless, within this context, we hope that the Committee understands the plight of the farmer when considering estate tax changes. We urge you to adopt relief provisions along the lines suggested.

Thank you again for allowing me to present our views.

The CHAIRMAN. Thank you very much, Mr. Woodward.

We will next hear from Mrs. Brookshire, the Women's Auxiliary, Associated Milk Producers.

STATEMENT OF BARBARA BROOKSHIRE

Mrs. BROOKSHIRE. I welcome this opportunity, Mr. Chairman, to appear on behalf of the 19,000 dairy farm wives represented in the Associated Milk Producers of the midstates region in support of proposals favoring the Federal estate and gift tax reforms.

The Associated Milk Producers are all family type dairy operations, banding together for better bargaining and service to its members. I am a dairy farm wife and partner and have worked in this capacity for 28 years.

The CHAIRMAN. Let me break in by saying that your testimony may be the most important of all today because the farm housewife is the one who bears a great deal of the burden of these decisions. We especially value your testimony.

You may proceed.

Mrs. BROOKSHIRE. We appreciate the fact that you do recognize this, Mr. Chairman, and we trust that the committee does the same.

Our operation is located in Putnam County, Ind., where we are marketing over a million pounds of milk annually for the grade A Indianapolis market. I am accompanied here today, Mr. Chairman, by three of our officers, Mrs. Glenn Thronson of Blue Mounds, Wis.; Mrs. Verlo DeWall of Shannon, Ill.; and Mrs. Harold Rawles of Albion, Ind., whom I would like to present to you at this time. They are seated behind me.

The CHAIRMAN. We are very happy to have you all.

Mrs. BROOKSHIRE. They are all dairy wives with families who are interested in continuing the family business.

Although our tax thinking is directed to the small family-type farm, let us remember that we are no longer thinking of a few acres, a few cows, and perhaps a tractor or two. To remain in farming today is big business, agribusiness, if you will, where an average farm of well-managed dairyland can generate $100,000 into our total economy producing tons of food for our Nation.

The love of the land and the ability to make it return profitably is not something acquired, but is rather an inborn characteristic that must be recognized, encouraged, and promoted.

While milking the family cow was once relegated to the role of the housewife, today the dairy wife is probably a college-educated woman who works beside her husband in management as well as in the total operation.

She is not building social security credits toward her future retirement; she has probably given up the opportunity of a regular paycheck with extended benefits to stay home and work with her husband in building their own business. Should she then be taxed for inheriting quite possibly what might not have been were it not for her years of diligent devotion?

While the $60,000 exemption enabled a farmer or small business owner of 1942 to pass on to his heirs a home, an automobile, and a substantial part of his business, but the $60,000 today can be absorbed in one small corner of the farm, perhaps only the home.

Within this past year a neighbor of ours installed a new milking parlor system at a cost of $80,000, which cost did not include the necessary bulk milk tank, silos, or any of the related areas.

Our present exemption would not cover this one phase of his family operation, to say nothing of the land values, the livestock, or the many pieces of equipment pertinent to his operation.

As Senator Gaylord Nelson reported in his December release, "Inflation has increased the value of business and farm assets over 224 percent since Congress enacted the $60,000 in 1942."

In our area land values alone have increased 250 percent in the last 5 years.

It has long been recognized that Americans spend the smallest percentage of their income to feed their families of any place in the world, and this is directly related to the program of efficiency found on the family farm.

There are less than 300,000 dairymen in America today providing an adequate supply of fresh milk and dairy products for 214 million

Americans. Private enterprise, the foundation of our society, not only produces cheap food for our table, but produces outstanding young Americans who are becoming the leaders of tomorrow.

One of the goals of the auxiliary which we represent is that we shall work to improve the present and future of dairying. It is our strong belief that our children shall have the opportunity to farm if they so desire, to continue in dairying if it be their choice, for only those who have grown with the program will have the fortitude and stamina to enter such a lifetime of devotion.

Unfortunately, at the present time, estate tax laws run in the opposite direction, forcing liquidation of farms, reduction of acreage, or subservience to a lifetime of taxation. President Ford has expressed concern over the impact of the estate tax laws on farmers—and we are grateful that Members of Congress are equally concerned for those who are working our family farms—I am well aware that 55 bills have been introduced during this election year, but the suggestion of delaying and extending the payments over years leaves cold chills rather warm feelings.

Let's get to the root of the problem, the hidden tax hikes created by inflation. This is the area that the farm family has to manage.

My husband is currently executor for the settlement of his father's estate, so we are personally involved in the effects of these tax laws. Our present gift tax laws prevent transferring more than a small acreage at today's inflated prices, hardly enough to cover the land itself, to say nothing of the improvements thereon, yet we wish to continue our dairy operation into the fourth generation, for it is a good way of life and the farm is equipped to serve as a dairy. Shall we sell the farm or shall we pass on a lifetime of debts to the grandsons?

If we are to improve the future of dairying and of farming, this committee must find a realistic way of alleviating these tax burdens, thus providing a stronger portion of the continuing operation.

Fewer than 2 percent of all tax dollars come from estate taxes—is it not better to keep food on our tables and to economize elsewhere?

It is presently an utter impossibility for a young man to enter into farming for less than $100,000. Would it not be better to have him continue a family operation rather than turn to a government subsidy as is done in many countries? Therefore I urge your committee to take immediate action to make every effort possible toward the continuation of the family farms that we may continue in our stewardship of the land.

Thank you, Mr. Chairman and members of the committee, for this opportunity to appear. We will be happy to try to answer any questions, if you so desire.

The CHAIRMAN. Mrs. Brookshire, you have been very articulate and very eloquent.

Our next witness this morning is Mr. Albert E. Geiss, International Association of Ice Cream Manufacturers from the Milk Industry Foundation.

Mr. Geiss, welcome to the committee.

STATEMENT OF ALBERT E. GEISS

Mr. GEISS. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I appreciate this opportunity to appear before you this morning on a subject which seriously involves my company and two national industries which I represent.

I am president of the Barber Pure Milk Co., Birmingham, Ala., a family-owned dairy. I am also president of the Milk Industry Foundation, located at 910 17th Street NW., Washington, D.C., and I speak for its members who are located in every State of the Union. The companies belonging to this organization are the bottlers of fluid milk and processors of fluid milk products.

Additionally, inasmuch as we were asked to consolidate our testimony. I am speaking for Mr. J. Lloyd Langdon, president of the International Association of Ice Cream Manufacturers, located in the Barr Building, Washington, D.C., and the members of that organization. This association also has members in every State of the Union, producing ice cream and related frozen products. Together, the associations represent companies which operate approximately 2,000 dairy processing and manufacturing plants.

To emphasize the fact that these industries are characterized by small family-owned enterprises, I would like to point out that according to a recent U.S. Department of Agriculture publication, 75 percent of the plants were operated by local companies which owned only one plant.

Moreover, 50 percent of the fluid milk processed and bottled in the United States today passes through local dairies operating but one plant.

The two organizations specifically want to focus attention on badly needed changes in our present estate tax provisions.

We are aware of the many bills that have been introduced and referred to this committee and of the similar legislation in the Senate. It is our understanding that although we are commenting primarily on H.R. 11770, introduced by Congressman Burleson, this hearing is really an overview.

We have read President Ford's recommendations presented March 5 in Springfield, Ill. We support his ideas even though all the details of the legislative proposal have not yet been transmitted to this committee or to the Senate Finance Committee.

We know some of the present bills relate only to revising estate taxation of farms, which we support.

However, in the President's statement of March 5, and in his earlier proposal at the beginning of 1976, it seems clear he intended not only to include farms, but also businesses and individuals. He speaks of, and I quote: "To ease the burden of estate taxes on the many Americans with modest estates * * *."

I am sure that agricultural organizations will speak to the problem of farmers and farm families. However, the burden of this tax is now most onerous, not only for farmers, but for businessmen and all Americans who work and save.

The farmer, with taxed dollars, has had to purchase real and personal property in order to maintain his enterprise. With the value of

the dollar constantly eroding, it is surprising that no prior effort has been made to ease the estate tax burden. In fact, several decades have passed with little change.

Senator Gaylord Nelson of Wisconsin has made a further point that since the $60,000 exemption was enacted in 1942, inflation has increased the value of business and farm assets about 224 percent, making this tax burden confiscatory.

All of you are aware of the appreciation in the value of individual housing, thus creating an ever-greater hardship for the family survivors.

Senator Nelson also remarked that the income tax exemptions have been increased several times by the Congress to a total of 50 percent. But the estate tax exemption has not bee touched.

To further drive home the adverse effect of the estate tax, he has been quoted as saying: "While the $60,000 exemption enabled a farmer or business owner in 1942 to pass along to his heirs a home, automobile and a substantial part of his business, the $60,000 can be absorbed today by the family residence alone."

The change that occurred within the last 2 years has made the burden of these estate tax payments more difficult to bear even with 10 years to amortize the obligation to the Treasury.

Originally we paid, and I speak from experience in my own company, 4 percent interest. Then, it jumped to 9 percent on July 1, 1975, with the passage of Public Law 93–625, and was reduced to 7 percent February 1. This is still a considerable increase and further erodes the financial position of those paying estate taxes.

The increase itself is a very substantial burden, but the uncertainty compounds the problem even further. Most family-owned milk and ice cream companies have no way of obtaining needed capital investment except by earnings or by debt financing, and much of it by debt capital.

The uncertainty of a changing rate of payment of estate tax interest greatly complicates the firm's ability to obtain capital from its normal financial lending institutes.

As with the farmers, the dairy products businesses, and particularly those family-owned enterprises, have purchased, with fully taxed dollars, the bricks and mortar for their buildings and equipment needed to process and package their extensive line of dairy products.

Additionally, they have purchased large fleets of rolling stock for delivering these perishable commodities to stores, homes, hotels, restaurants and other outlets.

Because the dairy industry is a very low margin industry, the retained earnings are small and even the 10-year amortization period is difficult to meet. The estate tax burden is often equivalent to repurchasing the family farm, or home or business. We have same situations where the estate tax constitutes well over 50 percent of the company's net worth.

Again I speak from personal experience with my company when using that percentage figure. I know from my own certain knowledge of at least 13 directors of our associations who are struggling under the activity liquidated by the tax load placed on the family members attempting to continue the business and pass it on to future generations.

I know there are many more dairy companies prospectively facing

this problem. I do know of many small companies, family enterprises, which have gone out of business. Some have closed their doors because they could not hope to raise the cash to pay these taxes.

There are a host of family dairy plants now for sale because they do not have the resources to face this kind of tax burden, to allow their sons and daughters to carry on the business with sufficient capital to make sure it is a viable operation.

I point out at this juncture that there has been an average decline in the number of fluid milk processing plants at the rate of 6 percent a year since 1969. Estate tax problems are probably a major reason for this decrease in plant number.

The exemption of $60,000 is still creating a hardship for the individual, who has worked all of his life and with fully taxed dollars, has purchased a home, personal property, and made what investments he could prudently make in order that his survivors would not have to sell their homes and sacrifice other assets to meet their estate tax obligations.

Most of the bills we have examined propose increasing the present $60,000 estate tax exemption in amounts up to $200,000. We think this is very modest in view of what has happened to the economy. Certainly it is obvious that the $60,000 exemption is not realistic in terms of the present values of the farm plants, small businesses, and the estates of the average working American who has been frugal in trying to take care of his or her family survivors.

We, therefore, hope that you will consider increasing the exemption to at least $200,000 as a minimum.

We support the idea of a tax moratorium for some reasonable period after death in order that the heirs of the farmers, the businessmen, or individuals could so arrange finances that they could then pick up the burden of the estate taxes over a period of years.

In this connection we urge that instead of the present 10-year payout period, we follow the initial proposal of the President, that there be a 5-year moratorium after death, and a period of 20 years with greatly reduced interest rates allowed to amortize the obligation to the U.S. Treasury.

We would hope that the interest rates would be permanently stabiized so we would not have a repetition of the rate changes which occurred in 1975.

It has long been the philosophy of our Government to encourage family farms, to help make viable the small and family businesses, and to make sure that the hardworking, thrifty people could retain and pass along most of the fruits of their own labor.

One of the most constructive ways that I know to reach these three important objectives would be to make these changes in the estate tax program effective as soon as possible.

Mr. Chairman, members of the committee, I thank you for your attention. I will be happy to answer any questions with this disclaimer. I am not a tax specialist. I am a businessman who has experienced firsthand the problems generated by our obsolete handling of estate tax problems—estate problems that can fall upon a family-owned business.

Thank you for your attention.

The CHAIRMAN. Thank you, Mr. Geiss.

Mr. CRISWELL. We have Mr. W. B. Criswell, Plains Cotton Growers Association.

Welcome to the committee, sir.

STATEMENT OF W. B. CRISWELL

Mr. CRISWELL. Thank you, Mr. Chairman.

I am a cotton and grain farmer of Idalou, on the Texas high plains. I am currently serving as the elected president of Plains Cotton Growers, Inc., our cotton producer organization on the plains, and it is on the authority of that organization's board of directors and on behalf of its 23,000 members that I speak today.

I very much appreciate the lead taken by this committee in seeking a solution to the grave problems arising out of the Federal estate tax, and I appreciate your taking time to hear the views of high plains farmers in that regard.

I know your time is limited and I will be brief.

It is my understanding that estate taxes, or death taxes, originated in our societies as a means to lessen or prevent the bad economic effects of a few people gaining an inordinate amount of wealth, property, and power in those societies. And there's much to be said for that objective, especially where agriculture is concerned, in our own society.

But the estate tax law in this country in recent years has been having the exact opposite effect.

The estate tax has become so burdensome that heirs to farm operations, operations barely adequate to support a family, are being forced to sell their land because they encounter extreme difficulty in obtaining funds to pay the tax.

And the primary buyers for these estates are large corporations or others who already hold title to wealth and power far greater than that of the deceased or his heirs.

As these farm enterprises go on the auction block, the death tax becomes a death-dealing tax as well, bringing about the demise of hundreds or maybe thousands of family farms every year.

There are several reasons why this tax has become so unbearably oppressive in recent years, not the least of which is the economic waves caused by inflation.

The market price of farmland since the $60,000 exemption was set in 1942 has ballooned by at least 600 percent. Irrigated farmland in my community in 1942 sold at $100 an acre and less, while the same land today can't be touched for less than $600 an acre.

Unfortunately, however, this does not mean that the true value of this land—the value in terms of its ability to produce income in constant dollars—has grown by 600 percent. It means instead that corporations, professional nonfarm people, and others among the wealthy, for speculative or inflation-hedging reasons, have bid the market price far above what it is worth to the man who hopes to support a family on what the land will produce.

Attached to my statement for the use of the committee is an example which I believe is typical of what has happened on the Texas high plains and will happen again and again unless the tax law is changed.

This example, as you can see, is based on the tax as applied to husband-and-wife ownership in a community property State such as Texas. It assumes 960 acres, which is close to the minimum size needed

for efficiency on a high plains irrigated farm. This land is valued at a minimum $600 per acre, and that value alone, excluding the value of improvements and farming equipment, has been used in the tax liability calculation.

Example 1 shows the tax due upon the death of either spouse—$59,100; and the tax due after the death of both spouses—$118,200—under the best of circumstances. Example 2 reflects the Federal estate tax due after both deaths—$191,008—if the farmer does not avail himself of sophisticated tax counsel. In any event, $118,200 and $191,008 is a substantial part of the estate's original $576,000 valuation.

While a 10-year payout of the Federal estate tax would be available, this does not reduce the amount of the tax burden.

Also, we are aware that a new income tax basis—cost—is available and would amount to $600 per acre. However, this is of little value to the family who desires to continue the farming operation and has no plans to sell the land.

We understand consideration is being given to coupling the Federal estate tax with a capital gains tax at death, which we believe would make the total taxload truly disastrous.

I think you can see from this example that there is a strong case, and a great need, for revising the estate tax law.

Without revision, the family farm enterprise, within one or two more generations, will be a thing of the past. The production of all our Nation's food and fiber will be done by a few corporate-type operations, to the detriment of our entire society.

I have addressed myself here only to the estate tax as it affects farming enterprises. That is because—and only because—farming is the business with which I am most familiar.

It does not mean that we in agriculture are not aware that other family-size businesses are faced with some of the same problems and are just as direly in need of relief.

Increasing the Federal estate tax exemption from $60,000 to $200,000, plus providing for the valuation of farm estate on productive capacity instead of inflated market value, as Congressman Burleson's bill would do, coupled with the defeat of any proposed legislation that would impose a capital gains tax at death, appears to be the minimum action required to alleviate the problem we have outlined.

We respectfully urge that this committee given full consideration to our views, and we offer any service that we may be able to render in the effort to correct the inequities that exist in the current Federal estate tax law.

Thank you very much.

[The material referred to follows:]

Estate Planning Examples

Introduction

Texas is a community property state, meaning essentially that all wealth accumulated by a married couple during their marriage belongs one-half to the husband and one-half to the wife.

The gross estate of an individual is subject to certain deductions in addition to the current $60,000 exemption. Among the deductible items are estate administration expenses, funeral expenses, debts, credits for state inheritance taxes,

and charitable gifts. The following examples assume that these deductions are offset by the value of land improvements and farm equipment, leaving land value as the *net* estate value.

	Community property	Each spouse's interest
Example 1. (Assumes estate of first expiring spouse is left to other than surviving spouse):		
Assume a married couple with community property valued at $576,000 (960 acres at $600)	$576,000	$288,000
If one dies, Federal exemption is		60,000
Leaving net taxable estate of		228,000
With a Federal estate tax liability of		59,100
Tax liability at death of surviving spouse		59,100
Total Federal estate tax		118,200
Example 2. (Assumes first expiring spouse leaves estate to surviving spouse):		
Original part of the community property	288,000	
Inheritance ($288,000 minus $59,100)	228,900	
Total estate upon death assuming no increase or decrease in value	516,900	
Federal exemption	60,000	
Net taxable estate	456,900	
Federal estate tax liability	131,908	
Total tax cost of transfer between generations ($59,100 plus $131,908)		191,008

The CHAIRMAN. Thank you very much.

That concludes all of the statements and, without objection, they will appear in full in the record, together with the supplemental materials that you have supplied.

You have certainly given us eloquent testimony on the need for action in the field of estate and gift taxes.

Don, tell me in the area where you live, with which I am, of course, quite familiar, what has been the change in valuation in land in the last 30 years?

Mr. WOODWARD. Land in the last 30 years in the area where I particularly farm has gone from around $200 or $250 an acre to some which has been sold recently for $700 an acre.

The CHAIRMAN. So it has been almost a three-fold increase.

Mr. WOODWARD. And there are instances in other areas where the land might be a little lighter and I remember I had a chance to buy some land some distance from my place for around $25 an acre some 30 years ago and that land is selling for over $200 an acre.

So that the lighter land has increased in value even more.

The CHAIRMAN. Even more, and a lot of that lighter land has been very productive.

Mr. WOODWARD. Very productive because of fertilizer and this type of thing.

The CHAIRMAN. Better farming practices?

Mr. WOODWARD. Yes.

The CHAIRMAN. So that half of our country used to be marginal and now it is very productive year after year.

Mr. WOODWARD. My father sold a ranch because it wasn't productive about that time and since that time the land has become quite productive so that he made a mistake.

The CHAIRMAN. That is true. That is a tremendous increase in valuation. Your kind of farming is not affected as much by some of the recreational investments but I know cattle ranches have in many

instances gone up even more in value because of tremendous pressure from outside buyers coming in buying a way of life.

Mr. WOODWARD. I have a son-in-law who is in the real estate business in a cattle country and he even hates to sell the land for what he can get for it because it seems so outvalued with people coming into that area to have mountain homes, hunting lodges and this type of thing, and this takes that land away from the cattlemen at exhorbitant prices.

The CHAIRMAN. I have a friend who has a ranch down in Klamath County who I am sure could sell his ranch for $2 million. Yet he is having a hard time making a living on it.

Mr. WOODWARD. That is definitely true.

The CHAIRMAN. That puts a tremendous burden. He wants to hold it. He doesn't want to exploit it. He is a conservationist at heart. It becomes a tremendous problem as to what happens when he dies and they put that valuation on it. The taxes will be almost impossible to raise.

Mr. Schneebeli.

Mr. SCHNEEBELI. Thank you, Mr. Chairman.

Mr. Grant, there seems to be a new push on the part of the farmers relative to estate and gift taxes. Have there been many instances recently that you are aware of where farms have had to be sold because of the enormous estate and gift taxes or is this just becoming now a big problem in the farming industry?

Mr. GRANT. Of course the rapid escalation of inflation over the last couple of years has intensified the situation but it has been a situation for a long period of time. I know of two brothers who were running a dairy with their father. The father died. They had not made adequate preparation and they sold the land and dairy to pay the inheritance tax.

Mr. SCHNEEBELI. But it has reached the acute stage in the last couple of years.

Mr. GRANT. Yes; and the Farm Bureau had held seven multi-State meetings in the recent past and the first priority of the 2,000 people attending these multi-State meetings was the reform of estate tax laws.

Mr. SCHNEEBELI. I am aware of that because I had dinner last week with the Pennsylvania Farmers Association. There seems to me to be a new push on the part of the farmers particularly and I wonder whether 3 or 4 years ago it wasn't as prominent an issue as it is at the present time.

Apparently it has not been because this is the first that our committee has heard of all of this—of this increasing demand for action. I am glad the chairman is taking this action.

Mr. GRANT. It was an issue.

Mr. SCHNEEBELI. But it was dormant, wasn't it?

Mr. GRANT. The chairman of the committee has taken an interest in this and Mr. Burleson has taken an interest in this and about 100 other Congressmen have taken an interest and this gives some hope to farmers that there may be something done.

It seems incomprehensible that just because a woman's husband dies she has to give up the farm.

Mr. SCHNEEBELI. I think other groups support you, too.

Mr. GRANT. We ought to remember that this is not only a farm bill.

The first two issues have to do with estates that are not farms as well as farms and the third point does have value to those people living in the city.

Mr. SCHNEEBELI. Yes. Thank you very much.

The CHAIRMAN. Mr. Landrum.

Mr. LANDRUM. Mr. Chairman, I think in all the experience that I have had as a member of this committee over the several years that I have been privileged to be a member, I have not heard a more constructive panel address itself to a more pressing problem than that which we have heard this morning.

Many of us could relate personal experiences, I am sure, that would emphasize what this lady and these gentlemen have said to us about the need to revise the estate and gift tax laws. I can tell you at the outset that I had forgotten about the hearing until Mrs. Landrum picked up the paper this morning and saw the schedule listed in the Washington Post and said, "What is your committee doing today," and I said, "Oh, I had forgotten that we are launching the hearings on estate and gift taxes." She said, "Get over there and don't be late. I don't want to be pushed out of what I have helped produce here if you predecease me."

Another personal experience that I was thinking while Mrs. Brookshire was so articulately explaining what is involved in operating a family dairy of an experience I had during my college days when I went out to the wheat harvest in Kansas and Oklahoma to pick up a little extra money and some experience, too. Most of what I got was experience.

I went into the wheat harvest and found that wheat was bringing 26 cents a bushel and the wheat farmers didn't give a damn whether they harvested it or not. One said, "Come on out and live with me and I will let you help my wife with the family dairy and you can play baseball for me twice a week."

I had a reasonably good college reputation as a baseball player. So I took him up. I was helping this lady in Newton, Kans., Mrs. Keys. I was helping this lady in her family dairy operation where we milked the cows and put the 5 gallons out on the highway for them to pick up. I don't know whether you use them now or not but back in those days they used what we call kickers that were put on the hocks of the cows to keep the one next to you from kicking you over and the one you were milking from kicking you.

You were milking with your hands. I had the cow next to me and the cow I was milking hocked into the kickers and they got to moving and kicked me over and got their feet on my chest. It was a rather brutalizing experience but they left enough wind in my lungs and enough space in my face for me to talk and produce some rather loud conversation. I heard this lady coming say, "Please be quiet. Don't say that any more. I will get to you as soon as I can."

She came and got me relieved from the pressures of the cows feet off my chest and some of the other things that I got removed after it was over.

Then I came to Congress about almost 30 years after that and one of the earliest notes I received was from that dear lady and it said, "If you are as successful in telling your colleagues how you feel as you were in letting those cows know how you felt, you won't have any trouble getting along."

I know it is not good on Monday to bring up things with such levity when we are dealing with such serious problems but we are dealing with the very heartland of America and I hope this committee, whether I am here long enough or not, will meet this problem by raising this estate tax exemption to at least $200,000.

It ought to be a quarter of a million dollars.

Thank you, Mr. Chairman.

The CHAIRMAN. One of the leading sponsors of this legislation in this field, Mr. Burleson.

Mr. BURLESON. Thank you very much, Mr. Chairman.

I certainly join with my colleague from Georgia in expressing my appreciation of what this panel has said. It is quite natural that I agree with all that has been said. When someone agrees with you, you know, you think it is good.

There has been an emphasis by all of you that this is not limited simply to agriculture and the rural areas. This is a thing that we hope to impress on our colleagues from the urban areas, that it is important to them. It is important of course to the Nation that we have an adequate supply of food and fiber and it is being done with the most efficient operation in the history of any nation, ours included, at the cheapest price.

Mrs. Brookshire, you mentioned about this coming to be a philosophical question in what you said about the young man going into an agricultural operation with a minimum of $100,000. If a young man had $100,000 to go into a minimium operation of whatever commodity, whether it be dairying or cotton or grain or something else, I would imagine that he would go to the bank and buy CD's or to the savings and loan where he wouldn't have to depend on the elements. If we break up family farms, our younger people are going to the cities to compound problems which are already insoluble in many respects.

Mr. Grant, you probably know this better than I, but something sticks in my mind that a few years ago, just 3 or 4 years ago, the average age of the farmer was about 56 years. I believe that has dropped a little maybe to 54, or something. That is encouraging and will be more encouraging if we give the incentive for our younger people to stay on the farm and produce, where it has become a sort of cliche that the agricultural small farm is the backbone of America. It is in numerous ways. You know that.

The estate and gift tax was never intended, as I understand, to raise revenue. We are going to hear a lot about this in the course of these hearings. That was never intended. It really was intended to provide for the distribution of the wealth. So it seems to me that it is time to turn this thing around, and you have given us the answers here that this affects all Americans, and we have to realize that somebody has to produce.

We can't all be receivers the largesse of government. Somebody has to produce. You are the people who raise food and fiber for those who buy at a reasonably cheap price as compared to all these other necessities of life.

We have to help in buying a $25,000 tractor or disk harrow, or whatever it is for those people who make it, for the wage earner who makes it in Illinois, Ohio, Pennsylvania, and a lot of other places. This is our system:

I don't have a specific question except just to comment here that you have covered this subject thoroughly and from the most reasonable standpoint furnishing supportive rationale on why we must do something about this estate and gift tax problem, or we are simply going to destroy the source of production in this country.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Burleson.

Mr. Conable.

Mr. CONABLE. Thank you, Mr. Chairman.

Mr. Grant, I want to talk to you particularly. I have a lot of respect for the Farm Bureau and always have had. I grew up on the farm and my brother is still on the family farm.

There has been an air of euphoria here this morning. Everybody is agreeing with you. I want to talk about some realities and get some realistic responses from you about what we are talking about here.

We are talking about increasing the exemption to $200,000. That would cost the Government $2 billion in revenue, or almost half the total amount raised from the estate tax. Farmers would be the primary beneficiaries and farmers have a special problem because of their lack of liquidity. I know what the difficulty is when you are in a cost squeeze relying yourself on a real market and buying the things you need to run a farm in an administered market to a substantial degree. Costs have gone up over a period of time and your margins have gone down inevitably.

Now I personally think the farm community has made a mistake in pushing this Congress for a solution because this is a very liberal Congress and it is inconceivable to me that they are going to give $2 billion to people with estates over $100,000. Maybe they are but that is not my view of this Congress. Everybody has been talking about reforming the estate tax. In fact, you are asking for a reduction of estate tax. Reform usually means that what you take in apples you give back in oranges, and vice versa, and this committee has traditionally approached problems of tax reform with an eye to revenue neutrality.

It is my view that farmers would be considerably worse off being taxed on capital gains at death than they would leaving the exemption where it is. What do you think about that, sir?

Mr. GRANT. Certainly if capital gains are taxed in the manner that you express then it might be a problem, but we are hoping that there will be recognition of the fact that there is a necessity to pass on the property to the heir whether it is farm property or city property.

Mr. CONABLE. I suspect the carrying over of the bases before death would create very serious problems for farming also. Revaluation at death has been a very important part of sweeping the slate clean and putting the new owner of the farm after an estate proceeding in a position where he will have a more realistic valuation of his place.

I am very much concerned about possible moves in this direction because I don't see this Congress giving $2 billion to people with substantial estates even though they may have problems of liquidity.

I wish you would be thinking of what sort of thing we can do to reduce the revenue loss to the Treasury, without doing violence to the farmers' need somehow to finance this kind of a contribution to Uncle Sam, that is, admittedly, very burdensome to him.

Mr. LANDRUM. Will my friend from New York yield.

Mr. CONABLE. Yes, I yield.

Mr. LANDRUM. I am disturbed about the statement that we are giving the farmers or giving people with estates of $100,000 or more $2 billion of Federal revenues. We aren't. We are not giving anything to anybody. We are just trying to find some means, my friend, of allowing the farmer, or dairyman, a chance to keep what he has. We are not giving him anything.

This type taxation developed and has been used several times in our history, before World War II, as only a temporary tax, and since World War II, as I know my friend understands it, has been kept on the books permanently, and now brings in about $6 billion a year. That is what its toal fund is.

Mr. CONABLE. $4.7 billion.

Mr. LANDRUM. The information given me last week was $6 billion, approximately. We are not giving anybody anything. They are keeping what they have.

Mr. CONABLE. I understand the point the gentleman is making. Tax expenditures, if they are remitted, are not gifts. The Government obviously is not a beneficent force when it is collecting money from people. I understand the point he is making and I agree with it as I well understand, however, in giving up revenue we have to make choices and I am simply judging that this Congress is not likely voluntarily, or it is not likely at least without a major phase in, to simply abandon $2 billion of revenue it now gets from estates.

If you are looking at this from a reform viewpoint, that means revenue neutrality, and the question is, where can we pick it up.

I want to tell you, Mr. Grant, that I am going to try to help you on this, and I am talking realistically only because I find there is really an undue euphoria in the farm community about the fact that you have something going at this point. I realize that it has been delayed a long time.

Do you have anything further to say about that, sir?

Mr. GRANT. Congressman Conable, we do have every intention of influencing this Congress, which you have a better appraisal of than I, certainly, but we have every intention of influencing these Congressmen this year, and we have started on the program of doing just that. We intend to do it clear across the Nation.

As Congressman Landrum has said, this is not a gift to farmers or to those owning other property, it is only 2½ percent of the total budget, and therefore, we think it is small enough that for the continuance of agriculture and the handing down of one piece of property to another, whether it is agriculture or not, is worthwhile.

Mr. CONABLE. Congressman Landrum made a good point. No tax remission is a gift. It simply means that we don't take that much away from then on. That is a point on which I would agree with him completely.

Mr. GRANT. I have three sons, and Congressman Burleson mentioned the fact of the age of farmers a few years ago. My two eldest sons decided they didn't want to bother with farming because they didn't see how the farm could be passed on. The youngest son is still in college and he thinks there is a possibility that he may be able to farm the present farm and is therefore interested in agriculture and taking courses in agriculture.

I think we need these young people on farms and I think it is a broader problem than perhaps we have appraised it as we have given our testimony.

Mr. CONABLE. I personally think farmers have a special estate tax problem generally, although admittedly some small businessmen too have problems in valuation and liquidity.

Therefore, I would hope that the farm community would think of ways in which they can be aided in this particular respect without the revenue loss which I am very doubtful this Congress will countenance, whatever the friendly individual attitudes of the members of this committee.

Mr. SCHNEEBELI. Will the gentleman yield.

Mr. CONABLE. I yield.

Mr. SCHNEEBELI. I would like to correct some figures. The $4.7 billion is less than 1.5 percent of our Federal revenues. Our Federal revenues total about $370 billion. So $4.7 billion is less than 1.5 percent. I would not use 2 percent, it is much less.

Mr. KETCHUM. Will the gentleman yield.

Mr. CONABLE. I had better yield the floor because I have had it more than 5 minutes.

Mr. KETCHUM. I thank the gentleman for yielding.

I saw my good friend's article in the paper this morning. I am looking at a copy of minority views of the Ways and Means Committee report to the Budget Committee which you signed.

> We reluctantly accept adding $2.1 billion to $2.4 billion to the President's deficit.

I think Mr. Grant is entirely correct.

The CHAIRMAN. Mr. Waggonner.

Mr. WAGGONNER. Thank you, Mr. Chairman.

With regard to the administration proposal providing for a 5-year moratorium and 20-year installment payments at 4 percent rather than 7 percent, would you care to comment on an aspect of that proposal which it does not do. That is that it does not remove the existing code restrictions to allow you those privileges.

Section 6166 provides for the terms wherein an extension to pay Federal estate taxes would be permitted, but the administration proposal does not remove those restrictions. It seems to me that this hinders the application the moratorium and installment propose.

Are you familiar with that provision of the code, or would you like me to read it to you so that you could comment?

EXTENSIONS PERMITTED

Talking about extension of time for payment of estate tax where an estate consists largely of interest in closely held businesses. The conditions for extension are these:

> If the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was * * * a citizen or resident of the United States exceeds "two circumstances". (1) 35 percent of the value of the gross estate of such decedent, or (2) 50 percent of the taxable estate of such decedent.

What is the net effect of having those restrictions without modification in place?

What is the net effect of having those restrictions without modification? It would seem to me that we are not getting nearly as much relief from the administration proposal as would appear to be the case at first glance.

I think this is something that needs further analysis. Maybe you can comment on it now and maybe you would like to comment later. If you do, I would like to hear it now.

Mr. WOODWARD. Mr. Congressman, I am not sure to whom you were directing your remarks.

Mr. WAGGONNER. Anybody.

Mr. WOODWARD. Well, I am not a tax expert, I am a farmer. I visited with people about these items and if you want a more technical report on it——

Mr. WAGGONNER. Let's leave it this way. Would you have your tax people prepare an answer to my posed question for the printed record of the hearings. So that you may properly respond. Mr. Chairman, I would ask unanimous consent that this information be included in the record at this point.

Mr. WOODWARD. We would be glad to do that.

Mr. WAGGONNER. I make this unanimous consent request, Mr. Chairman, so that they be allowed to supply that information in writing and that it be printed in our hearings at this point.

The CHAIRMAN. Without objection, so ordered.

Mr. WAGGONNER. That is all I have, Mr. Chairman.

[The data follows:]

AD HOC AGRICULTURAL TAX COMMITTEE RESPONSE FOR THE RECORD TO CONGRESSMAN WAGGONNER'S QUESTION AT THE ESTATE TAX HEARINGS, MARCH 15, 1976

Under present federal estate tax laws, the tax must be paid, unless an extension is granted, within 9 months after the farmer or rancher's death. This would place an insuperable burden on estates of farmers and ranchers to pay the tax if it were not for the provisions in existing law which permit at least some relief by granting an extension of time to pay such tax. In many instances, the estate of a farmer or rancher will qualify under either the hardship rule or Section 6166 of the Internal Revenue Code which authorizes the estate to pay the tax over a period of up to 10 years. However, in many cases even the 10 year extension rule will not be of substantial benefit and assistance since the earnings from the farm or ranch are often insufficient to pay the annual installments after living expenses are taken out plus the 7% interest (as of February 1, 1976) charged on the unpaid amount. The increase in this interest rate from its 4% rate prior to July 1, 1975 will further contribute to the unattractiveness or inability of electing to pay the estate tax over a 10 year period.

In addition, there are significant administrative burdens imposed by the Treasury Regulations on the estate of a farmer or rancher in operating the farm or ranch after the decedent's death in order to preserve the right to pay the estate tax over the 10 year period. Written reports are required to be made by the rancher's estate to the Internal Revenue Service of transactions regarding the farm or ranch operation, which in essence causes the Internal Revenue Service to become involved in the farm or ranch business. For instance, certain withdrawals of funds from the ranch business or certain sales or dispositions of interests in the ranch must be reported and can cause acceleration of the payment of the estate tax. The Treasury Regulations also require the rancher's estate to apply all undistributed net income earned in the fourth and all subsequent years following the rancher's death to the payment of the remaining balance of the estate tax.

Thus, while the 10 year extension of payment rule can be of value in some cases, the restrictions and limitations imposed by such rule on the operation of a farm or ranch and the increase in the interest rate on the unpaid balance of the tax can mitigate the intended benefit of paying the estate tax over a period of

years. As one knowledgeable commentator has said, granting additional time to pay estate taxes is not a satisfactory solution to the problem if the taxes are so high that a sale of the business is required.

The CHAIRMAN. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Criswell, I know in the examples that you gave you show in two cases a tax liability of $118,200, or a liability of $191,000 on land estimated at about $600 an acre. That is a little high for some of the land in my area, but in any event, to try to get at the figure we are faced with it would appear to me that a family or estate must have available in cash or the capability of converting to cash somewhere between $50,000 or $100,000 or else the farm or ranch, or whatever it is, the land has to be broken up.

Is that a fair appraisal of the problem the farmer is faced with?

Mr. CRISWELL. Yes, Mr. Pickle. That is a fair appraisal. The farm does have to be broken up. Parts of it have to be sold to raise the revenue to pay that inheritance tax at the time of death.

Mr. PICKLE. The option then would be that if they have to raise $50,000 to $100,000 probably the only way to do that is to sell the land because they have no assets.

Mr. CRISWELL. This is right.

Mr. PICKLE. That means breaking the farm.

Mr. CRISWELL. This is right. Of course we are only talking about the value of the land and if the person that is passing on has the equipment to farm this land the estate would be even greater and would require selling the farming equipment and more of the land.

Mr. PICKLE. The estate would be greater but if they had to sell that equipment, we will say, to get the cash, it is the same as if you broke up the farm.

Mr. CRISWELL. Yes.

Mr. PICKLE. The prospect we have is that a family must have $50,000 to $100,000 or my size of a reasonable farm from 300 to 600 or 900 acres, or else the land has to be sold.

Mr. CRISWELL. This is correct. I might add to that that we are talking about the revenue off the land and I am not an accountant, either, but an accountant or somebody appraising the situation might figure out where the loss of revenue from the inheritance tax might be partially gained or all gained back from the loss of income tax because of breaking up of the family farm, which is the most efficiently run operation there is in the United States today.

Mr. PICKLE. The Government might lose money in the long run.

Mr. CRISWELL. Yes. Looking at it from the income tax standpoint, it could lose more revenue there than they will gain in the inheritance tax.

Mr. PICKLE. The average farmer just keeps ahead of the bill collector.

Mr. CRISWELL. Right.

Mr. PICKLE. He hopes to make a payment on his equipment. If that farmer is faced with a $50,000 to $100,000 cash payment to keep it together there is no chance for him. There are very, very few who could.

Mr. CRISWELL. Very few operators can rake up that kind of money, very few.

Mr. PICKLE. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Steiger.

Mr. Steiger. Thank you, Mr. Chairman.

I join in thanking the panel for coming.

Mr. Grant, your proposal relative to the problem of the farm wife would alter the marital deduction. Is there any other method by which one could recognize the role that the woman plays on a family farm other than through the marital deduction?

Mr. Grant. Yes. There are ways that it can be done but not as adequately as is suggested here.

Mr. Steiger. Ms. Brookshire, do you agree with that? Is that, in your judgment, the way that we ought to handle that?

Ms. Brookshire. I think there are methods that are available for us today, those of us who have foresight to see to the distribution of property to avoid this situation. I believe the opportunity that is ours through a small corporation today if you have foresight. However, those who are caught in the present situation will be under the control of the present law. It is not possible to think of settling the farm that we are on because our parents still hold the farm in their name and they are not modern enough to see these new methods that are now available. Therefore, the farm wife who has served on that farm for 53 years who recently becomes widowed will be subject to the inheritance tax that is presented today.

As a woman of that age she will not be spending this money. It will be the son who is in operation of that farm. He will not only have to have her pay for her inheritance tax as a widow but in a short period of time she will be out of the picture, so that he will be the direct heir.

Again this severe tax. At 60 years of age it is more than likely that he will not live the 10 years or 20 years proposed that he can pay this tax so the grandson will be paying this tax of the grandmother, of the father, and now he will have another burden for there will be a third settlement of this same property tax.

So it is a continuing situation where we will be living under a tax situation. Farming does not allow this much freedom at the current price level. I believe the present issue of the pressure has come because of the inflation in the last 5 years. That is the reason we are speaking to Congress with such urgency now. Inflation has not been as bad until the last 5 years, and we cannot cope with this inflation without some help.

Farming is on a very narrow margin for every marketable product mentioned at this table. The wheat farmer does not get the price of the bread and the dairyman does not get the price of the milk. He gets a very small portion. We do not have this margin.

As far as our lost revenue is concerned, we might say, "Thank you, Congress, for all you have given us but we cannot afford it." We are appreciative of all the things that are offered. Yet we like to feel that we are in a good working area and we would like to have a little assurance that we could keep on and solve the problem.

Mr. Steiger. Thank you for your comments.

My concern, I must say, is to at least some extent the same concern that Barber Conable has expressed. There is a dilemma in which this committee and the Congress will find itself. I know a family farm wife right now whose husband died and she is faced with this problem because the estate tax is going to decimate her. There is no way she is going to be able to keep the farm for her children. She is going to have

to sell it. I am very, very mindful of the problem that is posed for both agriculture and small business.

But I am afraid that just raising the exemption will not resolve the problem. If I had to judge this committee or if I had to judge the Congress I'd say I don't see us reporting out a bill to only raise the exemption. Something else is going to come with it. Whatever bill we report out I hope will be a rational one and at least I hope we will be willing to deal with the problem.

I am just grateful to all of you who gave up time to come here and try to help us resolve this issue.

Thank you, Mr. Chairman.

The CHAIRMAN. Mrs. Keys.

Ms. KEYS. Thank you, Mr. Chairman, and members of the panel. I don't have specific questions to ask of you but I do certainly thank all of you for your testimony. Coming from Kansas, I understand well the problem this is inflicting upon the ability of the family farm to survive, and I have dedicated myself to helping this committee find the right solution.

I believe that probably we can't look entirely to raising of the exemption but perhaps we need to examine some of the areas about the use of fair market value as assessment. The possibility of unification of estate and gift taxes, some of the other possibilities that will help remove the often forced sale of all or part of the family farm rather to pay this tax. If you have anymore specific comments you would briefly like to make, any one, to help me in that area I would appreciate it.

Other than that, I would like to say that I do believe something must be done to remove the inequity to women in this whole picture. I have many relatives who are farmers and in the case of every one of them who have successful farms the farm wife and farmer have been equal working partners and certainly share in the achievements of that business totally together.

I do not believe that the wife should have to pay inheritance taxes on half of what is already hers. I have taken my time but if there are any short comments that could help me in the area of something that you believe would help other than the raising of the exemption, I would appreciate it.

Mr. GRANT. We perhaps will have some suggestions later. I don't have any now. I might state that there are parts of Kansas, Oklahoma, and Texas where if there were a death at this time it is a foregone conclusion that the farm will be sold.

I started as a sharecropper and my wife gave every bit as much as I did to the operation. So if I pass on she has to pay the tax. It seems incomprehensible that we would leave it that way.

Ms. KEYS. Thank you for your testimony.

Mr. CRISWELL. Ms. Keys, if I might make a short comment there, in our statement we did, and I believe in Mr. Grant's and some of the others' statements we did recommend that we tax the agricultural land on the productivity rather than market price of the land, which would alleviate part of the problem but we still feel that raising from the $60,000 to $20,000 would be fair, too.

Ms. KEYS. What would you feel about taxing it in the income basis?

Mr. CRISWELL. Well, this is the income from the production? Is that what you mean?

Ms. KEYS. No; I really meant the income tax basis.

Mr. CRISWELL. Of course land is not depreciated on the tax rolls, but whatever the purchase price of the land is, if it is ever sold you pay on the gain or loss of the land. But the land doesn't depreciate or have a depreciated table base like a tractor or any equipment.

Mr. BURLESON. Will the gentlelady yield.

Ms. KEYS. Certainly.

Mr. BURLESON. The lady has raised a very essential point in this whole issue. Certainly something has to be done about the surviving spouse problem in estate tax reform. On the valuation issue what you mean is to use the value of the property for its existing use at the time of death. We propose that if it has been dedicated to that purpose 5 years prior to the death of the decedent and for 5 years thereafter, that value is entirely reasonable. But as it is now, let me give an extreme example—there needs to be uniformity across this Nation in the regional offices of the IRS because their enforcement may vary.

But take an extreme example, the IRS can go out 20 miles from some little town or city and say that this property has the potential of a shopping center or a 40-story condominium, and place this value accordingly. As I said, of course, this is an extreme example. There should be a recognition of the use and character of the property at the time of death and for a period of time afterward.

In all candor, I haven't quite figured out how we can get that uniform inforcement of evaluation standards. Perhaps we will have to get our tax experts on the staff to do it. I have thought about it a lot and still have not come up with a satisfactory answer, at least to my satisfaction. It is a very essential point you raise.

Ms. KEYS. Thank you very much.

The CHAIRMAN. Mr. Martin.

Mr. MARTIN. I have no questions.

The CHAIRMAN. Mr. Fisher.

Mr. FISHER. Mr. Chairman.

I think most of my questions have already been put. It is clear that compromises are going to have to be found between the position that has generally been put forward so far this morning, and what fiscal prudence of the Government will permit. I simply would ask the question again that you give to us, whenever you can your thoughts as to how we make up loss of revenue that may be justified, in terms of the equities within farming and in terms of keeping family farms in existence. But somewhere on the spectrum something has to give because you cannot at the one time advocate a revenue loss of this magnitude and at the same time criticize Government for running deficits and allowing the debt to increase.

So I think it would be very helpful to us if you would give us any further thoughts along this line which you have, because I tend to agree with my colleague, Mr. Conable, that this alone is not likely to fly.

The CHAIRMAN. Are there further questions?

Mr. Ketchum.

Mr. KETCHUM. Thank you, Mr. Chairman.

I apologize for being late this morning, particularly with the distinguished panel that you have just been listening to. I suppose I would have to admit somewhat of a parochial interest in the panel since

Mr. Allen Grant and I are friends of long, long standing. He has probably done more to bring to the fore agriculture's position in California than any man now living. I congratulate him on his new position as president of the AFBF.

Mr. Grant and I have had our agreements and disagreements over the years. I was very closely associated with the California Farm Bureau Federation which probably will stand me immediately with a conflict of interest, and if indeed there is a conflict I would readily admit it. I believe that it is time that someone spoke up for agriculture in this great land of ours. I noticed a very interesting article in the paper just yesterday, Mr. Grant in which it was intimated that because certain people who came from farm backgrounds sit on some of the illustrious committees of this Congress that there is a conflict of interest.

Yet it is amazing to me that never once is there a suggestion of a conflict of interest because attorneys sit on committees of the Congress, and in effect, of course every bill we pass does represent a conflict of interest to them.

I want you to know that I support you. I feel as you do that there is very strong possibility that we may indeed make some progress after all these years here in this Congress no matter what its coloration, and I hope that you and your associates on this panel will spread that word all over the United States and bring this problem to its proper perspective and that is that we can't afford to wait any more just because it is an election year.

I thank you, Mr. Chairman, and yield back the balance of my time.

Mr. VANIK. Mr. Chairman.

The CHAIRMAN. Mr. Vanik.

Mr. VANIK. I regret that I wasn't here to hear the testimony. I have read it, and I had some questions that I wanted to direct to the panel.

Does anyone on the panel know what the average estate is of a person who dies in the United States today? Have you any idea what that might be?

Mr. GRANT. Mr. Congressman, I don't have the answer because I don't know how you could strike an average.

Mr. VANIK. I am endeavoring to find out, because I am endeavoring to find out how many people we are talking about in this particular increase in exemption. I would be very much surprised if the average estate in America was more than $15,000 or $18,000 net of debts. That is what we are talking about.

It seem to me that it is going to be rather difficult for us to convince constituents with the average of an $18,000 estate that people who have an estate of $576,000 or some substantial farm estate are entitled to some special tax relief.

My second question is, was it the idea of the panel that this would be limited to the small family farm or do we extend it to the small family business which might be a machine tool business or a service station, or perhaps a family owned oil well or gas well, or perhaps a family owned gravel pit or coal deposit.

It is going to be very difficult for the Congress to write class legislation dealing with one group of people. Did you have an idea that you wanted this solely for the farmer, or was it your thought that it would extend uniformly to whatever all Americans are able to accumulate?

Mr. GEISS. I would like to respond to that. I am afraid because I am

not a tax expert, and a man not familiar with the nature of many other industries I could only speak to the dairy industry and specifically as a member of the small family owned milk processing business in the United States.

Just as has been expressed by the people here representing the family farm, I must say that the effect of our present estate tax laws is devastating upon the small independent dairy processor who has a commitment to have specialized equipment.

Mr. VANIK. It is no different with respect to the family grocery, if there are any still around, or the family gas station, or the family automobile repair shop. They are all in the same dilemma and are rendering an essential service. I assume you want it across the board.

Mr. GEISS. That is correct.

Mr. VANIK. In our calculations we are talking about estate taxes, increasing the exemption across the board for everyone.

I want to ask you another question. All people have other privileges under the law. You can give a $30,000 lifetime gift to those members of your family whom you may trust before your demise. You may also give each surviving spouse, give every child $3,000 a year free of any income tax or free of any Federal tax. You can also establish a trust for the handling of the estate problem.

Am I correct? Assuming that, if these things are not done, for example, if a farmer has a number of children in his family, isn't it likely that he is liable to use the gift tax procedure which is available under the present law so that if we were to maximize the use of the privileges of the law as they now exist, it would permit a greater exemption than we have under the present law for husband and wife with the marital deduction?

Mr. GEISS. I would respond to that in this way, Congressman. Inflation has carried us to the point in 1976 where the $3,000 gift that one might make to one's child——

Mr. VANIK. It gets to be smaller.

Mr. GEISS. Gets to be smaller. I can't buy a truck for less than $20,000. If we are running a typical independent dairy business and I am speaking now of processing or manufacture of ice cream, it costs $50,000 for one ice cream freezer. It could take an awful lot of contributions over a period of time to children.

Mr. VANIK. You see, if you have six children and you are giving $3,000 a year for 10 years it can raise quite a lot of transfer of property.

Mr. GREEN. Will the gentleman yield for a moment.

Mr. VANIK. Certainly.

Mr. GREEN. I hate to interrupt, but I must say that I have been traveling around my own State and this is a very serious problem. I find many farmers having their family farms plowed under by the estate tax. This question of giving your six children $3,000 a year is really unrealistic. What has happened is not just national inflation but as the cities expand into the suburbs the value of the land that a family may have farmed for generations is driven up so high by its development potential instead of as farmland that it drives these families under. Something ought to be done about it by this committee.

Mr. VANIK. I am grateful for my colleague's remarks. He sounds like a very fine Senator.

Mr. Green. I accept the nomination.

Mr. Vanik. I have just one other question, and this relates to the basic question that we are dealing with. If the average family farm has five children, how are you going to maintain the family farm and divide it among perhaps five children at the time of the pass over. That is going to mean that the farm really can sustain one set of managers. I know in the wheat country, for example, a farm might be 3,000 acres and be worth about $3 million or $4 million. I don't know what it might be worth. The equipment might be worth $300,000 or $400,000, and the total number of jobs involved might be five or six with one farm manager.

In effect, if this provision stays in with four or five children, inheriting the estate with enlarged exemptions, for example, does that mean really that the five of them are going to operate the farm or does it mean that four of them are going to enjoy a rather substantial tax benefit while one of the five will probably take over the farm.

Isn't that really what happens?

Ms. Brookshire. Mr. Vanik——

Mr. Vanik. Yes.

Ms. Brookshire. If I may, please. We have within our farming operation the opportunity of a buy-sell agreement so that divisions made by the parent to the various children will then have the opportunity to sell to the other children who might continue in a one-man operation or management.

Mr. Vanik. Would it be your intention that when they buy-sell they would pay for the realized capital gain? If there is that buy-sell arrrangement between the children who are selling to the child who operates they are enjoying a rather substantial tax-free advantage that doesn't relate to family farming because they are not going to farm. They are going to do something else and they are going to be selling and coming into some substantial estate without paying the normal rate of taxation.

Ms. Brookshire. You have mentioned earlier the possibility of the $30,000 lifetime gift in addition to the $3,000 that one may give to the children each year. It is our experience that farm people do not have tangible dollars to give to other people whether they be in the family or to the Government in taxes.

Mr. Vanik. They give 100 acres a year. That is 1,000 acres in 10 years. You can do it by that kind of division. It can be divided.

Ms. Brookshire. Much of the business operation, Mr. Committeeman, is that not in that kind of a tangible gift. You can't give a silo. which is worth $35,000, to one's son for that is a part of your investment. That is part of your total picture.

Mr. Vanik. I have reason to believe that these things are legally divisible and that these things could transfer. I think you can indeed sell a silo or sell a barn or a homestead or you can sell just plain land or you can sell equipment. All of these things are salable because I see them sold all the time. I think these things can be divided if it is the design to do it. I am not suggesting this as a solution. I am trying to explore all of the other avenues of tax-free or reduced-taxation transfers that are available, and which I suspect are rather extensively used, perhaps not in your area, but thety are available to operators who may decide to utilize that feature.

My time is up. I want to thank you very much.

The CHAIRMAN. Mr. Mikva.

Mr. MIKVA. Mr. Chairman.

It sounds like a lot of people are running for the Senate today, and at the risk of Mr. Conable and me being the only Members left in the House, I would like to say to the panel that there is much more sympathy with your position than may appear when you talk about the solution.

I never knew the inheritance or estate taxes were intended to force somebody to sell a farm. That was not their original intent. The problem arise as it does in so many areas because the original farmers of that tax system put in a dollar amount as the exemption, and we come into that difficulty every time we use dollars and the value of the dollar changes. We ran into that earlier this year when we changed the surtax exemption from $25,000 to $50,000, and were dismayed to find that some 83 percent of the revenue loss was going, not to the small business man, but to corporations with over $250,000 a year in taxable profits, which is hardly the small businessman that we pictured we were helping when we made the change. The problem that some of us have is not with the objective of saving the farm or the small business from being sold in order to pay taxes, but to do it in a way that doesn't create a Mack truck sized loophole for a lot of people that you are not particularly interested in helping, and we are not interested in helping people who already are finding their way very well through the estate tax laws and doing very well with the amount of tax they pay.

That is going to take some ingenuity and I don't think it is going to be sufficient to talk about raising the $60,000 to $200,000, or some of the numbers I saw, because when we look at how that spreads we will find that most of that relief is going to the wrong people. Given the size of the revenue loss involved in that change, I would urge you to talk to your experts and anybody interested in this problem and bring some ingenuity to the problem.

The problem is not with the result you seek to achieve but with how we get there, and we ought to get there by not compounding the problem we are in by raising the dollar exemption which put us here in the first place.

Mr. VANIK. Mr. Chairman.

The CHAIRMAN. Mr. Vanik.

Mr. VANIK. I am quoting from a Federal table, "Personal Wealth Estimated from Estate Tax Returns, 1969", which is the latest we have. We are not very up to date on our records so that what I say has been probably affected by the circumcstances of inflation.

What this tells us on page 6 in substance, is that 92 percent of the American people have estates of less than $60,000. With a marital deduction that brings it up higher so that I would assume that what we are talking about is tax relief in effect for 5 percent of the American people.

I want you to understand that our political problem is so that you have some feeling for what we have to experience. We are dealing with taxpayers whose income is withheld and who have very little

property, who, by the time they clear their mortgage which is really a rental of property throughout their lifetime, end up with very little.

Really, what you are suggesting here is a special kind of tax relief for about 5 percent of the American people. I think it is going to take a very strong convincing case to impress upon us the critical need for doing something for 5 percent of the people and to convince the 95 percent on the other side who are paying substantially a tremendous part of the tax burden of this country through income taxes that someone else with a $522,000 estate or a $300,000 estate needs some kind of special relief.

I think that you are going to have to do a lot of work among the grassroots of our people who are the other 95 percent who might die too. They are trying to develop enough capital to educate their children, to buy an automobile, to perhaps buy a little farm or buy a litle place or get a little place for their retirement, and it is very, very difficult for me to really go back to the people who are in this plight, desperately trying to manage their affairs and also suffering the tremendous impact of inflation, and say to them that "It is to your good and welfare and the good and welfare of all of America that we provide this big tax relief, substantial tax relief to 5 percent of the people who have estates over, substantially over $120,000."

Ms. KEYS. Would the gentleman yield.

Mr. VANIK. I am happy to yield to my colleague.

Ms. KEYS. I just wanted to suggest to the gentleman that perhaps the ultimate result of allowing this practice to continue and the demise of the family farm to compound would be the aggregate corporate take-over of all the production of food in this country. I don't believe that would be in the interests of any of our constituents.

Mr. VANIK. I am really not prepared to argue that because my family had a family grocery store, and we were taken over by corporate activities. We just couldn't compete. I don't know that the communities in America have suffered a great deal because of that because the salaries and wages of the people who now work in these places is much higher, their takehome pay is much greater than it was in the individual operation.

I don't suspect for one moment that if we fail to provide this relief that the farmland is going to be idle. I think it is going to produce food one way or another. A new entrepreneur will move into it and produce from it. From the standpoint of productivity the whole issue relates to what is most efficient, what will produce the greatest amount of food under the highest labor standards, under the most useful and most profitable conditions.

I think that is ultimately the test and, just as my family had to close the doors on the neighborhood grocery store to the growing powerful A&P or Giant or whatever else came by and destroyed this, I think the people are still eating. They are buying food and are buying it in a competitive market. I think they are probably satisfied with it.

In spite of this there has been a resurgence of the family store because you get the extra hours store that now becomes a franchise, an individually owned business, and there has been a new area for family activities in the retail business.

So all I want for my people is an adequate supply of food at the best possible price under conditions in which they have money left over to buy it and if we provide extremely widened exemptions for tax relief for 5 percent of the people, it means that the other 95 percent are going to have to pay more. That is just all it is. I have to tell my 95 percent of the people—

You are going to have to pay more in taxes or, perhaps, never less, because we have to provide special relief to 5 percent of the people who are in this special area seeking a tax benefit.

I yield to my colleague.

Mr. GREEN. I thank the gentleman for yielding.

You made one statement that does not correspond with my experience. That is the assumption that this will continue to be a farm. One of the problems is that we are developing are farmland. We are building houses all over on it, and some of the best farmland in this country is being lost.

There is a way. The goal is not to give people tax breaks here. If people are going to use some kind of farm exemption and pay no tax and then to turn around and develop the land we should provide for recapture of the tax benefit. The object here is not to give people tax breaks but to keep farmland in farming and keep family farms going.

Mr. VANIK. I say to may f riend from Pennsylvania that he ought to work at the State level because his State of Pennsylvania provide no exemption for a widow, none for a minor child, none for an adult child, and none for a brother and sister. I think there is great need there for work at the State level. You have work to do in your State.

Ms. BROOKSHIRE. Mr. Vanik, I would like to speak to one issue. The quotation that you have just given is from a 1969 report.

Mr. VANIK. I said that.

Ms. BROOKSHIRE. Probably the urgency for the presence of this panel is because we are in 1976 and the inflation has hit us so drastically in these last 6 years. The 95 percent that you speak of, a good share of those will be a part of that 95 percent today because of the inflated figures. We are probably talking about 75 percent versus 25, perhaps only 65 percent versus 35 percent, because the inflated prices have pushed all of us into that figure.

Mr. VANIK. I might ask you what was a quart of milk selling for in 1969.

Ms. BROOKSHIRE. Would you believe that it was very close to the quart of milk that you are buying today?

Mr. VANIK. I don't recall it as that. I think I can give you that figure in about 5 minutes because I made a study of consumer prices in 1969, which I have in my office. I am not prepared to respond to it but I will have to get my answer into the record after I check my figures because I am trying to quote my questions from those records that I have available.

[Mrs. Brookshire submitted the following:]

I would also like to enter some 1969 and 1975 figures for comparison. In December 1969 in the Indianapolis market—Federal Order No. 49—the price paid for a hundred pounds of milk was $5.90. In December of 1975 that figure had increased to $9.72, a substantial figure numerically, but if the cost to produce that hundred pounds of milk has increased that much or more, it has little meaning. In those same years our labor costs have increased at least 2½ times . . . every phase of

handling that milk from farm to table, through many complexities, has also experienced the labor increase, which cost is directly passed on to the consumer. Would that we could pass on our share of the increased costs as easily . . . in most studies it is found that the price paid by the consumer is a little more than double what is received by the farmer. The price you have paid for a quart of milk was paid with inflated dollars. You are still feeding your family with 17 percent of your income.

Mr. VANIK. I would simply say that the inflationary impact about which you complain has been uniform. It has not singled out the farmer. It hasn't singled ou the family farm. It has afflicted the whole country.

Ms. BROOKSHIRE. Right.

Mr. VANIK. From where we sit I would say that it has affected the consumer, the retired people, the children of America probably more than anyone else. I just had to sit down and write my son's college a check where the tuition was probably twice what it was in 1969.

Ms. BROOKSHIRE. And it is the children of America that we are here to protect today.

Mr. VANIK. The point that I want to make is that I think that this situation is aggravated indeed but I would say that it is aggravated in a way that perhaps would carry the same proportion throughout our society.

First, I don't think it disturbs or changes the basic argument that I made, and that is that the tax relief that you seek is directed to a very small percentage of the American population, 5 percent, 6 percent, 3 percent. Whatever it is, it is a very small proportion of the American people.

Mr. KETCHUM. Will the gentleman yield.

Mr. VANIK. I yield.

Mr. KETCHUM. I thank the gentleman for yielding.

I would have to agree that what he is saying is that it affects a very small number of people, and I would call to the gentleman's attention that the very minuscule amount of the population of the United States are feeding and clothing all America, all America that has moved into the suburbs, and the urban population. I can tell the gentleman from experience that what the gentlelady is saying is entirely correct. When I started to farm I could buy a harvester to harvest my grain for in the neighborhood of $9,500 and 12 years later $37,000 for the same harvester, and was still receiving $2 a hundredweight for my grain.

Mr. VANIK. I say to the gentleman if I go back to those days I have a Chevrolet with a heater and defroster that I bought for $600.

Mr. KETCHUM. With a lot of junk that we made them put on it.

Mr. GREEN. Why don't you say that you are still driving it.

Mr. VANIK. I am still driving it because as a Member of Congress I have been affected by the inflationary impact.

The CHAIRMAN. Are there further questions?

Mr. Waggonner.

Mr. WAGGONNER. It looks like some people are getting uptight. I think it might be well to remember what Will Rogers well said. It might be a good point of departure. He used to say, "Things ain't like they used to be, and as a matter of fact, they never were."

Mr. GRANT. Mr. Chairman.

The CHAIRMAN. Mr. Grant.

Mr. GRANT. One brief statement to Congressman Vanik, that his parents' grocery store was closed down by competition, not by taxation.

The CHAIRMAN. Let me express my appreciation for your testimony. Let me ask you to do this: As we proceed we are going to develop legislative recommendations with which you have worked. Because it has been so many years since we have worked with the estate and gift taxes, many abuses have developed.

Before we do what you are suggesting, we will have to consider the basic equities and processes and to have a broader reform. As we consider these recommendations it would be my hope that you would stay abreast of our actions and, well, all of our meetings are public, and you will feel free to come back to us with additional recommendations as our legislative process continues.

With that, let me thank you again for your testimony.

Mr. CRISWELL. Mr. Chairman, may I make a remark here.

The CHAIRMAN. Yes.

Mr. CRISWELL. I think it is a pretty good point to point out the inflation and probably the income of the people that Congressman Vanik is talking about. The cost of living, or the cost of their groceries, is still only less than 17 percent of their disposable income. This is about the same figure that it has been for 20 some-odd years. This item should point out the difference in the amount of income and the inflationary show.

Mr. VANIK. I will respond to that. I just want to say, Mr. Chairman, that I would hope that members of the panel, in order to help us in this matter, would give us a report as to what is being done in their States or in the States that they know of in order to increase the exemptions at State levels.

If the arguments that you have presented have substance, then I think you should show us why the States have not been able to provide a $60,000 exemption with a $60,000 marital deduction, and I would like to know what progress is being made among the States dealing with the same problem much more intimately than we are, what chances there are of the States increasing their exemptions so that what you urge here might be done in tandem with the States because, frankly, if we reduce Federal taxes and the States remain where they are, or increase their levels of taxation, then we are simply transferring revenues from the Federal Treasury to the State treasury.

I would like to know what positive strides have been made in the several States to deal with this problem of preserving the family farm. You might add that to your statement, if you would.

The CHAIRMAN. Mr. Jacobs.

Mr. JACOBS. Thank you, Mr. Chairman.

I wondered would the panel object to a provision by which heirs would continue with the same exemption if they chose to sell the inherited property as opposed to retaining it for farming purposes, but where there would be increased exemption or perhaps a delay in that portion of the estate tax during the period they continued the property as a family farming operation, question mark.

Mr. WOODWARD. That is definitely a part of our idea. We feel that it should be maintained as a family farm by putting a period of so many years for it to be consistent in being a family farm.

Mr. JACOBS. I mean if heirs farmed for 10 years and decided they would let the place be developed for residential purposes you would have no objection to picking up or recapturing the tax at that time when this "humongeous" profit was to be made, to use a word my teenage nephew uses.

Mr. WOODWARD. I haven't gone into it that far. Maybe Mr. Grant has.

Mr. GRANT. That is one of the suggestions, that has been proposed, but it has real problems in it.

The CHAIRMAN. Thank you very much. We appreciate your testimony.

[Mr. Criswell subsequently submitted the following:]

PLAINS COTTON GROWERS, INC.,
Lubbock, Tex., March 19, 1976.

Hon. AL ULLMAN,
Chairman, Committee on Ways and Means,
U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your request for additional information concerning estate taxes, I am enclosing (1) a case history submitted to us by Dorothy Ann Kinney, Attorney at Law, Amarillo, Texas, and (2) a copy of a statement made on the floor of the House by the Honorable Paul Findley.

I would also like to comment further on the thinking introduced by Congressman Vanik to the effect that those of us on the panel Monday, March 15, were asking for a "special tax break" for only about five percent of the American people. The family farmers and family businessmen of America pay income taxes on everything they earn, just as do wage earners and others whose estate may fall below the $120,000.00 total estate tax exemption. We are not suggesting that the family farmer and small businessman be exempted from his share of the income tax load, but that a portion of their estates be exempted from a tax load that Mr. Vanik's "other 95 percent" are never subjected to.

The estates belonging to the five percent of the population referred to by Mr. Vanik were built with dollars left to that five percent after they had paid their fair share of the national tax load. They were built by a willingness to work longer hours than the other 95 percent were willing to work and by a willingness to live more frugally than the other 95 percent were willing to live.

Therefore I see no justification for the charge that we are asking for "special tax relief."

Again, we appreciate your committee's work and if we can be of any service whatsoever, please call upon us.

Sincerely,

W. B. CRISWELL, *President.*

Enclosure.

AMARILLO, TEX., *March 12, 1976.*

Re estate of Sam E. Lasley, deceased, Marble Falls, Tex.

O. A. FANNING,
Executive Assistant,
Plains Cotton Growers, Inc.,
Lubbock, Tex.

DEAR SIR: At the request of Ray Joe Riley of Dimmitt, Texas, I am furnishing you an example of the hardship caused by the present $60,000.00 estate tax exemption. The executrix has approved the release of this information.

A case in point is the Estate of Sam Lasley, Deceased. Mr. Lasley, a former resident of Stratford, Texas, developed cancer several years before his death. He was forced to leave his farms in Sherman County and move to Marble Falls, Texas. Knowing that death was imminent, he arranged for the installment sale of his best sections of farm land shortly before his death. The sale was consummated after his death.

Mr. Lasley's net taxable estate, including the land he contracted to sell, was $444,562.78. His four sections of land, small mineral interests and home had a gross value of $418,956.00. The total gross estate tax was $127,960.09. The net estate tax, after deductions of credit for Texas inheritance tax, was $117,777.61. The estate tax return was approved by IRS as filed. Mr. Lasley's estate at his death had insufficient liquid assets to pay the taxes. He had stocks and bonds of $1,965.84 and mortgages, notes, and cash of $80,822.50.

Mr. and Mrs. Lasley had lived frugally in order to accumulate the cash needed at death, but years of self-denial still did not produce sufficient cash to pay the estate and inheritance taxes. After reserving the amount which would be required to pay the estate's share of farm expenses under the farm-lease agreement for the crop year and paying indebtedness, the estate was able to pay only $54,777.62 of the estate taxes due at the time the return was filed. The estate elected to pay the balance over the 10 year period provided under Section 6166. At the time the decision was made, the interest note on deferred installments was 4%. On July 1, 1975, the interest rate was raised by the government to 9%, thus increasing the estate's problems.

The estate realized no taxable income in 1974. The return for 1975 is not available to date. Cash was further depleted by the expenditure of more than $10,000.00 in repairs on irrigation wells after Mr. Lasley's death.

The net result of inadequate and unjust exemption of $60,000.00 which has not been raised to reflect inflation and the value of the dollar is that this estate has had to borrow from the surviving widow funds with which to pay the balance of the estate tax and finance farming expenses.

This result was reached inspite of the frugality of the decedent and the sale on an installment basis of one of the 4 sections of land owned by the decedent and his wife at the time of his death.

I strongly urge that the estate tax exemption be raised to at least $250,000.00.

Sincerely,

(Mrs.) DOROTHY ANN KINNEY.

[From the Congressional Record, Mar. 11, 1976]

PRESERVING FAMILY ENTERPRISE AND FAMILY FARMS

Mr. FINDLEY. Mr. Speaker, the family farm is one of the hallmarks of American agriculture. The corner drugstore, the car dealership, hardware and furniture stores are all parts of Mainstreet, U.S.A. Traditionally, they have been family run and family owned. Over the years at great sacrifice to mom and dad, they have been established or purchased.

Often parents have used the family farm and the family store to train their children how to run a business and to teach them the virtues of hard work and honesty. The weekly allowance was earned by sweeping the floors, waiting on customers, or tending livestock. Family enterprise has been a part of what has made America great.

A greater percentage of farms are family owned today than ever and this trend must be preserved. Family ownership of nonfarm businesses is also extensive and should be encouraged. When dad dies, mom and the children too often sell to an outsider, rather than continue the business. The main reason for the interruption of family ownership is the burden imposed by estate taxes.

To facilitate the transfer of family ownership from one generation to another, I am introducing a bill to increase the exemption for Federal estate tax purposes and to provide extension of time for payment of estate taxes for small, family, and closely held businesses. My proposal will ease the liquidity problem which faces family farms and small businesses under the present Federal estate tax code. It will also help preserve and encourage ownership of family enterprise, both on Mainstreet and on the farm. The backbone of America has been the individual operating independently, working for the needs of the family.

Why increase the exemption? My answer: to preserve family enterprise. Inflation should not be permitted to destroy family enterprises. When the present $60,000 estate tax exemption was written into law, few working Americans and small businesses had estate tax problems. In fact, $60,000 was established when the dollar was worth a lot more than it is today. I propose that the estate tax be increased substantially to adjust for the effect of inflation.

When the present exemption was adopted, only 1 percent of the estates in this country were in excess of $60,000. A 100-acre farm in Illinois was worth $8,600. Because of inflation, that same farm is today worth over $200,000.

All of us know of hard-working individuals who never earned more than $5,000 to $6,000 a year but who, because of inflation, now have estates in excess of $60,000. Mom and dad bought a few acres at a time, farmed the land, and raised the kids. Now when dad dies, mom finds that she must pay burdensome taxes to keep the farm. My proposal, to increase the exemption, would alleviate this problem.

Why the proposal to stretch out the time in which to make payments of estate taxes? An increase in the estate tax exemption will not solve all of the problems for many farmers and small businessmen. Because of their hard work and success, some will still have estates larger than the increased exemption. My stretch-out proposal will make it easier for the spouse and for the children to pay the tax due on the larger estate. It will allow the small businessman and farmer to pay the obligation overtime and at a reasonable rate of interest. It will make it easier to continue the family ownership of a farm or small business following the death of mom or dad. It will help the young wife to preserve the estate if her husband dies so that she can continue to raise the children. It will help preserve family values and family business for generations of Americans.

My proposals will change the law and make it unnecessary for families to sell the family or business in order to obtain cash to pay Federal estate taxes.

Estate taxes were originally imposed because our society believes that no generation should be able to rest entirely on the work of others. But the estate tax was not set so low as to prevent one generation from helping another generation get started in a family enterprise. To have done so would have stifled the free enterprise system which has contributed so much to our great land. With inflation, the present level of exemption works to destroy the very enterprise that it originally sought to protect. The challenge now is to the Congress to modernize the estate tax law and make it conform to the realities of 1976. Let us all work to increase the exemption from estate taxes for all Americans and for legislation that will stretch out payments of estate taxes for family businesses and farms. For many small businessmen and farmers, the latter proposal will be as helpful as an increase in the exemption.

It is time to fight for and protect the family enterprise. As President Ford recently said:

> Too much love and too much labor goes into the development of a paying farm (and he might have added small business) to dismantle it with every new generation.

Let us preserve our family enterprises—our farms and small businesses— as vital to our American heritage.

The CHAIRMAN. The hearing will resume at 2 o'clock this afternoon. We have next a very distinguished and important panel and I hope the committee members will all be here at 2 o'clock to hear the panel.

[Whereupon, at 11:45 p.m., the committee proceeded to other business, and the hearing was recessed to reconvene at 2 p.m.]

AFTERNOON SESSION

The CHAIRMAN. Our next witnesses in this hearing are a very important panel. Thomas A. Melfe, American Bankers Association; Mr. Butala and Mr. Butler, American Bankers Association.

Mr. William Penick of the American Institute of Certified Public Accountants.

Chamber of Commerce, Mr. Walker Winter, and Mr. Robert Statham.

National Realty Committee, Mr. Albert Walsh.

And from the Public Citizen Tax Reform Research Group, Mr. Robert M. Brandon, and Mr. William Pietz.

A PANEL CONSISTING OF THOMAS A. MELFE, CHAIRMAN, TAXATION COMMITTEE, TRUST DIVISION, AMERICAN BANKERS ASSOCIATION, ACCOMPANIED BY J. H. BUTALA, JR., AND PAUL F. BUTLER, MEMBERS, TAXATION COMMITTEE, TRUST DIVISION, ABA; WILLIAM C. PENICK, CHAIRMAN, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY ARTHUR HOFFMAN, CHAIRMAN, COMMITTEE ON FINANCIAL AND ESTATE PLANNING, AND JOEL FORSTER, DIRECTOR, TAX DIVISION, AICPA; WALKER WINTER, CHAIRMAN, TAXATION COMMITTEE, CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY ROBERT R. STATHAM, DIRECTOR, TAX AND FINANCE SECTION, AND DONALD McDONALD; ALBERT A. WALSH, PRESIDENT, NATIONAL REALTY COMMITTEE; AND ROBERT M. BRANDON, DIRECTOR, PUBLIC CITIZEN TAX REFORM RESEARCH GROUP, ACCOMPANIED BY WILLIAM PIETZ, STAFF ATTORNEY

The CHAIRMAN. First we will hear them in that order. First the group from the American Bankers Association, Mr. Melfe. Welcome to the committee.

STATEMENT OF THOMAS A. MELFE

SUMMARY

If changes are to be made in the estate and gift tax laws and the current basis rule for property transferred at death, the ABA has developed some alternatives for consideration. They include:

1. *Rates and exemptions.*—The estate tax exemption would be increased to $100,000, less any part of the $30,000 gift tax exemption that is used, but the exemption would operate as a credit against the estate tax at the lowest rates of tax. The estate tax would be lowered, particularly in the $100,000—$500,000 range.
2. *Farms and other closely held businesses.*—A partial forgiveness of tax plus interest would be granted for these assets provided they qualify for deferred payment of the estate tax under section 6166 and meet certain other requirements. The 4% interest rate on amounts deferred under this section would be reinstated.
3. *Basis.*—The imposition of an additional, or appreciation, estate tax (AET) on net appreciation included in a decedent's estate.
4. *Generation-skipping.*—The imposition of a transfer tax upon the termination of a limited trust interest by treating the trust property as having been transferred by the beneficiary of such limited interest when the disposition of income and principal after such termination does not meet certain requirements. In general, shifts of beneficial interests among the family of the person creating the trust would be exempted from the tax. The term "family" includes ancestors, spouse, children and grandchildren, but not great grandchildren.
5. *Unification.*—For the purpose of determining the rate of tax applicable to transfers at death, transfers during life would be treated as death transfers.
6. *Marital deduction.*—The amount of the marital deduction would be increased to the greater of $250,000 or one-half of the decedent's adjusted gross estate, plus certain employment benefits.

Mr. MELFE. Mr. Chairman, and members of this committee, my name is Thomas A. Melfe. I am chairman of the taxation committee of the trust division of the American Bankers Association and on executive vice president of United States Trust Company of New

York. I am accompanied by Paul F. Butler, vice president and associate counsel of State Street Bank and Trust Company of Boston, and J. H. Butala, Jr., a vice president of Cleveland Trust Company, both of whom are former chairmen of the taxation committee.

At the time the ABA testified before this committee in 1973 on the same subjects we filed a draft transfer tax statute and accompanying comments dealing with the entire transfer tax area and the income tax basis rule. With your permission, we would like to resubmit the statute, and comments, and a commentary thereon.

A primary purpose of the statute was to develop alternatives responding to the criticisms of existing law, with particular emphasis upon (1) the basis rule, (2) generation-skipping transfers, (3) unification, (4) the marital deduction, and (5) rates and exemptions.

Since 1973 we have continued to review our alternatives, with the result that we have made changes in the unification and marital deduction areas. As to unification, our original statute fully integrates the present gift and estate tax laws into a single transfer tax system. If a change is to be made, we now prefer a simpler approach which accomplishes the policy behind unification—that is, to have the rates applicable to transfers at death reflect taxable gifts made during life. However, rather than a single transfer tax system, we would retain the present dual tax system for determining the rate of tax imposed on gifts and when a gift tax becomes payable, thus avoiding the necessity of substantial new law. The policy change would be made by substantially adopting section 601 of H.R. 1040 introduced in 1975 by Mr. Corman of this Committee. Our position on this issue, as well as other changes, is conditioned on there being no net increase in the overall tax cost of lifetime and death transfers.

Also, our initial position regarding the marital deduction was that present law should be changed to permit a current beneficial interest, that is, income interest, in property to qualify for the deduction. For technical and policy reasons we now believe present law should be retained, requiring either an outright transfer to the surviving spouse or an income interest plus a general power of appointment over the property. Although shifting to a current beneficial interest test would eliminate an existing requirement for qualification, we are concerned that it would cause more complexity and increase controversials with the Internal Revenue Service. As to the amount of property which may qualify for the marital deduction, we believe current law should be liberalized so as to permit the greater of $250,000 or one-half of a decedent's adjusted gross estate to qualify. This change, when combined with our proposed $100,000 exemption operating as a credit, would mean that there need be no estate tax on any estate of $350,000 or less where there is a surviving spouse. Estates of less than $350,000 comprise over 85 percent of all taxable estates.

With respect to generation skipping transfers, current law imposes a tax on the transfer of complete control over property, but a shift of limited interests in property without such a change in control is not a taxable event. Although most trusts are of a relatively short duration, a trust embodying a succession of interests lacking the control element could be insulated from estate or gift tax in the extreme case for 100 years or more.

The ABA proposal would shorten the period of time during which property can be held in trust and insulated from potential tax liability, to no longer than the lives of a decedent's children. A distribution from the trust to the creator's family—his spouse, children, and grandchildren, would not cause taxation, and where taxation results, our approach would in effect include the trust property in the estate of the skipped generation, usually a child of the decedent. Our suggested alternative is complex, but it is only applicable to long term trusts which themselves are complex.

Probably the most controversial issue is whether a change should be made in the current income tax basis rule for a decedent's property. After considering and rejecting the capital gains tax at death and the carryover basis solutions, as every major professional organization involved in the administration of estates has done, because either solution would cause great complexity and substantially increase the time and cost required to administer estates, we searched for a more satisfactory alternative. That alternative is an additional, or appreciation, estate tax (AET) on net appreciation included in a decedent's estate. The tax would be imposed at a flat rate in the range of 14 percent.

We believe the AET is by far the simplest change which has been suggested. We also believe that it is the fairest change that has been suggested in terms of its impact upon estates of varying size with the same percentage of net appreciation. Nevertheless, we continue to feel, as we did in 1973 when the AET concept was first suggested, that no change shoud be made in the basis rule because current law provides a better balance in terms of fairness and simplicity than would any suggested change, including the AET.

An important point to remember is that unrealized appreciation is a significant part of most estates in excess of $200,000 and this appreciation is already subjected to estate tax. Also, proof of basis would be a problem in many cases and where it could not be proved excessive taxation would result. In our opinion the real loser from any change in the basis rule would not be the large estate, which has the wherewithal to keep complete records and protect itself in controversies with the Internal Revenue Service, but the medium size estate where the cost of this protection becomes disproportionately large.

During the last year interest has increased substantially in the level of taxation issue, which includes rates and exemptions and the special problems of farms and closely held businesses. Many articles and editorials have discussed this subject. It has even received television coverage and has taken up a good bit of space in the Congressional Record, particularly during the last 4 months. When we testified in 1973 we did not take a specific position on farms and other closely held businesses. During the past few months, the ABA has developed a position on this matter, which I will refer to shortly.

We continue to believe the estate tax exemption should be increased to $100,000, less any part of the $30,000 gift tax exemption that is not used. But we feel the $100,000 should operate at a credit against tax at the lowest rates of tax rather than as a deduction against tax at the highest rate or rates of tax as it now does. This change would eliminate all estate tax on estates of not more than $100,000, which would comprise about 45 percent of all estates paying some tax.

President Ford has announced that the administration is going to propose an exemption of $150,000, which is estimated to produce a

revenue loss of slightly more than $1 billion. The revenue loss from our proposal would be only a small fraction of the $1 billion figure. If this committee desires to reduce estate tax revenues by a substantial amount we would suggest that a more modest exemption increase accompanied by rate reduction, particularly in the $100,000–$500,000 range, would be a fairer tax policy.

The level of taxation is the most important issue for this committee to decide. We respectfully suggest that this be done before dealing with specific areas. Otherwise, a coherent and balanced approach to the entire transfer tax area becomes difficult to obtain.

At the heart of the level of taxation issue is whether the estate tax should have a significant impact on the estates of persons in what is generally regarded as the middle class. Since 1942, when the exemption and rates were last changed, the middle class has been drawn into the estate tax web. You must decide whether this development should be continued, accelerated, or halted.

The ABA believes the problem which the payment of the estate tax raises for many farms and closely held businesses is real. A sale is often required even though members of the family would like to continue in the business. Some tax relief should be granted in these cases.

The President has outlined an administration tax relief proposal. Assets which would qualify for the relief are those which meet the requirements of the present law for payment of the estate tax in installments over a 10-year period. We believe the administration is on the right track but needs to slow down a bit and get a new engine in order to get safely to its destination.

Three additional qualification requirements should be imposed (1) that the asset be held for 2 years prior to death, (2) that it comprise 65 percent of the decedent's adjusted gross estate, and (3) that the family actively participate in the conduct of the business after death. We also suggest that partial forgiveness of the tax plus interest, in a percentage which increases each year be substituted for the administration's 5-year moratorium. The moratorium is, in effect, a 5-year noninterest bearing loan on the amount of the estate tax attributable to the qualifying asset. We do not favor extending the payment period from 10 years to 20 years. We do agree with the administration that the interest rate on the deferred tax should be returned to 4 percent. Finally, we recommend that the maximum amount qualifying for special treatment be $400,000 rather than the $300,000 proposed by the administration, and that the dollar-for-dollar reduction for this treatment when the value of the asset exceeds the maximum figure should be made much more gradual than that proposed by the administration.

Mr. Chairman and members of this committee, the ABA appreciates the opportunity to testify on this most difficult and controversial area of the tax law, and we hope that the materials we have submitted for your consideration are helpful. The association would be pleased to assist the committee and its staff in any way you deem it useful.

The CHAIRMAN. Thank you very much, Mr. Melfe.

Without objection, the supplemental materials will be included in the record. They are quite voluminous. On the other hand, extremely valuable. You have probably done more work in this area than any other group.

[The prepared statement and materials referred to follow. Oral testimony continues on p. 309.]

STATEMENT OF THOMAS A. MELFE
ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES ON
ESTATE AND GIFT TAX REVISION

March 15, 1976

Mr. Chairman and Members of the Committee:

My name is Thomas A. Melfe. I am the Chairman of the Taxation Committee of the Trust Division of the American Bankers Association and an Executive Vice President of United States Trust Company of New York. I am accompanied by Paul F. Butler, Vice President and Associate Counsel of State Street Bank and Trust Company of Boston and J. H. Butala, Jr., Vice President of Cleveland Trust Company, both of whom are former Chairmen of the Taxation Committee.

The American Bankers Association is a trade association composed of about 14,000 banks or some 96% of the banks in the country. Approximately 4,000 of the banks exercise fiduciary powers serving their customers as trustees and executors. Thus, the Association is keenly interested in any changes that might be made in Federal estate and gift taxation.

The Trust Division of the American Bankers Association (the ABA) testified before this Committee on estate and gift tax revision and a change in the basis rule for a decedent's property three years ago in March 1973. At that time, a Discussion Draft of a Transfer Tax Statute (Draft Statute) and Explanatory Comments (Comments) were submitted containing alternatives for changes in the law. We are resubmitting the Draft Statute and Comments as Appendix A to our statement. The purpose of the Draft Statute was to develop constructive alternatives for change that respond to the criticisms of current law, with particular emphasis being placed upon the following major areas:

1. The income tax basis rule for a decedent's property;
2. Generation-skipping Transfers;
3. Unification;
4. Marital Deduction;
5. Rates and Exemptions; and
6. Charitable Deduction.

We wish to re-emphasize that our organization does not favor enactment of each of the alternatives in these major areas.

The most significant new development since 1973 has been the increased attention being given to exemptions and rates, viz, the level of taxation issue. A focal point has been the effect of the estate tax on "family farms" and other closely held businesses. This subject was considered last year at hearings of the Senate Select Committee on Small Business. This year farms have been the subject of articles and editorials in many newspapers, including a front page article in The New York Times of February 15, 1976. The Administration has announced that it will propose (i) estate tax relief for farms and other closely held businesses which qualify for deferred payment of the estate tax under section 6166 and (ii) increasing the estate tax exemption from $60,000 to $150,000.

We hope that the level of taxation issue will be considered and disposed of by this Committee before it deals with the specific areas of concern. If this is not done, a coherent and balanced approach to the entire transfer tax area becomes difficult to attain. To illustrate, an increase in the exemption to the range of $120,000 to $150,000 would result in an estimated revenue loss of between $1.3 and $1.7 billion dollars, or about 30 to 35% of the estate and

gift tax revenues for fiscal 1975. In considering this area, the ABA has assumed that the tax revenues will not be substantially increased or decreased. Such an assumption necessarily accepts the fact that the estate tax, which was once regarded as being only a rich man's tax, now has a signficant impact on the middle class. This point was made in the Wall Street Journal's lead editorial of March 10, 1976. A determination should be made whether this is a development which should be continued or halted.

The ABA has continued to review the alternatives it presented to this Committee in 1973. Two changes have been made in the major areas of unification and marital deduction and one on a less significant but still important subject, the interest rate payable on estate tax which is attributable to farms and other closely held businesses and is eligible for a 10 year payment period under section 6166. The major changes are, first, to prefer the "simplified" unification approach described in the Commentary and, in general, contained in section 601 of H.R. 1040 introduced by Mr. Corman in 1975 rather than the full integration of the estate and gift taxes contained in the Draft Statute and, second, to continue existing law concerning the qualitative requirement of the marital deduction that the surviving spouse be given control over the property qualifying for this deduction rather than merely a current beneficial interest in this property. The unification change has been made for two reasons. First, it requires no change in substantive law, which we regard as desirable. Second, it permits the Committee and its staff in the limited time available to devote such time to other subjects in need of change. The reasons for the marital deduction change are discussed in the Commentary. We have always had reservations as to a shift to a current beneficial interest requirement, and in 1973 described our support for such a requirement as "hesitant".

The other ABA change of position is to support a return to the 4% interest rate for estate tax eligible for deferred payment under section 6166.

The ABA has recently prepared a revised Commentary discussing the major areas where changes has been suggested and the "new" issue of the taxation of farms and other closely held businesses. We are submitting the Commentary as Appendix B and believe you will find it helpful in analyzing the major issues and understanding the ABA alternatives. An effort was made to prepare the Commentary in nontechnical language. Each area discussed is divided into four sections, current law, major proposals for change, ABA evaluation and ABA alternative.*

The ABA alternatives in the major areas may be described briefly as follows:

1. Rates and Exemptions - the estate tax exemption would be increased to $100,000, less any part of the $30,000 gift tax exemption that is used, but the exemption would operate as a credit against the estate tax at the lowest rates of tax. The estate tax rates would be lowered, particularly in the $100,000 - $500,000 range.

2. Farms and Other Closely Held Businesses - a partial forgiveness of tax plus interest would be granted for these assets provided they qualify for deferred payment of the estate tax under section 6166 and meet certain other requirements. The 4% interest rate on amounts deferred under this section would be reinstated.

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*The Commentary is somewhat different from that contained at pages 381 through 427 of the Background Materials on Federal Estate and Gift Taxation dated March 8, 1976, which was prepared by the Staff of the Committee on Ways and Means for the use of the Committee.

3. Basis - the imposition of an additional, or appreciation, estate tax (AET) on net appreciation included in a decedent's estate at a flat rate which would reflect the highest long term capital gains tax rate and the highest estate tax rate. The AET rate would be 14% based upon a 35% capital gains tax rate and a 60% estate tax rate.

4. Generation-skipping - the imposition of a transfer tax upon the termination of a limited trust interest by treating the trust property as having been transferred by the beneficiary of such limited interest when the disposition of income and principal after such termination does not meet certain requirements. In general, shifts of beneficial interests among the "family" of the person creating the trust would be exempted from the tax. The term "family" includes ancestors, spouse, children and grandchildren, but not great grandchildren.

5. Unification - for the purpose of determining the rate of tax applicable to transfers at death, transfers during life would be treated as death transfers.

6. Marital Deduction - the amount of the marital deduction would be increased to the greater of $250,000 or one-half of the decedent's gross estate, plus certain employment benefits.

Since our testimony before this Committee in 1973 we have received comments from individuals and groups regarding some of the alternatives suggested in the ABA Draft Statute. Some of the comments suggest to us that there is a misconception as to the purpose of the Draft Statute. As previously mentioned, it is intended to address itself to each of the major issues and to present solutions representing reasonable compromises of the conflicting positions. Thus, the ABA suggested the form change should take _if_ a change were to be made in current law. The most controversial part of the Draft Statute has been the AET. Individuals and organizations have objected to (1) any change in current law, (2) the "imperfect" nature of the AET, and (3) its application to charitable

transfers. We would like to respond to these criticisms.

The ABA does not favor the enactment of the AET. In his 1973 testimony before this Committee, Stetson B. Harman, the then President of the Trust Division of the ABA, said:

> "In concluding my comments on the basis issue, I want to reiterate our opposition to any change in current law. We do not favor the enactment of the AET even if coupled with a deduction in the basic estate tax. Rather, we simply regard the AET as preferable to Carryover or the Capital Gains Tax."

This is still our position.

We urge this Committee to retain the present income tax basis rule because current law provides a better balance between fairness and simplicity than would any change which has been suggested, including the AET. Unrealized appreciation is usually a significant part of any gross estate in excess of $200,000. We regard any change which imposes a tax on unrealized appreciation either at death or at a subsequent time upon sale as a fruitless exercise. It would make the administration of a decedent's estate substantially more complex, particularly in the case of assets which are difficult to value. The problems that exist today in arriving at fair values in the negotiating process with the Internal Revenue Service are substantial. They will become more difficult if the basis rule is changed and there is a dual incentive for the Service to assert higher values. In our opinion, the real loser from any such change would not be the large estate which has the wherewithal to protect itself, but rather the medium size estate.

In general, the criticisms of the nature of the AET have been made by advocates of a capital gains tax at death and have focused on its failure to produce the same tax result which would have occurred if the decedent had sold

all of his property the day before his death. The AET was specifically designed to avoid this result, which, in our opinion, would have created a disproportionately heavy impact on smaller and medium size estates. This results because the capital gains tax is a debt and thus a deduction in computing a decedent's taxable estate. The deduction is more valuable and saves more tax to a larger estate that is in a higher marginal rate of tax. The ABA rejects the concept of parity of treatment between a lifetime sale and a constructive sale at death when the result is to tax smaller estates more heavily than larger estates. Logical symmetry should be disregarded when the result upon affected estates is upside down. The ABA is interested in the "bottom line" tax effect. The AET, a relatively low flat rate of tax on unrealized appreciation at death, produces a more desirable result than a capital gains tax at death for the small and medium size estate. Also, it is unrealistic and naive to believe that creating a parity of treatment with lifetime sales will reduce "lock in" - the failure to sell during life to avoid a substantial capital gains tax. "Lock in" will be reduced significantly only if a substantial tax incentive for lifetime sales is created. Finally, we would emphasize that the AET is the simplest and most straightforward change that has been suggested. In this respect it takes a back seat only to current law.

Regarding the application of the AET to charitable transfers, proposals for reducing the unlimited estate tax charitable deduction were made before 1973 and continue to be made. On the other hand, the needs of charities, and particularly public charities such as educational institutions and hospitals, have become greater during the past few years. To a substantial degree they are dependent upon transfers at death for support.

We still believe it accomplishes this objective better than any other approach which has been suggested, including the one recommended by the AICPA.

Changes in areas other than those discussed in the Commentary are needed and are included in the Draft Statute. We would like to refer specifically to six suggested changes whose importance has increased as a result of developments which have occurred since 1973, and one area in which change has been recommended by the General Accounting Office but where in our opinion current law should be continued.

1. Joint Property

Section 2040, applying a consideration in money or money's worth test to the taxation of joint interests in property, has not worked well. In the first place, the problem of proving consideration when the property has been held for a number of years is difficult. More importantly, this test, is inconsistent with the concept that each spouse contributes equally to the marriage. Section 2042 has been referred to as a "widow's tax". See Congressional Record, February 18, 1976. S.1862. The problem is particularly significant in the case of residences and farms, which are often held in joint names. The widow does not understand why the full value of this property should be included in her husband's estate upon his death when she regards her contribution to the family as being just as important as his. There is no completely satisfactory solution to this problem, but we do feel that the changes recommended in Sections 6 and 24 of the Draft Statute represent a better approach than existing law.

2. Contemplation of Death Transfers

Current law permits tax savings to be achieved by a deliberate

transfer made shortly before, and in contemplation of, death because the gift tax both reduces the gross estate and is a credit against the estate tax. A 1975 General Accounting Office Report (GGD-76-1) to the Joint Committee on Internal Revenue Taxation on "Proposed Changes in Estate Taxation" recommended changes in the law to eliminate the tax savings and to improve the operation of the gift tax credit. Section 28 of the Draft Statute also eliminates the tax savings by requiring the gift tax paid to be included as an asset of the decedent's estate for estate tax purposes. The ABA also supports the recommendations regarding the computation of the gift tax credit.

The ABA believes that the GAO Report does not go far enough in the contemplation of death area. We urge this Committee to eliminate the rebuttable presumption that transfers made within three years of death are "in contemplation of death" and substitute a rule requiring that the gift tax on all transfers made within two years of death be included as an asset of the decedent's estate, as does Section 28 of the Draft Statute. This change would eliminate a source of controversy that exists today regarding the decedent's intent in making transfers within three years of death.

3. Alternate Valuation Date

Current law properly permits a decedent's estate having a date of death value of $60,000 or more to be valued as of that date or, generally as of six months after death. The income tax basis for an asset included in a decedent's estate is the same as its estate tax value. The alternate valuation method may be used whether or not it results in a lower estate tax. In some cases, particularly with smaller estates, use of this method produces overall tax savings when the estate tax is increased because the higher values for assets which are sold reduce income taxes by more than the estate tax increase.

The GAO Report referred to above recommends that use of the alternate

valuation method be restricted to cases in which it produces a lower estate tax. The amount of the additional revenue that would result from this change would be small and, as noted in the preceding paragraph, would come largely from the smaller estates. Current law has the advantages of reducing valuation controversies and providing certainty as to the valuation date. Once the estate tax return is filed the choice of valuation date cannot be changed. If the alternate valuation method is available only when it results in a lower estate tax, audits of estates with assets difficult to value may necessitate making both valuations to determine which method does in fact produce the lower tax. The ABA regards this dual audit possibility as undesirable and recommends that current law be continued, as does Section 18 of the Draft Statute.

4. Expenses of Sale

Current law regarding the deductibility of expenses of sale under section 2053 is unclear. Circuit courts have reached contrary results. Compare Estate of Park v. Comm'r, 475 F.2d 673 (6th Cir. 1973), with Estate of David Smith v. Comm'r, 510 F.2d 473 (2nd Cir. 1975). The law should be clarified so that all expenses of sale which are allowable under applicable state law are deductible for purposes of section 2053, as is done under Section 29 of the Draft Statute.

5. Life Insurance

Current law regarding the tax consequences of the retention of non-beneficial incidents of ownership by a decedent-insured is unclear. Circuit courts have reached contrary results. Compare Rose v. United States, 511 F.2d 259 (5th Cir. 1975) and Terriberry v. United States, 517 F.2d 259 (5th Cir. 1975) with Estate of Skifter v. Comm'r, 468 F.2d 699 (2nd Cir. 1972), and Estate of Fruehauf v. Comm'r, 426 F.2d 80 (6th Cir. 1970). The law should be

clarified, as is done under Section 26 of the Draft Statute, to provide that non-beneficial incidents of ownership retained by a decedent-insured do not cause taxation under section 2042.

6. Charitable Remainder Trusts

The changes made by the Tax Reform Act of 1969 regarding charitable remainder trusts were undesirable in some respects. The new law has resulted in very complicated regulations and serious problems in drafting trusts that satisfy their requirements. Current law should be changed to return in part to pre-1969 law. Specific recommendations are contained in the Comments (pages 161-66) to Sections 14 and 31 of the Draft Statute.

7. The Gift Tax Annual Exclusion

Current law is uncertain in several respects regarding the availability of the exclusion for a trust income interest. Compare Rosen v. Comm'r, 397 F.2d 245 (4th Cir. 1968), with Fred A. Berzon, 63 T.C. 601 (1974), and see Estate of David H. Levine, 63 T.C. 136 (1974), rev'd, 526 F.2d 717 (2d Cir. 1975). The law should be changed to provide that an annual exclusion will be available for a transfer in trust when the donee is the only beneficiary and the trust property would be includible in his gross estate if he died immediately after the transfer, as is done in Section 11 of the Draft Statute.

AMERICAN BANKERS ASSOCIATION DISCUSSION DRAFT OF TRANSFER TAX STATUTE AND EXPLANATORY COMMENTS

Appendix A

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PREFACE

The Tax Reform Act of 1969 hearings before the Ways and Means Committee included testimony concerning revision of the estate and gift tax laws and a change in the current income tax basis rule for property transferred at death. Due to a lack of time, the 1969 Act did not deal with these subjects. Representative Wilbur D. Mills, Chairman of the Ways and Means Committee, did, however, announce his intention of having the committee consider these subjects in the future.

During the last three years the Trust Division of the American Bankers Association has had the estate and gift tax laws and a change in the basis rule under continuing study. The members of the Trust Division would prefer to avoid substantial changes in these areas where stability, certainty and simplicity are primary objectives. Nevertheless, change appears likely and they desire to participate in the process of shaping it.

The Trust Division has developed what it regards as a constructive program for change in the estate and gift tax laws and the basis rule that responds in every major area to the criticisms of current law. This program is set forth in the discussion draft (the "Draft") of statutory provisions and explanatory comments (the "Commentary") that follow. Preparation of the Draft was found necessary since in some areas - for example the taxation of limited trust interests - policy decisions could not finally be made without a proposed statutory provision. On balance, the Draft does not simplify current law. The additional complexity is required in order to respond to the criticisms of this law.

The Draft is based upon our belief that the present level of estate and gift taxation (estimated in the Economic Report of the President, January, 1973, at $4.6 billion for fiscal 1973 and $5.0 billion for fiscal 1974) is appropriate, and has the effect of reallocating the amount of tax payable by affected taxpayers but does not significantly increase or decrease the total amount of transfer taxation. The additional revenue derived from some changes would be offset by the decreased revenue that would result from other changes. It is believed that the Draft constitutes a modest tax increase in terms of long range tax revenues. Thus, it is true "reform", within the total ambit of all affected taxpayers, rather than a tax increase disguised as reform.

The starting point for our review of the current estate and gift tax laws and the basis rule was the work of the American Law Institute and the Treasury Department under the administration of the late President Johnson. The American Law Institute publication, Federal Estate and Gift Taxation, Recommendations of the American Law Institute and Reporters' Studies (1969) (the "ALI Project") contains the resolutions adopted by the Institute with explanations and the studies and proposals of the reporters. The Treasury's work, Tax Reform Studies and Proposals (1969) (the "Studies") proposed changes under three main headings: (1) taxation of appreciation at death, (2) unlimited marital deduction and unification of the estate and gift taxes, and (3) generation skipping transfers. The Draft accepts some of the ideas of these groups, rejects others and modifies still others. In each instance the Commentary sets forth the basis for our actions.

SUMMARY OF TRANSFER ACT DRAFT STATUTE
OF AMERICAN BANKERS ASSOCIATION

I. Sections Containing Major Changes in Current Law

1. Section 1. Basic Tax.

This section imposes a single, cumulative transfer tax on an individual's taxable transfers of property in place of the current two separate gift and estate taxes. Taxable transfers are defined separately in Sections 3 and 17 for lifetime transfers and transfers at death respectively. The tax is computed in the same manner as the current gift tax, *viz.*, by calculating a tax on the individual's total transfers to that time, including the transfers to be taxed, and by then subtracting from this amount the tax on the individual's prior transfers, *i.e.* those in preceding calendar quarters where a lifetime transfer is involved, or all lifetime transfers if transfers at death are being taxed.

The Section 1 rate schedule reduces the current estate tax burden on medium estates by eliminating the rapid and steep progression which is present in the lower brackets. As a result of the inclusion of the Section 2 tax and the single rate structure, it is also possible to lower the Section 1 rates to a maximum of 60% in the top bracket from the current top 77% estate tax rate.

2. Section 2. Additional Tax on Certain Transfers.

Section 2 imposes an additional tax (AET) of 14% upon the net appreciation in an individual's transfers at death. Net appreciation in transfers within two years of death is also subjected to the AET in order to prevent avoidance through transfers shortly before death. Current law would be continued as to the income tax basis of assets included in a decedent's gross estate - this basis would be the value of the asset on the applicable valuation date. In the case of property transferred more than two years before death, its basis, increased by the Section 1 tax attributable to unrealized appreciation, will be "carried over" to the donee.

Net appreciation is determined on an aggregate basis by subtracting the basis of the transferred property from its fair market value. Certain assets are deemed to have a basis for AET purposes equal to their fair market value. These assets are (1) life

insurance and annuity contracts, (2) any item of tangible personal property held for personal use whose fair market value is $5,000 or less, (3) any item of tangible personal property whose fair market value is less than its adjusted basis immediately prior to the transfer and (4) items constituting income in respect of a decedent. The basis for remaining assets is the greater of (i) their adjusted bases or (ii) $100,000 less the amount of the specific exemption under Section 12 (not to exceed $30,000) for transfers made more than two years prior to death. As a result of this "minimum" basis an AET will never be imposed in connection with decedents for whom a transfer tax return for transfers at death will not be required. In computing the AET, all property acquired before the Draft's effective date will have a basis equal to its fair market value on that date, adjusted under the normal rules for subsequent events.

Section 2 contains a special rule for a surviving spouse's share of community property. The spouse may elect (1) to have her share of community property owned at death subjected to a 14% AET, in which case the basis of this share will be increased to its value on the applicable valuation date, or (2) to use a carryover basis for her share.

No exemption from the AET is provided for net appreciation in property qualifying for the marital or charitable deduction. However, the impact of the AET on charitable transfers is lessened by permitting the computation of the allowable charitable deduction for purposes of the Section 1 tax without reduction for the AET and by excluding from inclusion in a decedent's transfers at death any transfer made during life that is wholly charitable at death.

3. Sections 8 and 25. Transfers in Trust.

Sections 8 and 25 restrict the time during which property may be held in trust, and successive beneficial interests given to several generations, without having the property subjected to transfer tax. Generally speaking, these sections are directed at long-term trusts that continue after the death of the transferor's children without the trust property being vested in his grandchildren for transfer tax purposes. They do not affect normal types of trust dispositions for a person's "family", _viz._, his children and grandchildren.

The general rule, set forth in subsection (a), is

that the value of property passing to a beneficiary's descendants upon a termination or distribution is considered as a transfer by the beneficiary for transfer tax purposes. The general rule is not applied to excluded transfers, as described in subsection (c)(8). Any tax payable is to be determined by inclusion of the trust property in the transfers of the beneficiary and is to be paid out of the property subject to tax at the marginal rate or rates of tax.

Key words, "beneficiary", "value of property passing to a beneficiary's descendants", "termination" and "distribution", are given their common meanings (subsection (c)) except that a distribution does not include a transfer of current income. A special provision, subsection (d), that treats a person receiving property as having made a transfer of such property is directed at infrequent situations and assures that Sections 8 and 25 cannot be avoided by making unnatural dispositions of trust property.

There are two excluded transfer provisions, one for terminations and one for distributions. An outright distribution to a child or grandchild of the person who created the trust is an excluded transfer, as is a distribution in further trust for a grandchild if the trust property is "vested" in the grandchild for transfer tax purposes unless he dies under the age of 35 years. Any termination prior to the death of the last survivor of the children of the transferor who are trust beneficiaries is an excluded transfer.

4. Sections 9, 13, 21, 28 and 35. Time Transfer is Taxed, Adjustments and Credits.

Section 21, which replaces sections 2036 through 2038, continues the "hard-to-complete" approach regarding the timing of the tax on transfers under which the transferor retains an economic interest in the transferred property or control over it. Section 13 classifies transfers as incomplete to the extent that the value of the transferred property would be included under Section 21 in the individual's transfers at death if he were to die immediately after the transfer. Section 9 makes a prior transfer taxable upon the occurrence of any event which removes the transfer from the protection of Section 13.

Sections 28 and 35 provide adjustments for property taxed at death under Section 21 which had been

subjected to tax upon its original transfer or was thereafter taxed under Section 9. This can occur where the transferor retains a contingent interest and all preceding interests in others terminate prior to his death. Section 28 includes in transfers at death an amount equal to the transfer taxes previously paid; Section 35 allows a credit in the amount of such transfer taxes against the Section 1 tax.

Section 28, independently of its interaction with Sections 9, 13, 21 and 35, requires inclusion in transfers at death of an amount equal to the transfer taxes paid on transfers made within two years of death. Thus such transfers will not give rise, as do transfers "in contemplation of death" under current law, to tax savings in an amount equal to the estate tax on the gift tax.

5. Sections 10, 15, 27 and 32. Marital Deduction.

These sections replace sections 2056 and 2523 and make quantitative and qualitative changes in the marital deduction. As to quantity, a deduction is permitted for the greater of $250,000 or one-half of the individual's "adjusted transfers". The percentage limitation is applied against the aggregate of the individual's transfers, as under the current estate tax, rather than against the amount of current transfers to his spouse, the gift tax approach. The term "adjusted transfers" means the aggregate of the individual's transfers after the Draft's effective date (reduced by available annual exclusions but not by the amount of the specific exemption and, in the case of transfers at death, by the Section 29 and 30 deductions). A special rule is provided for community property to allow the transferor a fixed dollar deduction equivalent to the $250,000 maximum for non-community property. If information needed to properly compute the deduction is not available, the deduction is limited to 50% of transfers within the calendar quarter (if a lifetime transfer is involved) or of the transfers at death; in the case of converted community property, no deduction is permitted.

In computing the deduction for transfers at death, certain employment benefits, including up to $50,000 in group life insurance proceeds, are allowed as additional deductions.

As to quality, Sections 15 and 32 permit transfers in which the spouse has only a current beneficial

interest to qualify for a deduction. A current beneficial interest is defined as a right for life commencing as of the date of transfer (i) to all the income from property or from a specific portion thereof, payable not less frequently than annually, or (ii) to the use of property or a specific portion thereof. An "income" interest in a charitable remainder trust, or an annuity, is treated as a right to receive income.

The transferor may elect (by will in the case of transfers at death) to subject to tax property which otherwise would qualify for the marital deduction. In all other respects Sections 15 and 32 are mandatory in application.

Sections 10 and 27 provide for the inclusion in the donee spouse's transfers, at a time no later than her death, of property for which a marital deduction was previously allowed. They are necessary because the term "current beneficial interest" includes interests, such as an income interest, which will not be taxed under any other section of the Draft upon their termination.

6. Section 26. Life Insurance.

This section continues current law (section 2042) as to life insurance other than group term insurance -- the proceeds of such policies will be included in the insured's transfers at death if they are receivable by his estate or if he held at his death an incident of ownership in the policies. The term "incidents of ownership" excludes any non-beneficial right or power held by the insured which he may exercise only in a fiduciary capacity. That part of section 2042, treating a reversionary interest in a policy as an incident of ownership if its value exceeds 5% of the policy's value immediately prior to the death of the insured, is eliminated.

Section 26 changes current law regarding group term life insurance by requiring the inclusion of such insurance in the insured's transfers at death, irrespective of whether the insured retains any incidents of ownership in the policy.

In order to avoid the possibility of achieving substantial transfer tax savings by transfers made "in contemplation of death", Section 2 applies the AET to transfers made within two years of death and Section 28

requires inclusion in transfers at death of the transfer taxes paid on transfers made within two years of death. Section 26 also contains a two year rule requiring that if an insurance policy is transferred within two years of death an additional amount shall be included in transfers at death equal to the difference between the proceeds and the value taxed on the lifetime transfer.

7. Section 34. Credit for Transfers at Death.

This section replaces the current $60,000 exemption, which operates as a deduction, with a credit, not to exceed the amount of the tax, of $10,000 (the transfer tax on taxable transfers of $100,000) reduced by 10% of the amount claimed in computing the transfer tax on lifetime transfers as an exemption under Section 12 or prior law.

II. Sections Containing Non-Major Changes in Current Law

1. Sections 3 and 17. Taxable Transfers.

Section 3 combines sections 2503(a) and 2512(b), and provides in a single section for the treatment of full or partial consideration in lifetime transfers. The uncertainty that exists under present law concerning the effect of a promise to make a gift is eliminated by stating that such a promise is not a transfer for transfer tax purposes.

Section 17 combines sections 2031(a), 2043(a) and 2051 and also provides for the treatment of full or partial consideration in transfers at death.

2. Section 4. Certain Property Settlements.

This section continues section 2516, which treats certain transfers in settlement of marital rights and for the support of minor children as made for full consideration, except that the requirement of a divorce within two years of the written agreement is eliminated and in the case of transfers between the spouses a requirement is substituted that the spouses live apart continuously for at least two years after the transfer or until the sooner death of either spouse.

3. Sections 6 and 24. Joint Interests.

Under current law (section 2515), the creation of a joint tenacy or a tenancy by the entirety in real

property is not a completed gift when made unless the transferor elects to have it treated as such; in all other cases the creation of a joint tenancy with another person is a completed gift of a part of the value of the property, except when the transferor can regain the entire property without the consent of the other tenant. Section 2040 includes in the gross estate of a joint tenant or tenant by the entirety the full value of the property, reduced only by the amount shown to have originated with the other tenant.

Sections 6 and 24 modify current law and provide that (1) the creation of joint interests (including a tenancy by the entirety) in the transferor and another is a transfer to the extent of the value of the interest controlled by the transferor immediately thereafter (Section 6), and (2) the death of a joint tenant is treated as a transfer of his proportionate share of the property's value (Section 24). Section 24 also provides that upon the death of a joint tenant who could reacquire the entire amount involved, the amount taxed will be based on the percentage of the total consideration which he contributed to the joint interests; to this extent the "consideration-contributed" test of section 2040 is continued. Similarly, under Section 6, as under current law, no transfer occurs upon the creation of or an additon to a joint interest, such as a joint bank account, in which the contributor may thereafter withdraw his entire contribution.

4. Sections 7 and 22. Powers.

These sections make limited changes in sections 2041 and 2514. The references in sections 2041(a)(2) and 2514(b) to disclaimers and renunciations are eliminated because of the inclusion in Section 16 of a general disclaimer provision. The definition of a general power of appointment is broadened in both sections to include a power created after the Draft's effective date which is limited by an ascertainable standard. The rule relating to the tax treatment of the lapse of a power has been modified so that if more than the greater of $5,000 or 5% of the trust corpus is subject to the power, the entire amount as to which the power is not exercised is treated as a release. Finally, a new subsection (c) is included in Section 22 to insulate from tax at death any amount which was previously taxed as an exercise of, or a release of, a power under Section 7 and which would otherwise be

taxable under Section 22(a)(2)(ii) as a lifetime transfer to which Section 21 would have been applicable had the powerholder been the transferor.

5. Section 11. Annual Exclusion.

This section replaces subsections (b) and (c) of section 2503. It continues the $3,000 per donee annual exclusion but limits its availability to an outright transfer or a transfer in trust where the donee is the only beneficiary and the property is includible in his transfers at death if he dies immediately after the transfer.

6. Sections 14 and 31. Charitable Deduction.

While these sections continue sections 2055 and 2522, changes are proposed in the related area of section 664 concerning charitable remainder trusts. See Part IV, item 1. Also, a lowering of the present 6% unrealistic rate of return used by the Treasury tables to 4 1/2% is suggested.

Section 31 modifies section 2055(c) to require a reduction in the allowable charitable deduction only for taxes imposed under the basic tax of Section 1 - the deduction is not reduced by reason of a payment of the Section 2 tax from a charitable bequest.

7. Section 16. Disclaimers.

Section 16 establishes the requirements of an effective disclaimer for transfer tax purposes. It must be an "irrevocable and unqualified refusal in accordance with local law" to accept the rejected interest which is made within nine months after the interest becomes indefeasibly fixed and before any benefits have been accepted from it. This test liberalizes current law under which a disclaimer will be effective only if the interest is rejected within a reasonable time after the individual learns of its existence, which in the case of a future interest may be long before it becomes indefeasibly fixed.

8. Section 18. Alternate Valuation.

This section modifies section 2032 in providing that a distribution by an executor or trustee to a beneficiary will not "fix" the alternate valuation date for the transferred property unless the distribution gives rise to the recognition of gain or loss to the estate or trust.

9. Section 19. Property in Which Individual Had an Interest.

Section 2033 is revised to exclude an interest in property which the individual transfers prior to his death unless the interest is certain to become possessory.

10. Section 23. Employment Benefits.

This section requires the inclusion of employment benefits in an employee's transfers at death and thereby eliminates the section 2039(c) exclusion. The term "employment benefits" is defined broadly, thus causing Section 23 to be broader than section 2039. Life insurance on the employee's life is not covered by Section 23 but rather by Section 26. Section 23 is not applicable to amounts receivable under the Social Security laws and the laws relating to retired railraod employees.

11. Section 29. Disbursements.

This section continues section 2053 except that (i) the deduction for claims is liberalized to cover all claims against property included in transfers at death or in transfers made within two years of death that are paid, regardless of the time of payment, and (ii) all expenses of sale that are proper administration expenses are deductible, regardless of the purpose of the sale, except for those relating to property not subject to claims that are paid after the period for assessing the transfer tax. Also, a new provision is added to make it clear that amounts payable under a divorce or separation decree or under a written agreement incident to a divorce or separation are allowable deductions so long as the spouses live apart continuously thereafter.

12. Section 33. Previously Taxed Property.

Where the transferee dies within a ten-year period after the receipt of property this section replaces the credit of section 2013 with a deduction. A full deduction is available if the second inclusion follows the first by six years or less, and the allowable amount decreases by 25% for each year thereafter. A further limitation provides that no deduction is available for an interest in a trust unless the trust property is included in the individual's transfers at death.

13. Section 44. Apportionment of Tax.

This section replaces sections 2206 and 2207 and provides rules for the apportionment of the Section 1 and Section 2 taxes to non-testamentary property included in an individual's transfers. A pro rata allocation of the Section 1 tax is used for property included in transfers at death under the provision relating to powers, joint interests and amounts paid as transfer taxes (Sections 22, 26 and 28, respectively). The Section 1 tax to be apportioned for property included in transfers at death under Section 25 or Section 27, relating to "generation-skipping" transfers and property not otherwise includible for which a marital deduction was previously allowed, is based upon the individual's highest marginal rates of transfer tax. The Section 2 tax is allocated to the property containing net appreciation on a pro rata basis using the ratio of its net appreciation to total net appreciation.

III. Sections in Which Current Law is Continued Unchanged

1. Section 5. Transfer by a Husband or Wife to Third Party. - continues §2513.
2. Section 12. Specific Exemption. - continues §2521.
3. Section 20. Dower or Curtesy Interests. - continues §2034.
4. Section 30. Losses. - continues §2054.
5. Section 36. Credit for State Death Taxes. - continues §2011, with appropriate adjustments in rates.
6. Section 37. Credit for Death Taxes on Remainder. - continues §2015.
7. Section 38. Credit for Foreign Death Taxes. - continues §2014.
8. Section 39. Liability for Payment. - continues §§2022, 2502(d).
9. Section 40. Recovery of Taxes Claimed as Credit. - continues §2016.
10. Section 41. Definition of Executor. - continues §2203.

11. Section 42. Discharge of Fiduciary from Personal Liability. - continues §2204.

12. Section 43. Reimbursement Out of Estate. - continues §2205.

13. Section 45. Missionaries in Foreign Service. - continues §2202.

14. Section 46. Members of the Armed Forces Dying During an Induction Period. - continues §2201.

15. Section 47. Certain Residents of Possessions Considered Citizens of the United States. - continues §§2208, 2501(b).

16. Section 48. Certain Residents of Possessions Considered Nonresidents Not Citizens of the United States. - continues §§2209, 2501(c).

IV. Suggested Changes in Related Areas

A. Miscellaneous

1. Section 664

The definition of a charitable remainder "income" unitrust contained in section 664(d)(3) should be modified (i) to base the "income" limitation upon the rate of return used in the Treasury Tables to value the charitable interest on the original transfer, which is currently 6%, rather than 5%, and (ii) to permit a payout, pursuant to the exercise of a general power of appointment held by a recipient, of the amount by which all payments to the recipients are less than the aggregate projected annual return for the years from the commencement of the trust under that rate of return in the Treasury Tables. See pages 162-66.

2. Section 678

This section should be changed to provide that a person (other than the grantor) is not to be treated as the owner of trust property as a result of a power of withdrawal if the trust income is currently distributable to such person and the amount subject to the power does not exceed the greater of $5,000 or 5% of the trust property. See pages 81-82.

B. Payment of Tax

The suggestions for changes which are summarized below are discussed in a separate section of the Commentary beginning on page 194.

1. Section 6601(b)

This section should be changed to delete the special 4% rate of interest for certain deferred estate tax payments. This change should remove the only sound reason for rejecting the substantial liberalizations of the liquidity provisions referred to in items 2 through 6.

2. Section 6165

This section should be amended to substitute the use of security arrangements for bonds where the time for payment of the tax has been extended. If this change is made, section 2204 should be modified to release a fiduciary from personal liability upon payment of the tax currently due and execution of a security arrangement satisfying the provisions of section 6165.

3. Section 6166

Several liberalizing changes should be made regarding the circumstances under which payment of the tax may be deferred. Deferral should be permitted in any case where the value of the decedent's interest in a closely held business exceeds 20% of his transfers at death. The definition of a closely held business should be broadened to include, in the case of stock, any stock not traded on a national securities exchange or in an over-the-counter market, or if so traded, 20% or more of the stock and, in the case of a partnership carrying on a trade or business, the required percentage would be reduced from 20 to 10 and the limitation on partners would be increased from 10 to 20.

4. Section 303

This section should be amended to conform its requirements to those of section 6166 discussed above. It should also be modified (1) to extend the redemption period to 10 years, and (2) to apply the section only to the extent the redeeming shareholder is liable for the payment of death taxes or funeral or administration expenses.

5. Section 6161(a)(2)

This provision, permitting the period of time to pay the tax to be extended for a reasonable period not to exceed 10 years in the case of "undue hardship" to the estate, should be changed to eliminate the word "undue".

6. Section 6163(a)

This section, granting an extension of time for the payment of tax on a reversionary or remainder interest in property, should be broadened to permit a deferral of the tax on any asset which is not received by a fiduciary or a beneficiary within 15 months of the decedent's death.

CHAPTER X. TRANSFER TAX

PART I. Imposition of Tax.

Section 1. Basic Tax
Section 2. Additional Tax on Certain Transfers

PART II. Transfers Other Than at Death (Lifetime Transfers).

Subpart A. Provisions Relating to Includibility --

Section 3. Taxable Transfers
Section 4. Certain Property Settlements
Section 5. Transfer by a Husband or Wife to Third Party
Section 6. Joint Interests
Section 7. Powers
Section 8. Interest in a Trust or its Equivalent
Section 9. Transfers to Which Section 13 Applied
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Subpart B. Exclusion and Deductions --

Section 11. Annual Per-Donee Exclusion
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Section 14. Charitable Deduction
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Subpart C. Disclaimers --

Section 16. Disclaimers

PART III. Transfers at Death.

Subpart A. Provisions Relating to Includibility --

Section 17. Taxable Transfers
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Section 21. Transfers With Retained Interest
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Section 25. Interest in a Trust or its Equivalent
Section 26. Life Insurance
Section 27. Property to Which Section 15 or 32 Applied
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Subpart B. Deductions and Credits --

Section 29. Disbursements
Section 30. Losses
Section 31. Charitable Deduction
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Section 33. Previously Taxed Property
Section 34. Credit for Transfers at Death
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PART IV. Miscellaneous Provisions

Section 39. Liability for Payment
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Section 44. Apportionment of Tax
Section 45. Missionaries in Foreign Service
Section 46. Members of the Armed Forces Dying During an Induction Period
Section 47. Certain Residents of Possessions Considered Citizens of the United States
Section 48. Certain Residents of Possessions Considered Nonresidents Not Citizens of the United States

Section 1. Basic Tax.

(a) Imposition of Tax. - A tax, computed as provided in subsection (b), is hereby imposed on the taxable transfers by a citizen or resident of the United States of property, real or personal, tangible or intangible, wherever situated. The term "taxable transfers" means (1) for transfers

other than at death, the taxable transfers as defined in section 3, and (ii) for transfers at death, the taxable transfers as defined in section 17.

(b) Computation of Tax. - The tax imposed by subsection (a) of this section shall be an amount equal to the excess of -

(1) For transfers other than at death -

(i) a tax, computed in accordance with the rate schedule set forth in this subsection, on the aggregate sum of the taxable transfers for the calendar quarter and for all preceding calendar quarters subsequent to [, 197], over

(ii) a tax, computed in accordance with such rate schedule, on the aggregate sum of the taxable transfers for all such preceding calendar quarters.

(2) For transfers at death -

(i) a tax, computed in accordance with the rate schedule set forth in this subsection, on the aggregate sum of the taxable transfers at death and the taxable transfers other than at death for all calendar quarters subsequent to [, 197], over

(ii) a tax, computed in accordance with such rate schedule, on the aggregate sum of the taxable transfers other than at death for all calendar quarters subsequent to [, 197].

Rate Schedule

If the amount of taxable transfers is:	The tax shall be:
Not over $150,000	10% of such amount.
Over $150,000 but not over $200,000	$15,000, plus 12% of excess over $150,000.
Over $200,000 but not over $300,000	$21,000, plus 14% of excess over $200,000.
Over $300,000 but not over $400,000	$35,000, plus 17% of excess over $300,000.
Over $400,000 but not over $500,000	$52,000, plus 20% of excess over $400,000.

Over $500,000 but not over $700,000 . . . .$72,000, plus 23% of excess over $500,000.

Over $700,000 but not over $1,000,000 . . . .$118,000, plus 26% of excess over $700,000.

Over $1,000,000 but not over $1,500,000 . . . .$196,000, plus 30% of excess over $1,000,000.

Over $1,500,000 but not over $2,000,000 . . . .$346,000, plus 33% of excess over $1,500,000.

Over $2,000,000 but not over $2,500,000 . . . .$511,000, plus 36% of excess over $2,000,000.

Over $2,500,000 but not over $3,000,000 . . . .$691,000, plus 39% of excess over $2,500,000.

Over $3,000,000 but not over $3,500,000 . . . .$886,000, plus 42% of excess over $3,000,000.

Over $3,500,000 but not over $4,000,000 . . . .$1,096,000, plus 45% of excess over $3,500,000.

Over $4,000,000 but not over $5,000,000 . . . .$1,321,000, plus 48% of excess over $4,000,000.

Over $5,000,000 but not over $6,000,000 . . . .$1,801,000, plus 50% of excess over $5,000,000.

Over $6,000,000 but not over $7,000,000 . . . .$2,301,000, plus 52% of excess over $6,000,000.

Over $7,000,000 but not over $8,000,000 . . . .$2,821,000, plus 54% of excess over $7,000,000.

Over $8,000,000 but not over $9,000,000 . . . .$3,361,000, plus 56% of excess over $8,000,000,

Over $9,000,000 but not over $10,000,000 . . . . $3,921,000, plus 58% of excess over $9,000,000.

Over $10,000,000 . . . . $4,501,000, plus 60% of excess over $10,000,000.

Section 2. Additional Tax on Certain Transfers.

(a)(1) Imposition of Tax. - An additional tax of 14 percent is hereby imposed on the net appreciation in the value of the property transferred by a citizen or resident of the United States at death, or within a period of two years ending with the date of his death to the extent that the property so transferred has not been disposed of prior to his death in a transaction which results in the recognition in full of gain or loss. The term "net appreciation" shall mean the excess of (i) the fair market value of all property so transferred (as determined for purposes of imposing the tax under section 1) over (ii) the basis of such property.

(2) Spouse's Election Concerning Community Property.

(A) General Rule. - For purposes of this section, and subject to the provisions of subparagraph (B), the surviving spouse of a citizen or resident of the United States may elect to have his or her share of community property (held as of the date of the deceased spouse's death) treated as property transferred under this section 2 with a basis as provided in paragraph (b)(2) and subject to an additional tax of 14 percent on the net appreciation in such share determined as of the date of death or the alternate valuation date, as the case may be, used in valuing the transfers at death of the deceased spouse.

(B) Method of Election. - An election pursuant to subparagraph (A) may be made at or prior to the date on which the return with respect to the deceased spouse's transfers at death is filed.

(C) Liability for Tax. - The tax imposed under this section upon property with respect to which an election is made pursuant to this paragraph (2) shall be charged to the surviving spouse's share of the community property.

(b)(1) Basis, In General. - For purposes of this section and except as provided otherwise in this subsection or in subsection (d), the basis of property shall be the fair market value on the applicable valuation date of all property enumerated in subsection (c) and the greater of (i) the basis (adjusted as provided in section 1016) of all other property or (ii) $100,000 reduced by the aggregate of

the amounts previously allowed to the individual as a deduction pursuant to section 12 for transfers made more than two years prior to such individual's death.

(2) Basis, Surviving Spouse's Share of Community Property. - For purposes of this section and except as provided in subsections (c) and (d), the basis of the surviving spouse's share of community property shall be the basis (adjusted as provided in section 1016) of the surviving spouse as to such property.

(3) Certain Charitable Transfers. - For purposes of this section, the basis of property transferred to or belonging to a pooled income fund (as described in section 642(c)(5)) or to a charitable remainder trust (as described in section 664) shall be the basis of the property originally transferred by the individual to such fund or trust immediately after the transfer increased, in the case of a transfer to a charitable remainder trust, by the aggregate amount that is considered as a provided in section 664(b)(2).

(c) Assets Having a Basis Equal to Fair Market Value. - The property enumerated below shall be deemed to have a basis equal to its fair market value on the applicable valuation date:

(1) life insurance contracts.
(2) annuity contracts.
(3) income in respect of a decedent, including pension and profit sharing benefits.
(4) any item of tangible personal property held for personal use provided that its fair market value does not exceed $5,000.
(5) any other item of tangible personal property having a fair market value less than its adjusted basis immediately before the transfer.
(6) cash.

For purposes of this subsection, items normally sold as a set or collection shall be treated as a single item.

(d) Property Acquired Before [, 197]. For purposes of this section, the basis of property (other than property described in subsection (c)) acquired by an individual prior to [, 197] shall be its fair market value on [, 197], adjusted (as provided in section 1016) for the period after [, 197].

Section 3. Taxable Transfers.

For transfers other than at death, the term "taxable

transfers" means the total amount of transfers (exclusive of transfers made for an adequate and full consideration in money or money's worth, and reduced in the case of any other transfer by the amount of consideration received in money or money's worth) during the calendar quarter, reduced by the amount of the exclusion and deductions allowed under subpart B of this part. For purposes of this section, a promise to make a lifetime transfer, whether or not enforceable under local law, shall not be deemed a transfer.

Section 4. Certain Property Settlements.

Where husband and wife enter into a written agreement relative to their marital and property rights, any transfers made pursuant to such agreement -

(1) to either spouse in settlement of his or her marital or property rights, or

(2) to provide a reasonable allowance for the support of children of the marriage during minority, shall be deemed to be transfers made for an adequate and full consideration in money or money's worth, provided that in the case of a transfer pursuant to (1) the spouses thereafter live apart continuously for at least two years or until the sooner death of either spouse.

Section 5. Transfer by a Husband or Wife to Third Party.
[Present §2513].

Section 6. Joint Interests.

(a) General Rule. - There shall be included in the transfers of an individual, for the calendar quarter within which joint interests in property are created in another person or persons and himself, the excess of his contribution to such interests over the value of his interests immediately after the creation of such interests, unless such individual can regain his entire contribution without the consent of any other person. In determining the value of a joint interest in property, each holder of such an interest shall be regarded as owning an equal undivided share of such property, unless his undivided share is determined by means of a different proportion under local law.

(b) Additions. - An additional contribution to joint interests in property shall be regarded as a creation

of such interests to the extent of the additional contribution.

(c) Definition. - For purposes of this section, the term "joint interests" means interests in property which are possessed by two or more individuals (1) jointly with right of survivorship (whether or not such right is considered contingent under local law) or (2) by the entirety.

Section 7. Powers.

[Present §2514, reworded to conform, except that (i) subsection (b) will read as follows:

"The exercise or release of a general power of appointment created after October 21, 1942 shall be deemed a transfer of property by the individual possessing such power."

(ii) subsection (c)(1), relating to the exclusion from the category of general powers of appointment of powers limited by an ascertainable standard, will be deleted with reference to powers created after the effective date of the Draft; and

(iii) subsection (e) will read as follows:

"The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The preceding sentence shall not apply with respect to the lapse of a power during a calendar year if the property which could have been appointed by exercise of such lapsed power did not exceed, at the time of such lapse, the greater of the following amounts:

(1) $5,000, or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied."]

Section 8. Interest In a Trust or its Equivalent.

(a) General Rule. - Except as provided in subsection (c)(8) (relating to excluded transfers), there shall be included as a transfer by an individual who is a beneficiary of a trust or its equivalent (to the extent not otherwise treated as a transfer under this part II) the

value of property passing to his descendants upon a termination or distribution during his life.

(b) Computation and Payment of Tax. - The tax payable under this section shall be computed in accordance with the provisions of this chapter and, unless the beneficiary otherwise elects, shall be paid out of the property subject to the tax. Such tax shall be an amount equal to the excess of the tax over the tax computed without including such transfer in the transfers for the period.

(c) Definitions. - For purposes of this section and section 25 of this chapter

(1) Beneficiary. - The term "beneficiary" means any person (except a transferor or a person who is a successor to a beneficiary by means of an assignment) who, immediately prior to a termination or distribution, is entitled to receive property subject to a transfer in trust or its equivalent or is a permissible recipient of such property pursuant to the exercise of a power held by any person or would be so entitled, or would be a permissible recipient, except for an assignment made by him.

(2) Descendant. - The term "descendant" means issue in any degree of the beneficiary or of any spouse of the beneficiary and any spouse of such issue and includes issue by adoption (provided such issue is not otherwise a descendant of the beneficiary) and any successor to a descendant by means of an assignment.

(3) Termination and Distribution. - The term "termination" means any occurrence, other than a distribution, whereby a person who is a beneficiary immediately prior to such occurrence ceases to be a beneficiary. The term "distribution" means any transfer pursuant to the terms of the governing instrument whereby property ceases to be a part of a trust or its equivalent. A payment of current income shall not be considered a "termination" or a "distribution".

(4) Power. - The term "power" means an authority in any person to do any act in relation to a beneficial interest in property, including any authority the exercise of which is limited by a fixed and ascertainable standard but which authority is not presently exercisable by reason of such limitation.

(5) Transferor. - The term "transferor" means any person to the extent that property is transferred by him pursuant to the provisons of this chapter.

(6) Member of the Same Generation. - The term "member of the same generation" means, in the case of any person who is not a descendant of a grandparent of the transferor, any person who is not more than twenty-five years younger than the transferor, but does not include any

descendant of a beneficiary who is a member of the same generation as the transferor.

(7) Value of Property Passing to a Beneficiary's Descendants. - The term "value of property passing to the beneficiary's descendants" means

(A) as to a distribution, the actual value of property so passing; and

(B) as to a termination,

(i) to the extent that subparagraph (B)(ii) does not apply, the value of the property that would be distributed to the descendants of the beneficiary as a final distribution, if the trust became distributable at the termination plus, as to any property that would not be so distributed, the full value thereof to the extent the descendants of the beneficiary have an interest therein;

(ii) if the property is subject to a power that is or may become exercisable after the termination in favor of the beneficiary's descendants, the value of the property that would pass to the descendants if the power were exercisable upon such termination and the beneficiary held the power and exercised the power in favor of his descendants, or, if greater, permitted the property subject to the power to pass to the beneficiary's descendants as takers in default of appointment.

For purposes of this subparagraph (B), the value of property passing to a descendant shall be reduced by an amount equal to the value of any consideration in money or money's worth received by the beneficiary by reason of any assignment causing the termination and the value, determined at termination, of any income interest then outstanding in such property of any person other than a descendant of the beneficiary.

(C) In applying subparagraphs (A) and (B), no reduction shall be made for any tax imposed by this chapter.

(8) Excluded Transfer. - This section shall not apply to the following:

(A) Pre-existing Trust. Property held in trust on [, 197] until such time as an individual is deemed a transferor with respect to such property.

(B) Terminations.

(i) Descendants. - A termination prior to the death of the survivor of a class consisting of one or more of the transferor's spouse, any ancestor of the transferor, the

transferor's children and their spouses if, immediately after the termination, each such person or persons used as a measuring life is a beneficiary and at least one of such persons is used as a measuring life.

(ii) Collaterals. - A termination prior to the death of the survivor of a class consisting of one or more of the transferor's spouse, any ancestor of the transferor, the children of a member of the same generation as the transferor and the spouses of such children if, immediately after the termination, each such person or persons used as a measuring life is a beneficiary and at least one of such persons is used as a measuring life.

(C) Distributions. - An outright distribution to a child or grandchild of the transferor or of a member of the same generation as the transferor. For purposes of this paragraph a disposition shall be deemed to be made outright to a grandchild if it is in trust for such grandchild and

(i) no subsequent distribution of property (including current income) may be made other than to such grandchild, except upon his death before attaining the age of 35 years; and

(ii) either the property will, no later than such grandchild attaining said age, pass outright to, or be subject to a general power of appointment held by, such grandchild or the property will upon such grandchild's death be distributed to his estate.

(d) Recipient Treated as Transferring Property to Himself. - If upon a distribution property is payable to a person who

(1) is not an ancestor, child or grandchild of the transferor or of a member of the same generation as the transferor, or a spouse of any such person, and

(2) is not a descendant of an individual who was a beneficiary immediately prior to the distribution, there shall be included in the transfers of such person for the third calendar quarter commencing after the event causing the distribution sixty percent of the value of the property determined as of the occurrence of said event.

(e) Regulations. - The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and section 25.

Section 9. Transfers to which Section 13 Applied.

If, after a transfer of property by an individual for which a deduction was allowed under section 13, an event occurs by reason of which the property would not be included in his transfers at death upon his death immediately after said event, the individual shall be deemed to have made a transfer of the property upon the occurrence of said event.

Section 10. Transfers to Which Section 15 or 32 Applied.

If the income from or the use of property for which a deduction was allowed under section 15 or 32 is disposed of by an individual and such disposition effects a termination of his current beneficial interest, the individual shall be deemed to have made a transfer, upon the disposition becoming effective, of the property as to which such termination occurs. For purposes of this section, the value of the right to receive a fixed dollar amount per year shall be that percentage of the property as of the termination of such right which the fixed dollar amount is to the annual net income of the property, as of the date of transfer, computed by use of the rate of return prescribed on such date of transfer for the valuation of interests in transferred property under this chapter.

Section 11. Annual Per-Donee Exclusion.

In the case of an outright transfer of property to any person during a calendar year, $3,000 of the transfer, less the aggregate amount of transfers to such person during all preceding calendar quarters of the calendar year for which an exclusion under this section is allowable, shall not be included in the total amount of transfers made during the calendar quarter. If property is transferred for which a deduction is allowable under section 15 based upon a percentage of the value of the property transferred such deduction shall be applied prior to the calculation of the amount excludable under this section. As used in this section, the term "outright transfer of property to any person" shall include a transfer in trust or its equivalent if the property would be included under this chapter in the transfers at death of such person upon his death immediately after the transfer and if prior to the death of such person no other person may in any event have a right, or eligibility pursuant to the exercise of a power, to the property or to the income from or the use of the property.

Section 12. Specific Exemption.

There shall be allowed as a deduction an amount equal to $30,000 less the aggregate of the amounts allowed as a deduction pursuant to this section and any equivalent provision of prior law with respect to preceding calendar quarters or calendar years commencing after December 31, 1931.

Section 13. Deduction for Certain Transfers Treated as Transfers at Death.

There shall be allowed as a deduction the value of property transferred by an individual which would be included under section 21, 23 or 26(a)(1) in his transfers at death upon his death immediately after the transfer.

Section 14. Charitable Deduction.

[Present §2522, reworded to conform, except that a new subsection (c)(3) shall be added:

"No deduction shall be allowed under this section for an interest in property for which a deduction is allowed under section 15 by reason of the same transfer."]

Section 15. Marital Deduction.

(a) Allowance of Deduction.

(1)(A) General Rule. - Subject to the limitation of paragraph (2) of this subsection, there shall be allowed as a deduction the value of all property included in an individual's transfers which passes outright to his spouse or in which his spouse possesses a current beneficial interest.

(B) Property Formerly Held as Community Property. - If after [, 197] property held as community property was by an individual and his spouse converted, by one transaction or a series of transactions, into separate property of such individual and his spouse (including any form of co-ownership by them), a deduction shall be allowed under this section with respect to any property acquired at any time by him in exchange therefor (by one exchange or a series of exchanges) which shall not exceed one-half the

excess of $250,000 over the sum of

(i) twice the amounts previously allowed as a deduction under this section with respect to transfers of such converted community property, and

(ii) all other amounts previously allowed as a deduction under this section.

(2) Limitation. - (A) The deduction provided in this section, when added to amounts previously deducted hereunder shall not exceed an amount equal to the greater of $250,000 or one-half of the value of an individual's adjusted transfers.

(B) If available records are such that, under regulations prescribed by the Secretary or his delegate, the limitation on the amount of the deduction allowable under this section cannot be computed under subparagraph (A) of this paragraph (2),

(i) the deduction allowed under this section shall not exceed one-half the value of the property transferred under this chapter during the calendar quarter, reduced by any amounts applicable thereto for which exclusions are provided in section 11 but not reduced by any amount allowable as a deduction under section 12, and

(ii) no deduction shall be permitted under this section for a transfer of property described in subparagraph (B) of paragraph (1) of this subsection.

(b) Definitions. - For purposes of this section,

(1) Current Beneficial Interest. - (A) the term "current beneficial interest" means a right for life commencing as of the date of transfer, (i) to all the income from property or all the income from a specific portion thereof, payable annually or at more frequent intervals, or (ii) to the use of property or a specific portion thereof. (B) For purposes of subparagraph (A),

(i) a right to receive payments from a charitable remainder trust (as described in section 664) shall be considered as a right to all the income from the property held in such trust if the payments described in paragraphs (1), (2) or (3)(A) of section 664(d) may be made only to the spouse; and

(ii) a right to receive a fixed amount per year shall be considered a right to receive all the income from property or a specific portion of such property.

(2) Property Passing Outright. - The term

"property . . . which passes outright" includes property (other than property or a specific portion thereof from which payments are to be made pursuant to a right described in paragraph (1)(B)(ii) of this subsection) held as a separate fund, under regulations of the Secretary or his delegate, in which no person other than the spouse or her estate has any beneficial interest except pursuant to the exercise by the spouse of a general power of appointment described in section 22.

(3) Adjusted Transfers. - The term "adjusted transfers" means the total value of an individual's transfers for the current calendar quarter and for all preceding calendar quarters subsequent to [, 197], reduced by any amounts applicable thereto for which exclusions are provided in section 11 and by any amounts for which a deduction is or was allowed under section 14, but not reduced by any amount allowed as a deduction under section 12. For the purposes of this paragraph, a transfer of community property includible in an individual's transfers shall be deemed to be a transfer of the entire community interest of both spouses in the property transferred and the transferred amount shall be the aggregate value of both halves of the community property so transferred.

(c) Election. - An individual may elect, in accordance with regulations prescribed by the Secretary or his delegate, to have all or any portion of his property to which subsection (a) is applicable treated as property to which said subsection is not applicable.

Section 16. Disclaimers.

(a) General Rule. - If an individual makes a disclaimer, as defined in subsection (b), in whole or in part with respect to an interest in property, he shall not thereby be deemed to have made a transfer under this chapter or to have possessed the interest for the purposes of this chapter.

(b) Definition. - The term "disclaimer" means the irrevocable and unqualified refusal in accordance with local law to accept, in whole or in part, an interest in property, but only if

(i) the refusal is by a written statement, made within 9 months of the interest becoming indefeasibly fixed and filed with the transferor, his legal representative, or the person who holds the legal title to the

property to which it relates; and
(ii) prior to the refusal, such individual has not waived his right to disclaim, or accepted the interest or its benefits.

Section 17. Taxable Transfers.

For transfers at death, the term "taxable transfers" means the total value of all transfers (exclusive of transfers made for an adequate and full consideration in money or money's worth, and reduced in the case of any other transfer by the amount of consideration received in money or money's worth) to which sections 19 through 28 of this part are applicable, reduced by the amount of the deductions allowed under subpart B of this part.

Section 18. Alternate Valuation.

[Present §2032, reworded to conform, except that
(i) the words "distributed" and "distribution" will be deleted from subsection (a) wherever they appear, and
(ii) the following sentence will be added at the end of subsection (a):

"For the purposes of this subsection, a distribution to a beneficiary by the executor or a trustee shall not be deemed a sale, exchange or other disposition of property unless gain or loss under subtitle A of this Title is recognized upon the distribution."]

Section 19. Property in which Individual Had an Interest.

There shall be included in the transfers of an individual at death the value of all property to the extent of his interest therein at his death. This section shall not apply to an individual's interest in property he transferred prior to his death unless such interest is certain to become possessory.

Section 20. Dower or Curtesy Interests.
[Present §2034]

Section 21. Transfers with Retained Interest.

(a) General Rule. - Except as provided in

subsection (b), there shall be included in the transfers of an individual at death the value of all property as to which he has made a transfer and has retained until his death

(i) a right or eligibility pursuant to the exercise of a power (other than a power taking effect upon the death of the person holding the power) to receive the property or the income from or the use of the property, which right or eligibility is not subject to a condition precedent (other than the exercise of such a power) immediately prior to his death; or

(ii) a power, held in any capacity either alone or in conjunction with any person, to determine the persons (other than ones described in section 31) who shall receive the property, or the income from or the use of the property, or the time at which the property or the income from or the use of the property shall be received by any such person.

Any right, eligibility or power to which this section is applicable shall be deemed to relate first to amounts constituting income from the transferred property, notwithstanding any provision of the governing instrument or local law. As used in this section, the term "power" means an authority to do any act in relation to a beneficial interest in property, including but not limited to an authority whose exercise is limited by a fixed or ascertainable standard (whether or not such an authority is exercisable pursuant to such limitation at the death of the holder thereof).

(b) Exception for Certain Charitable Transfers. - The transfers of an individual at death shall not incoude the value of any property as to which he has made a transfer to a pooled income fund (as described in section 642(c)(5)) or to a charitable remainder trust (as described in section 664) if, after his death, no person other than one described in subsection (a) of section 31 has any interest in such property.

Section 22. Powers.

[Present §2041, reworded to conform, except that
(i) subsection (a)(2) will read as follows:

"To the extent of any property (i) with respect to

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which such individual has at his death a general power of appointment created after October 21, 1942, or (ii) with respect to which he has at any time exercised or released such a power of appointment by a disposition to which section 21 would be applicable at his death if he had been the transferor of such property. For purposes of this paragraph, the power of appointment shall be considered to exist on the date of such individual's death even though

(1) the exercise of the power is subject to a precedent giving of notice, whether on or before the date of death notice has been given; or

(2) the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether on or before the date of death the power has been exercised."

(ii) subsection (b)(1)(A), relating to the exclusion from the category of general powers of appointment of powers limited by an ascertainable standard, will be deleted with reference to powers created after the effective date of the Draft;

(iii) subsection (b)(2) will read as follows:

"For purposes of this section, the lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be deemed a release of such power to the same extent it was so deemed under section 7(e) when it occurred"; and

(iv) a new subsection (c) will be added to read as follows:

"(c) Special Rule. - In any case to which subsection (a)(2)(ii) applies, the value of property to be included in an individual's transfers at death shall be reduced by the amount of such property previously included in his transfers under section 7."

Section 23. Employment Benefits.

(a) General Rule. - Except as provided in subsection (b), transfers of an individual at death shall include the value of all amounts receivable other than as insurance on his life by any beneficiary by reason of surviving the individual under any form of plan or agreement

derived from or connected with the individual's employment at or prior to his death.

(b) Exceptions. - Subsection (a) shall not apply to any amount receivable pursuant to (i) subchapter II of chapter 7 of Title 42 of the United States Code (relating to federal old-age, survivors, and disability insurance benefits), or (ii) chapter 9 of Title 45 of said Code (relating to retirement of railroad employees), unless the individual possessed at his death a right to designate the recipient of such amount, or (iii) employer contributions before [, 197].

Section 24. Joint Interests.

(a) General Rule. - There shall be included in the transfers of an individual at death the value of his joint interest, immediately prior to his death, in any property. For purposes of this subsection, each holder of joint interests in property shall be regarded as owning an equal undivided share of such property, unless his undivided share is determined by means of a different proportion under local law.

(b) Exception. - In the case of a termination at death of joint interests held by an individual who immediately prior to his death could acquire the entire property subject thereto without the consent of any other person, there shall be included in the transfers of the individual at death that part of the value of such property which bears the same proportion to the total value of such interests as the consideration in money or money's worth furnished by the individual bore to the total value of all consideration furnished for such property.

(c) Definition. - For purposes of this section, the term "joint interests" shall have the meaning prescribed for that term in section 6(c) of this chapter.

Section 25. Interest in a Trust or its Equivalent.

Except as provided in subsection (c)(8) of section 8 of this chapter (relating to excluded transfers), there shall be included in the transfers at death of an individual who is a beneficiary of a trust or its equivalent (to the extent not otherwise treated as a transfer at death) the value of property passing to his descendants upon a

termination or distribution occurring upon his death.

Section 26. Life Insurance.

(a) General Rule. - There shall be included in the transfers of an individual at death the value of all property -

(i) Group term life insurance. - To the extent of the amount receivable as group term insurance under policies on the life of the individual, by any beneficiary other than a present or former employer of the individual by reason of his status as employer.

(ii) Other life insurance. - To the extent of the amount receivable (other than as insurance includible under (i)) under policies on the life of the individual by his executor or by any other beneficiary with respect to which the individual possessed at his death any incident of ownership, exercisable either alone or in conjunction with any other person.

(b) Additional Proceeds Includible. - In any case where (i) within a period of 2 years ending with the date of his death an individual transfers any incident of ownership in a policy of insurance on his life referred to in subsection (a)(ii) and (ii) by reason of such transfer subsection (a) is not applicable, there shall be included in the transfers of the individual at death the amount receivable at death as insurance under such policy reduced by the amount previously taxed under this chapter by reason of such prior transfer.

(c) Incident of Ownership. - For purposes of this section, the term "incident of ownership" shall not include any right in or power over a policy of insurance exercisable in a fiduciary capacity unless the insured may derive an economic benefit from the exercise of such right or power.

Section 27. Property to Which Section 15 or 32 Applied.

There shall be included in the transfers of an individual at death all property or a specific portion

thereof passing to beneficiaries (including all amounts accrued or collected with respect to such property or portion but not yet distributed), and not includible in his transfers under any other section of this part, as to which (i) a deduction was allowed under section 15 or 32, and (ii) the individual immediately prior to his death possessed a current beneficial interest. For purposes of this section, the value of the right to receive a fixed dollar amount per year which is payable from a separate fund shall be that percentage of the total as of the termination of such right which the fixed dollar amount is to the annual net income of the fund, as of the date of transfer, computed by use of the rate of return prescribed on such date of transfer for the valuation of interests in transferred property under this chapter.

Section 28. Transfer Taxes Paid on Transfers Other Than at Death.

There shall be included in the transfers of an individual at death an amount equal to the transfer taxes

(1) on his taxable transfers within a period of 2 years ending with the date of his death, and

(2) on any other taxable transfers for which a credit is allowable under section 35.

Section 29. Disbursements.

(a) General Rule. - There shall be allowed as a deduction amounts, allowable under local law, which are paid after an individual's death from property included in his transfers at death or included in his transfers within a period of 2 years ending with the date of his death

(1) for funeral expenses;

(2) for claims against such property, including amounts payable to a spouse under a decree of divorce or of separate maintenance, or under the terms of a written instrument incident to such divorce or separation, or under a written separation agreement, if the spouses lived apart continuously after the entry or execution thereof; and

(3) for expenses incurred in connection with the administration of such property, provided that such expenses incurred in connection with property not subject to claims are paid before the expiration of the period for the assessment of tax under this chapter. For purposes of this section, a claim founded upon a promise or agreement shall be deductible only to the

extent that it (i) is contracted for an adequate and full consideration in money or money's worth, or (ii) would be deductible under section 31 if the amount were transferred in the form of a bequest.

(b) Estate, Succession, Legacy, Inheritance or Transfer Taxes. - No deduction shall be allowed under this section for estate, succession, legacy, inheritance or transfer taxes, except that, if such a tax is imposed on property for which a deduction is allowable under section 31, the executor may, subject to such conditions as are imposed pursuant to regulations prescribed by the Secretary or his delegate, elect to deduct under this section the amount of such tax.

Section 30. Losses.
[Present §2054]

Section 31. Charitable Deduction.

[Present §2055(a)-(e), reworded to conform, except that

(i) subsection (c) will begin as follows:

"If the tax imposed by section 1, or . . . "; and

(ii) a new subsection (e)(3) shall be added:

"No deduction shall be allowed under this section for an interest in property for which a deduction is allowed under section 15 or 32 by reason of the same transfer."]

Section 32. Marital Deduction. -

(a) Allowance of Deduction. -
(1) (A) General Rule. - Subject to the limitation of paragraph (2) of this subsection, there shall be allowed as a deduction the value of all property included in an individual's transfers at death which passes outright to his spouse or in which his spouse possesses a current beneficial interest.
(B) Property Formerly Held as Community Property. - If after [, 197] property held as community property was by an individual and his spouse converted, by one transaction or a series of transactions, into separate property of the individual and his spouse (including any form of co-ownership by

them), a deduction shall be allowed under this section with respect to any property acquired at any time by him in exchange therefor (by one exchange or a series of exchanges) which shall not exceed one-half the excess of $250,000 over the sum of

(i) twice the amounts previously allowed as a deduction under section 15 with respect to transfers of such converted community property, and

(ii) all other amounts previously allowed as a deduction under section 15.

(2) Limitation. - (A) The deduction provided in paragraph (1) of this subsection, when added to amounts previously deducted under section 15 shall not exceed an amount equal to the greater of $250,000 or one-half of the value of an individual's adjusted transfers.

(B) If available records are such that, under regulations prescribed by the Secretary or his delegate, the limitation on the amount of the deduction allowable under this section cannot be computed under subparagraph (A) hereof,

(i) the deduction allowed under this section shall not exceed one-half of the value of property transferred at death reduced by the amount of the deductions allowable under sections 29 and 30, and

(ii) no deduction shall be permitted under this section for a transfer at death of property described in subparagraph (B) of paragraph (1) of this subsection.

(C) In computing the applicable limitation imposed by this paragraph (2), the fact that a deduction is allowed under this subsection for property which is included in the individual's transfers at death under sections 23 or 26(a)(i) shall be disregarded, to the extent that such property constitutes

(i) amounts payable or receivable under

(1) an employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of his separation from employment (whether by death or otherwise), or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) a retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of his separation from employment (by death or otherwise), or at the time of termination of the plan if earlier, was a plan

described in section 403(a);

(3) a retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (vi), or which is a religious organization (other that a trust), and which is exempt from tax under section 501(a);

(4) chapter 73 of Title 10 of the United States Code; or

(5) a plan established in accordance with those provisions of this Title amended by P. L. 87-792 to encourage the establishment of voluntary pension plans by self-employed individuals; or

(ii) proceeds of policies of group-term life insurance not in excess of $50,000.

(3) Effect of Delay in Distribution. - The fact that the spouse of an individual will not receive property pursuant to an outright transfer, or will not receive the income from or the use of property or an annuity from property, until a distribution of such property is made by an executor or a trustee pursuant to the terms of the governing instrument shall not prevent the spouse's interest in such property from satisfying the requirements for the deduction provided in this section, unless the executor or trustee is, by the specific terms of such instrument, authorized or directed to delay the distribution beyond the period reasonably required for administration of the individual's estate.

(4) Exercise of Elective Rights. - If the spouse of an individual becomes entitled under local law to exercise a right with respect to property included in the individual's transfer at death, including but not limited to rights of dower or curtesy or a right to an election in lieu thereof, and such right is exercised, the exercise shall be deemed to have occurred as of the date of death of the individual for purposes of this section.

(b) Definitions. - For purposes of this section,

(1) Current Beneficial Interest. - (A) the term "current beneficial interest" means a right for life, commencing as of the date of transfer, (i) to all the income from property or all the income from a specific portion thereof, payable annually or at more frequent intervals, or (ii) to the use of property or a specific portion thereof.

(B) For purposes of subparagraph (A),

(i) a right to receive payments from a charitable remainder trust (as described in section 664) shall be considered as a right to all the income from the property held in the trust if the payments

described in paragraphs (1), (2) or (3)(A) of section 664(d) may be made only to the spouse; and

(ii) a right to receive a fixed amount per year shall be considered a right to receive all the income from property or a specific portion of such property.

(2) Property Passing Outright. - The term "property . . . which passes outright" includes

(i) property (other than property or a specific portion thereof from which payments are to be made pursuant to a right described in paragraph (1)(B)(ii) of this subsection) held as a separate fund, under regulations of the Secretary or his delegate, in which no person other than the spouse or her estate has any beneficial interest except pursuant to the exercise by the spouse of a general power of appointment described in section 22, and

(ii) property paid to the spouse or her estate before the date prescribed for the filing of the transfer tax return as an allowance or award made after the decedent's death pursuant to local law for the support of the spouse during the settlement of the decedent's estate.

(3) Adjusted Transfers. - The term "adjusted transfers" of an individual means

(i) the total value of the individual's transfers during life and subsequent to [,197], reduced by any amounts applicable thereto for which exclusions are provided in section 11 and by any amounts for which a deduction was allowed under section 14, but not reduced by any amount allowed as a deduction under section 12, and

(ii) the total value of the individual's transfers at death, reduced by the amount of the deductions allowable under sections 29 and 30.

For the purposes of this paragraph, a transfer of community property includible in an individual's transfers at death shall be deemed to be a transfer of the entire community interest of both spouses in the property transferred and the transferred amount shall be the aggregate value of both halves of the community property so transferred.

(c) Election. - An individual may elect by will, under regulations prescribed by the Secretary or his

delegate, to have all or any portion of his property to which subsection (a) is applicable treated as property to which said subsection is not applicable.

Section 33. Previously Taxed Property.

(a) General Rule. - Subject to the limitation of subsection (b), there shall be allowed as a deduction in computing the taxable transfers of an individual the value of property transferred to the individual within a period of ten years ending with the date of his death to the extent that such property was taxed under this chapter. The value of the property so transferred shall be determined as of the date of the prior transfer.

(b) Limitation. - (1) The deduction provided in subsection (a) shall not be available for any interest in a trust or its equivalent except to the extent property constituting the trust or its equivalent is included in the individual's transfers at death or was paid or distributed to him prior to his death.

(2) If the date of the prior transfer was more than six years before the individual's death, the deduction provided in subsection (a) shall be reduced as follows:

(i) by 20% if the individual dies after the expiration of six years from, but before the expiration of seven years from, the date of the prior transfer;

(ii) by 40% if the individual dies after the expiration of seven years from, but before the expiration of eight years from, the date of the prior transfer;

(iii) by 60% if the individual dies after the expiration of eight years from, but before the expiration of nine years from, the date of the prior transfer;

(iv) by 80% if the individual dies after the end of the ninth year from the date of the prior transfer.

Section 34. Credit for Transfers at Death.

There shall be allowed as a credit against the tax imposed by section 1 on transfers at death the lesser of

(1) the amount of such tax; or

(2) $10,000 reduced by an amount equal to a tax imposed at the rate of 10% on the aggregate of the

amounts allowed as a deduction pursuant to section 12 and any equivalent provision of prior law.

Section 35. Credit for Transfer Taxes Previously Paid.

If a tax imposed by section 1 has been paid by an individual with respect to a transfer of property to which section 21 thereafter applies, and if, after the transfers, the property has not been included in the transfers of any other person, the amount of such tax shall be allowed as a credit against the tax imposed by section 1 upon such individual's transfers at death.

Section 36. Credit for State Death Taxes.
[Present §2011]

Section 37. Credit for Death Taxes on Remainder.
[Present §2015]

Section 38. Credit for Foreign Death Taxes.
[Present §2014]

Section 39. Liability for Payment.
[Present §§2022, 2502(d)]

Section 40. Recovery of Taxes Claimed as Credit.
[Present §2016]

Section 41. Definition of Executor.
[Present §2203]

Section 42. Discharge of Fiduciary from Personal Liability.
[Present §2204]

Section 43. Reimbursement Out of Estate.
[Present §2205]

Section 44. Apportionment of Tax.

(a) Tax Imposed by Section 1. - Unless an individual directs otherwise in his will -

(1) Property Included Under Section 25 or 27. - if any part of his taxable transfers at death consists of property included in such transfers under section 25 or 27, there shall be paid from such property a portion of the tax imposed by section 1 equal to the tax on the value of such property calculated at the

highest marginal rates of tax applicable to his transfers at death.

(2) Property Included Under Section 22 or 26. - if any part of his taxable transfers at death consists of property included in such transfers under section 22 or 26, received or receivable by one or more persons other than the executor, there shall be paid from such property such portion of the tax imposed by section 1 (less the tax apportioned under paragraph (1)) as the value of such property bears to the total taxable transfers (less the amount therein to which paragraph (1) is applicable).

(3) Property Included Under Section 28. - if any part of his taxable transfers at death consists of an amount included in such transfers under section 28, there shall be paid from the property whose transfer caused section 28 to become applicable such portion of the tax imposed by section 1 (less the tax apportioned under paragraph (1)) as the value of such amount bears to the total taxable transfers (less the amount therein to which paragraph (1) is applicable).

Section 45. Missionaries in Foreign Service.
[Present §2202]

Section 46. Members of the Armed Forces Dying During an Induction Period.
[Present §2201]

Section 47. Certain Residents of Possessions Considered Citizens of the United States.
[Present §§2208,2501(b)]

Section 48. Certain Residents of Possessions Considered Nonresidents not Citizens of the United States.
[Present §§2209,2501(c)].

COMMENTARY

Section 1. Basic Tax.

This section involves two of the five most important issues in the Draft - what is an appropriate rate structure and whether al transfers made during life or at death should be taxed under a single transfer tax rate structure.

A. Single Rate Structure

Generally speaking, current law imposes an estate tax on transfers at death and a gift tax on transfers during life. Each tax has a separate rate schedule and a different exemption. The gift tax rates are three-quarters of the estate tax rates in the same rate brackets. The estate tax exemption (deduction) is $60,000. The gift tax exemption is $30,000. An annual gift tax exclusion of $3,000 for gifts of present interests to any number of persons is also available. The gift tax is imposed on the actual amount of the gift - the gift tax itself is not treated as an additional transfer subjected to tax. Under the estate tax law, the tax itself is subjected to tax because it is imposed on the gross estate reduced only by the deductions. Despite the substantial tax incentive for lifetime giving, only a small percentage of the individuals for whom estate tax returns are filed make such gifts in amounts exceeding the lifetime exemption and the annual exclusions.

An important policy question involved in determining whether there should be a single rate structure applicable to lifetime transfers and transfers at death is the extent to which lifetime giving should be encouraged. We believe such giving should be encouraged, and certainly not actively discouraged, because of our belief that it is socially desirable to have property transferred to or for the benefit of younger generations where there is usually a greater need and a greater willingness to make the property productive. Thus, the issue becomes whether the present dual rate structure strikes a proper balance between creating incentives for lifetime giving and being fair as between different taxpayers.

This question is one upon which reasonable men can differ. The fact that the Reporter for the ALI Project decided not to put a resolution involving it before the Institute for a vote indicates the difficulty. The Reporter states (pages 56-57):

"In the work of the Reporter, the Consultants and the Tax Advisory Group, the underlying question of the desirability or undesirability of shifting from the present dual tax system of estate and gift taxation to a unified tax was extensively considered. The issue was considered by the Council which was almost evenly divided, favoring retention of a dual system by a majority of but one vote. Given the complexity and difficulty of the problem, the time required for its thorough exploration and the improbability of reaching any clear consensus, the Reporter, with the approval of the Council, did not propose a resolution on the issue. The Institute supported this abstention. There is, therefore, no ALI recommendation on the choice between a dual tax system and a unified tax."

We recognize the force of the contention that current law grants an undue preference to lifetime gifts which should be corrected because it prefers the relatively wealthy individual who can afford to make significant lifetime gifts over the less well-to-do individual who cannot afford to do so. If it assumed that the revenue to be produced by the transfer tax system is to remain the same under a single rate structure, the "unified" rates would be below the present estate tax rates. The revenue effect of unification - the increase in death taxes that would result from taking into account prior lifetime transfers - has been estimated as a long run increase of 7%. (ALI Project, page 413).

Section 1 establishes a single rate structure for all transfers, whether made during life or at death. Our acceptance of a single rate structure is conditioned upon the rates being lowered to offset the additional transfer taxes that will be payable at death by persons who make taxable transfers during life. This qualification accords with the position taken by the ALI Project, in recommendation 45, which states (page 57):

"Inasmuch as the primary justification for changing to a unified tax system is to keep the rates on deathtime transfers by those who do not or cannot make lifetime transfers at a lower rate than would be possible under a dual tax system, it should be understood by those charged with determining the rate structure, if a unified tax is adopted, that the purpose of the shift to a unified tax would be undermined if the rate structure evolved under it were designed to produce more revenue than would be produced under a dual tax system."

The Studies not only recommend a single tax structure (page 355), but also propose a "grossing-up" concept as to lifetime gifts. This concept is explained as follows (page 369):

> "The tax will be imposed upon the fair market value of the property transferred, including in the case of lifetime transfers the amount of the Federal transfer tax incurred on the transfer, which is an integral part of the making of the gift. Under present law the tax upon lifetime gifts is based upon the fair market value of the property transferred exclusive of any gift tax. However, in the case of testamentary transfers, the present estate tax is imposed on the full value of the property in the estate, including that portion used to pay the estate tax imposed. Under the unified transfer tax this difference in treatment between lifetime gifts and testamentary transfers is eliminated by 'grossing up' the fair market value of lifetime gifts, thus causing the transfer tax in effect to be paid out of the property taxed, as is the case with testamentary transfers. A table would be provided showing the amount of the grossed-up transfer in order that taxpayers will not be burdened with complex calculations."

The Studies then state that "Since some incentive for making lifetime gifts is economically desirable, the present $3,000 annual exclusion would be retained" (page 355).

We oppose the use of grossing-up for all lifetime transfers on two grounds. First, lifetime gifts are actually discouraged since the payment of the additional transfer tax imposed on the tax results in the loss of subsequent earnings on that amount during the remaining life of the transferor. Second, grossing-up is complicated and will not be understood. The complexity is indicated by the Studies reference to the necessity of a table "in order that taxpayers will not be burdened with complex computations". As to understanding, a person who makes a transfer of $25,000 to a child recognizes that he has made a gift of that amount, but he will have difficulty in comprehending why he will be deemed to have made an additional taxable gift of the tax on the $25,000. The common denominator of the two current but different methods of imposing the estate tax and the gift tax is, of course, simplicity - a desirable but elusive objective.

The grossing-up concept is, however, applied in Section 28 as to transfers made within two years of the decedent's death in order to prevent a transfer tax saving by

a "death-bed" transfer. The combined effect of Sections 1 and 28 is to reduce substantially the present tax incentive in favor of lifetime gifts and to have as the sole remaining incentive the absence of a tax on the transfer tax itself for transfers made more than two years before death.

B. Rate Structure

The rate schedule in Section 1 is significantly lower than the current estate tax rate schedule. Its use would involve a substantial revenue loss and would be warranted only if revenues of approximately the same amount as the reduction were generated from some other source. Under the Draft, this source is primarily the AET imposed by Section 2. It is, of course, impossible to determine precisely what amount of revenue would be produced by the AET. The Studies state (pages 333-34)

> "On estate tax returns filed in 1966, the total value of property of a type that might show appreciation (stock, real estate, trust interests and noncorporate business assets) was about $15 billion. The portion of this that represented appreciation was probably in the range of 40 to 50 percent.
>
> This suggests that the appreciation passing through the estate of estate tax filers in 1966 must have been in the general magnitude of $6 to $8 billion, or about $7 billion. An additional amount of appreciation about 65 percent as large, or about $4.5 billion, passed from decedents for whom an estate tax return was not required."

The figures referred to in the quotation are now out-of-date. More recent figures for estate tax returns filed in 1970* indicate that the total value of assets that might show appreciation is in excess of the $15 billion figure. Further, our experience indicates that the 40-50% figure suggested as the portion represented by appreciation is low. We believe that the additional new revenue that would be derived from subjecting the amount of net appreciation to the AET at a 14% rate of tax, plus that derived from other changes in current law made by the Draft, should closely approximate the annual loss in revenue from the rate schedule set forth in Section 1 after the effect of a single transfer tax rate structure is considered.

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* Statistics of Income - 1969, Estate Tax Returns, Internal Revenue Service Publication 764 (7-72).

The largest percentage reduction in Section 1 rates, as compared to the current estate tax rates, is made in the lower bracket rates. The current estate tax rates commence at 3% on the first $10,000 and then increase rapidly to 30% at a taxable estate of $100,000. This steep progression has been criticized by the ALI Project (pages 47-49), the Studies (pages 355-56, 370) and the overwhelming majority of interested groups and individuals.

Section 2. Additional Tax on Certain Transfers

A. Introduction

Under the current federal estate tax law, property included in a decedent's gross estate is given an income tax basis equal to its estate tax value. Thus, unrealized appreciation in the form of the difference between the decedent's basis and this value escapes income taxation. This result has been criticized as a "loophole" in our present tax laws.

Unrealized appreciation at death does not, however, escape tax entirely since it is subject to estate tax. Put another way, imposition of an income tax on such appreciation at death would result in an estate tax loss because the income tax would be a deduction in computing the estate tax. Clearly, no "loophole" exists as to property transferred during life and not subject to federal estate tax because the basis of such property is not increased to its fair market value at the time of the gift.

The current basis rule for a decedent's property is also criticized as having an undesirable "lock-in" effect on capital assets which have appreciated substantially since acquisition. An older individual holding such assets acquired many years ago will naturally be reluctant to reduce those assets to cash while alive at a substantial income tax cost when he knows that, if held to death, the assets will receive a stepped-up income tax basis.

The "lock-in" problem has been magnified by the changes made in the Tax Reform Act of 1969 which limit the use of the alternative method of computing the tax on capital gains to the first $50,000 of gains and which, subject to certain limitations, impose a minimum tax of 10% on one-half of the gains. The result of these changes is an income tax on capital gains that may exceed the old 25% limitation by more than 10%. We do not believe this problem is susceptible of a truly effective solution without the creation of a significant tax incentive for

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selling during life. Such a solution might be a transfer tax credit for certain capital gains taxes, which is contained in H.R. 3068 that was introduced by Representative Broyhill.

Two changes in the current basis rule have been widely discussed. The first is to impose an income tax on unrealized appreciation at the time of transfer, whether during life or at death and, if the transfer is made at death, to allow a deduction in computing the estate tax for this income tax.

The second suggested change is to carryover the decedent's basis for his property to the beneficiaries receiving this property as a result of a transfer at death, and to increase the basis of each asset having unrealized appreciation by its proportionate share of the estate tax imposed upon the net unrealized appreciation in all estate assets. Thus, the basis rule for transfers subject to estate tax would, in general, be the same as the present basis rule in section 1015(d) for transfers that are subject to gift tax. The reason for increasing the decedent's basis by the part of the estate tax attributable to the net unrealized appreciation is to prevent a double tax - an estate tax and an income tax - being imposed on an amount equal to that part. The capital gains tax at death proposal eliminates the double tax in a different manner - by granting an estate tax deduction for the income tax on the net unrealized appreciation at death.

Any change in the basis rule will introduce more complexity into the administration of estates and therefore increase the time required to administer them and the costs of administration. Current law has the virtue of simplicity since basis becomes irrelevant upon death and problems of proof of basis disappear.

We oppose <u>any</u> change in the basis rule unless it is accompanied by

a. A reduction in current estate tax rates so that the "cost of dying" is not increased;

b. A liberalization in the rules with respect to proof of basis so that if the facts necessary to determine basis are unknown it will be the fair market value as of the date (or approximate date) when the property was acquired by the decedent; and

c. A current "start-up" date so that property owned by an individual on the effective date of the change would be given a new basis equal to its current market value for the purpose of applying the change to property owned at death.

Assuming these three conditions would be satisfied, we favor taxing unrealized appreciation at death to carryover basis. We have, however, rejected a capital gains tax at death in favor of an additional estate, or transfer, tax (AET) on such appreciation. This tax would apply to property transferred at death and to property transferred within two years of death if it is not sold prior to death. The AET would not apply to other lifetime transfers, as to which carryover basis would be continued.

Some people will say that the AET is nothing more than a capital gains tax at death in disguise. They are correct in the sense that the result is the same - the taxation of net unrealized appreciation at death. However, as will be explained in detail below, there are significant differences between these two approaches to taxing such appreciation. These differences are so important to us that if the choice were only between a capital gains tax on net appreciation transferred during life or at death and carryover basis we would favor carryover basis. In order fully to understand our reasons for preferring an AET, it is necessary to examine in detail the capital gains tax and carryover proposals.

B. Carryover Basis

The carryover basis concept would raise a number of problems, regardless of the exact form the statute would take.

Determining Basis. Under existing law basis becomes irrelevant upon death. Accordingly, many persons have not maintained satisfactory records with which to establish basis. Any change to a carryover basis rule would work to the disadvantage of and produce hardships for individuals who acquired assets from such persons. Fairness requires that any carryover basis rule should permit a person acquiring property at death that (i) was owned by the transferor on the date of enactment of the rule or (ii) was owned by another person on such date who transferred it by gift to the transferor after that date to use as the transferor's basis the property's value on that date for the purpose of computing gain (but not loss).

Administrative Complexity and "Suspended Basis". If an estate consists of a number of assets, the allocation of the increase in basis attributable to the estate tax may require a considerable amount of time. Further, this increase will be uncertain ("suspended") until the estate tax is finally determined and by that time there may have been a number of sales of assets and the income tax returns reporting these sales will have to be readjusted to determine gain or loss to reflect the change in the final estate tax figures.

"Lock-In". Carryover perpetuates rather than solves the "lock-in" problem. It is clearly a less satisfactory solution to this problem than current law or a tax on net unrealized appreciation at death, which have the effect of freeing up the flow of capital assets no later than at death. Carryover has this effect only to the extent that appreciated property must be sold after death to raise funds with which to pay death taxes, administration expenses and claims.

No Satisfactory Way to Increase Basis. There is no simple and fair way to provide for an increase in basis for the estate tax attributable to the net unrealized appreciation when a marital deduction, or community property, is involved. Under the carryover proposal, the basis of all estate property (including the qualifying for the marital deduction or the surviving spouse's share of the community property) would be increased by the estate tax attributable to net appreciation.* This result is unfair because property qualifying for the marital deduction, or the surviving spouse's share of the community, does not generate any estate tax. The entire basis increase should be allocated to the non-marital property and none to the surviving spouse's share of community property. The effect of not making such an allocation would often be to increase the capital gains taxes incurred to raise funds with which to pay estate taxes because the basis increase in the non-marital property or the decedent spouse's share of community property will be lower than it would be if the entire increase were allocated to such property.

In a non-community property estate involving the marital deduction, a solution is difficult because it will not be known at a decedent's death what property passes to the marital and non-marital funds and, therefore, the property entitled to the basis increase is uncertain at the very

* See, for example, Section 106 of H.R. 1040 (The Tax Equity Act of 1973).

time sales will be made for taxes. In a community property estate, the basis adjustment can easily be allocated entirely to the decedent's half of community assets but in so doing the surviving spouse is penalized because under existing practice sales of community assets to raise funds for taxes, administration expenses and community debts to involve both halves of the community assets and the surviving spouse is involuntarily burdened with reporting gain realized as to her community half of each community asset sold by the personal representative.

Mushroom Tax Effect of Carryover. In many cases, one being where the estate consists of "one asset" - a farm or a closely-held business - which cannot be divided for sale to meet its obligations, the effect of the carryover basis rule may prove little different from a tax on net appreciation at death. In order to raise funds to pay the estate tax, the executor will realize capital gains and will then have to make additional sales to pay the income taxes on the gains, thus creating a "mushroom" tax effect. To the extent that capital gains must be realized in order to raise funds with which to pay the estate tax, carryover amounts to a partial capital gains tax at death.

Funding Marital Bequests. There are two basic types of marital deduction formula clauses - pecuniary (fixed sum) amount or fractional share. Under current law, satisfaction of a pecuniary clause with appreciated property results in a realization of gain in an amount equal to the difference between the basis and current value of the property when distributed. The recipient takes over new bases for the distributed assets equal to their date of distribution values. Many lawyers prefer this type of clause to the fractional share clause because it simplifies administration. The gain problem could be very serious under carryover basis. While it could be cured by changing the income tax law so as not to treat the satisfaction of a marital bequest in a pecuniary amount as a taxable transaction, this solution would not be entirely satisfactory since the executor in funding the bequest could affect the rights of the beneficiaries significantly by his choice of the property that he selects in that he may use "high" or "low" basis property. The fiduciary duty of impartiality might suggest that the executor would have to make a pro rata division of basis between the marital and non-marital portions of the estate. Such a requirement would produce complexity in making partial distributions and tend to remove one of the primary advantages of the pecuniary bequest, namely, simplicity.

Net Tax Increase. A serious reservation that we

have regarding carryover is that its enactment would not be accompanied by a significant reduction in transfer tax rates applicable to transfers at death. Under carryover a part of the tax (i.e. the income tax on gain when the property is sold) is deferred until the sale. This, in combination with the addition to basis of the estate tax on net unrealized appreciation, makes it very difficult to devise a reduced rate structure which will properly reflect the additional tax attributable to the carryover.

C. Capital Gains Tax on Net Unrealized Appreciation

1. The Proposal

A capital gains tax at death was proposed by the Treasury Department in the 1963 hearings before the Ways and Means Committee and was rejected. It was resurrected in slightly modified form in the Studies. The major elements of this most recent proposal (the Proposal) are:

1. The decedent's final income tax return would include all appreciation on capital assets as if the assets had been sold immediately prior to death. Also, the unrealized appreciation in property transferred by gift rather than at death would be subject to income tax at the time of the transfer.

2. Unrealized losses on capital assets would be allowed on the decedent's final return and if the losses exceed gains an offset would be allowed against capital gains for his three prior taxable years and then against ordinary income for the year of death and three prior years. Losses on lifetime gifts would also be allowed except as to transfers between related parties described in section 267.

3. All gains would be long term regardless of the holding period.

4. The income tax on the gains taxed at death would be deductible in computing the estate tax payable.

5. Only appreciation occurring after enactment would be taxed. With regard to assets held on the enactment date, in computing gain the taxpayer could claim as his basis the higher of actual basis or value on the enactment date and in computing loss the taxpayer would use the lower of actual basis or value on the enactment date.

6. Gain on property qualifying for the marital or charitable deduction or for the orphan's exemption and on personal and household effects having a value of not more than $1,000 per item would not be taxed. Losses on all personal and household effects would be disallowed.

7. When property passes to a spouse or charity or qualifies for the orphan's exemption and the gain is exempt from tax, the basis of all property in the estate would be reallocated to each asset based upon fair market value before the taxable gain, if any, is computed.

8. A minimum basis of $60,000 would be allowed so that no tax would be due if the value of the estate was not more than $60,000.

9. Items giving rise to ordinary income (now classified as income in respect to a decedent) would be "accrued" and reported on the decedent's final return but would be eligible for income averaging.

2. A Critique

We believe the Proposal is, for the reasons discussed below, unfair and overly complex and therefore is an unacceptable approach to taxing appreciation at death.

a. Regressive Nature of Tax.

Fairness must be a central feature of any tax. The impact of the Proposal imposed in connection with an estate tax is uneven and favors the large estate. Put another way, the effect of the new tax would be regressive when considered with the estate tax. This is caused by the removal, through an estate tax deduction for the capital gains tax, from the estate tax base of a portion of the estate assets which would otherwise be taxed at the highest estate tax rate or rates. Thus, the true rate of new tax on the gain is a function of the complement of the highest estate tax rate or rates at which the deducted capital gains tax would otherwise be taxed in the estate (i.e. the complement of x is 100-x). To illustrate using current rates, an estate taxed at the highest rate of 77% would be subject to an effective net additional tax commencing at only 23% of the actual capital gains tax paid but an estate whose highest estate tax rate was 30% would be subject to an effective net additional tax of at least 70% of the actual capital gains tax paid. Lower estate tax rates alone cannot remedy the inequitable and unfair impact of the capital gains tax proposal on the medium estate.

The regressive nature of a capital gains tax on net unrealized appreciation at death is clearly demonstrated by the following illustration, employing the lower transfer tax rate schedule of the Studies. Assume a taxable estate, before tax but after expenses and claims have been deducted and with no marital or charitable deduction, of $4,500,000, with assets having a total basis of $1,500,000. Under current law, the estate tax is $2,115,400, or 47% of the total estate. Using the maximum 25% rate of tax in effect when the Proposal was made, the capital gains tax is imposed on the appreciation in the estate, $3,000,000, and the amount of this tax, $750,000, is deducted from the assumed estate of $4,500,000 to result in a taxable estate after allowance for the specific exemption of $3,690,000. The transfer tax, using the lower rates proposed in the Studies, will then be $1,373,100. The total tax "cost of dying" will be $2,123,100, a negligible increase of $7,700 in tax revenue over current law.

If, however, the taxable estate were $450,000, with assets having a total basis of $150,000, the current estate tax is $110,500, or 24.5%. Again using a 25% rate of tax, the capital gains tax would be $75,000, and the taxable estate before the exemption would be $375,000. The Studies transfer tax is $66,150, and the "cost of dying" will be $141,150 - an increase in tax over current law of $30,650 or 28%.

When the percentage increase in tax in the smaller estate is compared with that of the estate ten times larger having the same proportion of net appreciation, the regressiveness is apparent. Using current capital gains rates, rather than the 25% rate, and the transfer tax rates in the Studies, the disparity in result between the medium and large estate becomes even more pronounced. The increase in tax for the large estate would be 7.6%, while the increase in tax for the medium estate would be 44.7%.

The disastrous effect that such an overall increase in tax would have on a medium estate consisting largely of a closely held business is apparent.

b. Technical Objections to the Proposal.

The regressive operation of a capital gains tax on net unrealized appreciation included in a decedent's gross estate is, standing alone, sufficient reason to justify its rejection. In addition, there are technical reasons to reject the Proposal or parts thereof.

(1) Complexity.

The Proposal is needlessly complex. Complicated adjustments and computations will be required in all but the simplest estates. Exclusions and exemptions are included which are either inappropriate or inadequate. Administration is complicated by payment of the tax through two returns, an income tax return and a transfer tax return. The discussion which follows points up the aspects of this unnecessary complexity.

(a) Reallocation of Basis-Marital, Charitable and Orphan's Exclusions.

The reallocation of basis concept is one of the most objectionable features of the Proposal in that when applicable it would introduce substantial complexity into the administration of estates. The reason for its use is explained as follows:

> "The exemption on property passing to a surviving spouse, to orphans, or to charity requires a special rule relating to basis, so that, in the case of the spouse or orphans, the gain that escapes tax at the death of the decedent will be taxed when the property is transferred by such spouse or orphan. The basic objective of using allocated, rather than actual, basis is to eliminate any tax incentive for the decedent or his executor to transfer any particular piece of property to any particular person or entity, where such a disposition might be undesirable from a nontax standpoint." (Studies at page 345).

Reallocation of basis would be unnecessary if there were no exemptions for transfers to certain classes of beneficiaries. The Proposal takes the position that it is inappropriate to impose a capital gains tax on property which qualifies for the marital deduction, for the charitable deduction or, subject to certain limitations, which passes to orphans (a child of the decedent under the age of 21 years, if the other parent of the child does not survive the decedent). When applicable, the exemptions would create a "hybrid" system of part capital gains tax at death and part carryover of basis that would raise administrative problems and add considerably to the time required to administer estates.

The most serious administrative problem - that of "unknown" basis - will arise in any case where a reallocation

is required and, as is usually the case, the "exempt" property is not segregated as of the decedent's death. To illustrate, assume that the decedent leaves one-half of his residuary estate to his wife and one-half to his children and the executor makes sales of assets shortly after death, in part to raise cash for expenses, claims and taxes and in part for investment reasons. How is the executor to determine the income tax cost basis for the assets sold? Logically, all sales for expenses, claims and taxes or for investment reasons and allocable to the children's share should be exempt from tax except to the extent the value of the property sold exceeds its estate tax value and all sales for investment reasons and allocable to the marital share should be taxed based upon reallocated basis. It is, however, impossible to make such differentiations until the administration of the estate is completed and the amounts needed for expenses, claims and taxes are finally determined and the respective shares are fully distributed. As a practical matter, the reallocation of basis provision is, because of the uncertainty it produces, unworkable in the type of "typical" case under discussion.

Reallocation would apply to a large number of estates (apparently even to cases where charity is given a small cash bequest); when there are a number of different assets the reallocation process would be time-consuming. Further, a serious problem would be presented in connection with funding marital bequests. Even assuming that a complete inter-spousal exemption is enacted, there would still be many cases where the decedent would prefer to divide his property in such a manner that one-half would be taxed in his estate and one-half in his wife's estate in order to reduce the combined transfer taxes on both estates. Thus marital deduction formula clauses would continue to be used and the same problem discussed above concerning the realization of gain upon the funding of a bequest of a pecuniary amount qualifying for the deduction would be present.

The orphan's exemption bears no relationship to need and seems unnecessary. An allowance for minor children was a part of the estate tax law until 1950 (1939 Code, section 812(b)(5)). It was repealed. No reason has been given that justifies its reinsertion into the law, particularly if there is a reduction in the transfer tax imposed on transfers at death. Also, its amount - $3,000 multiplied by the difference between 21 and the child's age at the decedent's death - will in many cases be hopelessly inadequate and not even cover basic educational costs.

The charitable exemption in the Proposal, seems

unduly broad in that it would appear to exempt from any tax gain on assets transferred to charity in satisfaction of a cash legacy where the benefit of the exemption would not increase the amount passing to charity.

(b) Interdependent Computations

The Proposal may involve interdependent computations of the capital gains tax and the transfer tax when gain must be recognized to pay administration expenses and claims and the capital gains tax will reduce the value of property that will pass to the surviving spouse or charity and qualify for the marital or charitable deduction. The amount of the marital or charitable deduction is dependent upon the capital gains tax and the amount of this tax is dependent upon the amount of property that qualifies for the deduction. An unlimited marital deduction does not avoid this problem. The average practitioner will, at best, have difficulty with the interdependent computations and, at worst, be unable correctly to determine the taxes.

(c) Income in Respect of a Decedent

The Proposal would change the current method of taxing income in respect of a decedent, commonly referred to as 691 income. This change is not a necessary part of evolving a system for taxing net appreciation at death, which is fundamentally concerned with taxing capital rather than income. The Studies state (page 347) with respect to 691 income:

> "The rules presently contained in section 691 were developed to avoid the bunching of income in the decedent's final return. But the complexities of section 691 have created troublesome problems. Therefore, for decedents dying after December 31, 1969, section 691 would cease to have application. The basic rule would be that gain on an asset, the sale or exchange of which would produce ordinary income or capital gain, or a combination of both, will be taxed at death with ordinary income to the required extent and capital gain as to the remainder." (emphasis added)

Under the Proposal a recipient of property now classified as 691 income and subject to taxation as ordinary income would receive a basis for such property equal to its value on the applicable valuation date and the amounts received by the recipient in excess of (or below) basis would result in ordinary income (or loss). In substance, the Proposal would recreate the problem - bunching of income at one point

of time which will actually be received over a longer period - which led to the enactment of section 691 in the first place.

The quotation creates a false impression. The major administrative problems relate not to bunching but to liquidity and valuation. 691 income is unique in that in many cases it is not marketable and/or difficult to value. The Studies recognize that liquidity is a problem. It is, therefore, difficult to understand why the Proposal accentuates this problem by accruing all payments in the decedent's final taxable period.

The quotation also creates the impression that the complexities relating to 691 income will be removed if it is accrued at death. This is not the case. The same problems would continue to exist under an accrual concept. When the income in respect of a decedent will fluctuate in amount and is not payable upon the decedent's death (thus requiring a discount in taxing it in the decedent's final return) its receipt by the recipient will result in the realization of ordinary income (or an ordinary loss) under the Proposal. In such cases the Proposal does not simplify but rather complicates the taxation of 691 income since the slate is not wiped clean as of death. Further, in some cases the recipient might not be able to take advantage of any ordinary loss that would be available under the Proposal.

(d) Net Losses

The Proposal would permit any net unrealized loss at death to offset gains in the decedent's final taxable year, then to offset gains realized during the three preceding taxable years and finally, subject to certain limitations, to offset ordinary income for the year of death and the three preceding taxable years. Aaditional complexity and expense would result from refund claims while the benefit to be derived from refunds is lessened by the higher transfer tax as a result of any refund being an asset of the decedent's estate and increasing the gross estate. Further, when there is a net loss upon death, the benefit to be derived from it may depend upon the time of year during which the decedent died (which will affect his income for that year) and his income, including gains, during the preceding three years. Taxpayers in identical positions as to the amount of the net loss would be treated differently.

The Proposal's handling of losses presents an obvious inconsistency between lifetime transfers and transfers at death. The Studies state (page 339):

"Losses will be allowed on lifetime gifts under the same rules as apply at death. However, no losses will be allowed on transfers between related parties."

The provisions regarding disallowance of losses on sales or transfers between related parties are found in section 267. Related parties include a transferor's brothers and sisters, spouse, ancestors and lineal descendants and a trustee of a trust created by the transferor. Thus, because of the broad scope of the term related parties, losses would not be allowed on substantially all transfers of property than an individual would desire to make. The provisions of section 267 are not applicable to estates. Estate of Hanna, 37 T.C. 63 (1961), rev'd, 320 F.2d 54 (6th Cir. 1963). Since losses will be allowed on transfers to related parties at death, a result of the Proposal is to penalize lifetime giving.

(e) Start-Up Date

The Proposal takes the position with respect to assets acquired prior to the enactment date that in computing gain basis will be the higher of (1) the basis of the asset immediately before death under current law or (2) its fair market value on the enactment date (adjusted under current law for changes occurring after that date) and that in computing loss basis shall be the lower of (1) or (2). Thus a taxpayer's actual basis for an asset - (1) - will still be important even though the asset is not sold during his life. This introduces complexity and in some cases it will be impossible to establish actual basis.

(f) Minimum Basis and Exclusions from Tax for Types of Property

By allowing a minimum basis of $60,000, the Proposal exempts from tax a substantial amount of net unrealized appreciation. If the imposition of a capital gains tax on unrealized appreciation at death is sound, we question the advisability of creating such a liberal income tax exemption. Based upon the estimates referred to in the Studies (page 334), approximately 35% of the net unrealized appreciation passing at death is a part of estates not required to file an estate tax return. The fact that the Proposal's minimum basis coincides with the $60,000 estate tax exemption points up the close relationship between the capital gains tax at death and the estate tax. Both are taxes imposed on capital.

The Proposal exempts from the tax all gain on

ordinary personal and household effects of a value of less than $1,000 per item and provides that no loss will be allowed for personal and household effects. The per item exclusion is too low, and should be higher so as to minimize proof problems as to basis for should tangibles. The failure of the Proposal to permit losses to offset gains where the value of $1,000 is exceeded is unfair.

(g) Source of Payment of Tax

Under the Proposal, the net appreciation would be taxed "in the final income tax return of the decedent." While such an approach is understandable in the case of appreciation on property owned solely by the decedent at his death, it presents a problem regarding property that is not so owned, such as property held in an irrevocable trust or jointly held property. It would be unfair, and perhaps unconstitutional, to impose an income tax on net appreciation attributable to non-probate property against the decedent's probate estate when the beneficiaries of the non-probate property and the probate estate are different - the tax should be imposed on the owner of the non-probate property.* This solution would, however, be troublesome where, for example, the non-probate property has net appreciation but the property in the estate has a net loss in that the loss could not be used to offset the gain.

2. Effect on State Income Taxes

The Proposal contemplates that "persons holding appreciated assets at death would be treated as if they had sold such assets just before death, and such gains would be taxed in the final income tax return of the decedent." A number of states have income tax statutes whose starting point in determining the state tax is taxable income for federal income tax purposes, with certain adjustments that do not include a reduction for capital gains. Thus, unless legislative changes were enacted in these states, which would be unlikely, the Proposal would result in not only a federal tax but also a state income tax on the gain. This is an undesirable result in that it would raise the "cost of dying" even higher.

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* If a surviving joint tenant has ownership rights in the property under applicable state law, it is questionable whether an income tax on the net appreciation in his or her share could be imposed as a result of the death of the deceased joint tenant.

D. An Additional Estate Tax on Net Appreciation

1. General Explanation

The most satisfactory way of taxing net appreciation at death is by the imposition of an additional estate (transfer) tax. The AET would be applied at a single 14% rate.to net appreciation included in (i) an individual's transfers at death and (ii) in his transfers made in the two years immediately preceding death unless the transferred property is sold before death. Thus the AET could not be avoided by a transfer "in contemplation of death". A minimum basis equal to the "exemption" for transfers at death would be allowed in order that no AET would be owed by any decedent's estate not required to file a transfer tax return. Current law - carryover basis - would be continued as to all other lifetime transfers.

The credits applicable to the basic transfer tax would not apply to the AET. No exclusion from the AET would be available for property included in transfers at death and qualifying for the marital or charitable deduction.

In the interest of simplicity, no special rule is established for depreciable property, including that subject to recapture under section 1245 or 1250. This simplified treatment contrasts with the treatment of such property under current Canadian law imposing a capital gains tax at death pursuant to which this property would be considered to have been sold for an amount midway between fair market value and the original cost less depreciation.

Only appreciation occurring after the effective date of the AET would be subject to the tax. The start-up date would apply to each spouse's share of community property. The use of a start-up date will necessitate a gradual five year phase-in of the Section 1 basic transfer tax rates in order to prevent an immediate revenue loss. The choice between a start-up date with gradual basic transfer tax rate reduction and immediate full rate relief with use for AET purposes of actual basis will obviously affect individuals differently - the individual who dies shortly after the effective date of the Draft with little unrealized appreciation in his assets will derive no real benefit from the AET's start-up date, while the individual who dies at the same time with assets containing significant appreciation would probably be disadvantaged by the use of actual basis under the AET, regardless of an immediately effective full reduction in the transfer tax rates. On balance, we believe a start-up date is appropriate, mainly because it seems unfair to penalize persons who did not keep an accurate record of

basis in reliance upon existing law.

No benefit is provided under the AET for a tax rebate attributable to a net loss at death. Since a consequence of the AET is a reduction in the basic transfer tax rates, the decedent with a loss will still receive the benefit of a reduced tax imposed under Section 1 and will be better off than under current law. If it is deemed advisable to give relief to an estate with a net loss, this could be done (i) by permitting a reduction of the basic transfer tax in an amount that would be the equivalent of what the AET would have been if the estate's basis for its property had been its fair market value on the applicable valuation date reduced by the net loss or (ii) by permitting carryover basis, assuming that the decedent's basis may be substantiated.

An AET has three main advantages over the Proposal. They are:

Fairness. The effect of the tax is progressive as a result of the entire net appreciation being subject to both the basic transfer tax and the AET.

Simplicity. The collection and administration of a tax on net unrealized appreciation at death would be simplified by combining it with the estate tax collection process since there would be a single collection and audit (involving the same valuations) by a single auditing agent.

Constitutionality. Some people believe that the imposition of a capital gains tax on net unrealized appreciation at death would be unconstitutional. We disagree with this conclusion. Nevertheless, any problem in this regard is avoided by the AET, which is an excise tax as contrasted to an income tax.

a. The Method of Determining the Tax

There is an element of double taxation in taxing appreciation at death if the full value of the estate is subject to transfer tax and the full amount of the net appreciation at death is subject to the AET. The Proposal avoids this result by allowing a transfer tax deduction for the capital gains tax. The logical way of avoiding this result in connection with the AET is to increase the basis of the decedent's property by the transfer tax attributable to the net appreciation before imposition of the AET. However, providing such a basis step-up in computing the AET introduces regression in the same manner as exists under

the Proposal because the higher marginal rate at which the appreciation is taxed in the large estate results in a proportionately larger step-up in basis in such an estate than in a medium estate in a lower marginal tax bracket.

At the cost of logic, regression can be eliminated by making no provision for an adjustment to basis, thus freeing the computation of the AET from the basic transfer tax rates in Section 1. Such an approach does, however, introduce an element of double taxation into the transfer tax structure. This double tax has the effect of making the AET progressive in the sense that given the same amount of net appreciation the AET is more significant in the case of the large estate because the double tax element is proportionately larger in that estate.

Under present section 1015(d) the basis of property transferred by gift may be increased by the gift tax paid. The step-up is not limited to the gift tax on the net appreciation but rather is based upon the gift tax on the full value of the transferred property. This result is difficult to justify logically because it is only the net appreciation that is subject to both income tax and gift tax. As mentioned above, the AET would apply to lifetime transfers made within two years of death unless the transferred property were sold before death. Thus, if current section 1015(d) were continued, the double tax element - both a basic transfer tax and an AET on net unrealized appreciation - would not be present in the case of a gift within two years of death as a result of the basis step-up. In order to prevent an income tax incentive for transfers "in contemplation of death", section 1015(d) should be revised to eliminate the step-up basis for such a transfer. This section should also be revised to limit the basis step-up in other cases to the transfer tax on the net appreciation.

b. Rate of Tax

The double tax element previously referred to justifies a rate substantially below the applicable capital gains tax rate or rates. The AET rate reflects the complement of the highest transfer tax rate and the highest capital gains tax rate.* In this way a decedent whose net unrealized appreciation is subjected to the highest transfer tax rate would pay approximately the same total tax as he

*The complement of x is 100-x.

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would pay if a capital gains tax on this appreciation at death were imposed and a deduction for this tax were allowed in computing the transfer tax. Other decedents except those with small taxable incomes in the year of death would pay a smaller AET than they would pay under a capital gains tax at death. The highest transfer tax rate under the Draft is 60%. Using this rate and a current capital gains tax rate of 35%, the AET would be set at 14% - 35% x 40% (100-60).

c. Treatment of Appreciation Qualifying for Marital and Charitable Deductions

Section 2 grants no dispensation from the AET for transfers that qualify for the marital or charitable deduction. As a matter of theory, imposition of a tax on appreciation should not turn upon the destination or use of the appreciation. Further, if exemptions from the AET based upon the recipients of the property subjected to the tax or adjustments to it are introduced, simplicity is lost, and administration becomes complex. It is time that simplicity and ease of administration, whether it works "for" or "against" the taxpayer, be considered as priority objectives in the enactment of tax laws.

(1) The Marital Deduction

The marital deduction provides a postponement of estate tax in the estate of the first spouse to die; the deferred tax becomes payable upon the death of the surviving spouse. An AET exemption for property which qualifies for the marital deduction would similarly delay AET liability in the first spouse's estate. This would, however, be a mixed blessing for the surviving spouse. While more funds might be available for her use during her lifetime, she would hold the assets qualifying for the marital deduction with a basis equal to that of the decedent. Thus, the "lock-in" effect would be accentuated and if the spouse sold the appreciated assets the entire appreciation would be taxed under the income tax at rates which might be substantially higher than the AET rate.

The failure to grant an exemption from the AET for marital deduction property obviously produces a higher tax upon the death of the first spouse to die than if an exemption were granted. This "additional" tax will be particularly significant in the case of the medium estate, say between $100,000 and $500,000. The impact of the additional tax on such estates will, however, be mitigated by the basic estate tax rate reduction contained in Section 1. Further relief is made available by increasing the maximum marital deduction to the greater of $250,000 or

one-half of the adjusted transfers. Still further relief is made available by not considering the AET as a debt of the estate for marital deduction purposes under Section 32, with the result that the maximum marital deduction available on the death of the first of two spouses to die is not affected by the AET.

(2) The Charitable Deduction

Under Section 2(a)(1) the AET will apply to any transfer, including one that is entirely or partially charitable, made at death or within two years of the grantor's death. On the other hand, the AET will not apply to any transfer made more than two years prior to the grantor's death where the transfer is partially charitable and no non-charitable beneficiary has an interest in the property transferred after the grantor's death. The exclusionary rule for transfers made outside of the two year period will apply to those made to pooled income funds or to charitable remainder trusts even though the grantor retains an interest in or a power over the transferred property or to entirely charitable transfers where the grantor retains a right to designate the charitable beneficiaries. This result is accomplished by changing current estate tax law and excluding under Section 21 of the Draft such transfers from the individual's transfers at death, which (except for property transferred within two years of death) constitute the property upon which the AET is imposed.

In cases where the AET is imposed, a differentiation is made in the amount subject to tax depending upon whether Section 21 is applicable. If that section is not applicable, as would be the case with a wholly charitable transfer made within the two year period or with a transfer made within the two year period to a pooled income fund or a charitable remainder trust where as of the date of transfer it is certain that there will be no non-charitable beneficiary of the property after the grantor's death, the value of the property transferred, determined as of the time of transfer, will be the figure against which the basis is applied in determining the AET.

If as a result of a non-charitable beneficiary having an interest succeeding the grantor's interest in a pooled income fund or charitable remainder trust created during the grantor's life there is a taxable interest in the fund or trust, the value of the transferred property as of the date of death or the alternate valuation date (rather than its value on the date of the creation of the trust) will be subject to the AET as a result of the transfer being included in the grantor's transfers at death under Section 21.

When Section 21 is applicable, the problem arises as to what the income tax basis of the property should be in computing the AET. A charitable remainder trust is exempt from income tax and a pooled income fund is also exempt from tax on long term (but not short term) capital gains. A "loophole" would exist if the basis for computing the AET was the basis of the assets held at death because the tax could be avoided at no cost in capital gains tax by selling appreciated property transferred by the grantor immediately after receipt. This result is avoided by providing in Section 2(b)(3) that the basis to be used in computing the AET is the donee's basis for the assets originally transferred immediately after the transfer plus, in the case of a transfer to a charitable remainder trust, an "upward" basis adjustment equal to the aggregate capital gains taxed to a recipient through the grantor's death. This adjustment will prevent an AET being imposed on amounts subjected to income tax after the transfer and prior to the grantor's death.

It will no doubt be contended by some persons that granting an exemption from the AET for charitable transfers which "take effect" at death is inappropriate. On the other hand, other persons will contend that an AET should not be imposed on <u>any</u> charitable transfer. The position taken in the Draft <u>is a</u> compromise of these conflicting positions. The AET may be avoided for charitable transfers, but only if the transfer is made outside of the normal two year "contemplation of death" period <u>and</u> the grantor creates an irrevocable interest in property <u>to</u> charity during his life.

Although Section 2 does not grant an AET exemption for transfers of appreciated property to charity, indirect relief is provided under Section 31 by permitting calculation of the charitable deduction for the purpose of the Section 1 transfer tax without reduction for the AET, thus maintaining for the estate the full benefit of the charitable deduction available under current law. For example, if the estate of $4,500,000 previously used for illustrative purposes were bequeathed in its entirety to charity, an AET of $420,000 would be payable on the entire appreciation in the estate, $3,000,000. Although the charity would actually receive no more than $4,080,000, the estate may claim a charitable deduction of $4,500,000 under Section 31. As the appreciation in an estate increases, the benefit to charity for this provision becomes proportionately greater because of the higher marginal rates at which the transfer tax would be imposed on the AET amount.

2. Technical Explanation

a. Imposition of Tax - Section 2(a)(1).

Subsection (a) imposes the AET at a 14% rate on the net appreciation in the transfers of an individual at death or within two years immediately preceding death. The two year provision excepts from its application any property that is disposed of prior to death in a transaction resulting in the recognition in full of gain or loss. This provision prevents avoidance of the AET by a transfer "in contemplation of death". As used in Section 2(a)(1), "the recognition in full of gain or loss" upon a disposition by a recipient of transferred property means that the full gain or loss realized by reason of such disposition is included in the calculation of his income tax liability. Thus, the sale prior to the grantor's death of property transferred by him within two years of his death to a charitable trust described in section 4947(a)(1), to a charitable remainder trust described in section 664 or to a pooled income fund described in section 642(c)(5) will not avoid the application of the AET.

Net appreciation is the difference between the fair market value of the property (the "estate tax value" concept of current law) and the basis of such property. The appropriate basis for different assets is determined through the application of subsections (b), (c) and (d).

b. Special Election for Community Property - Section 2(a)(2)

Current law (section 1014(b)(6) and (7)) provides a change in basis for a surviving spouse's share of community property upon the death of the other spouse to its value on the applicable valuation date for the deceased spouse's share of this property. This result is inappropriate in the context of an AET since it would permit the complete avoidance of a tax on one-half of the unrealized appreciation in community property that occurs prior to the death of one of the spouses. A distinction in treatment of separate property and community property for AET purposes is justified by the differences in these two types of property.

Two approaches to community property and the AET were considered. First, the surviving spouse's share of community property could be subject to the AET along with the deceased spouse's share. Although permissible (see Fernandez v. Wiener, 326 U.S. 340 (1945)), this approach seems unfair in that the differences between separate and community property would not be recognized. Second, carryover basis could be applied to the surviving spouse's share,

with the result that the basis for this spouse's share would be one-half of the total basis for the community property immediately prior to the other spouse's death. The second approach has been used, except that an election has been given to the surviving spouse to subject her share of the community property to tax at the AET rate of 14%. If an election were made, current law providing for an increase in basis would be continued for his or her share of the community property. An election is appropriate because in some cases the death of one of the spouses will virtually compel the sale of community property and it would be unfair not to permit the surviving spouse to take advantage of the AET if it would produce a lower tax on her share of the property sold. The AET which becomes payable by reason of the surviving spouse's election would be chargeable to her share of the community property.

If the surviving spouse makes an election, the AET on her share of the community property that is subject to the tax is computed separately from the AET on the deceased spouse's property. This separate tax computation makes it impossible for the surviving spouse to make an election for the purpose of reducing the deceased spouse's AET by using a loss on the surviving spouse's share of community property to offset a gain on the deceased spouse's separate property. The surviving spouse's AET is under the specific language of subparagraph (A) to be computed by use of the same valuation method used by the deceased spouse - date of death or the alternate valuation date.

The election is available regardless of the type of community property involved. Thus, it could be used by the husband when the wife died first for pre-1927 California community property even though the wife has only an expectancy in such property or by a husband in any other community property state where the wife also has only an expectancy.

Two limitations on the election are provided one in subparagraph (A) and one in subparagraph (B). The first of these -- a procedural matter -- provides that the election must be made no later than the date for the filing of the deceased spouse's transfer tax return. It is anticipated that the regulations would prescribe the method of making the election. The most satisfactory method would appear to be that used for the election of the alternate valuation date - checking a box on the transfer tax return - and the signature of the spouse on the return.

The second limitation, a substantive one, has been imposed as a result of the term "(held as of the date

of the deceased spouse's death)" in subparagraph (A), which means that the election is not available with respect to community property that is transferred prior to the death of the deceased spouse. Thus, if the deceased spouse's share of community property is subjected to the AET by reason of a transfer within two years prior to death, his spouse is not permitted the election of subsection (a)(2) with respect to her share of any community property transferred before death. No hardship can result to the surviving spouse in such a case since she does not own the property at death.

c. Basis - Section 2(b), (c) and (d)

Subsection (b) provides the general rule to be used in determining the basis of the decedent's assets. It is separately stated for the decedent spouse and the surviving spouse's share of community property. The only difference between the treatment of the two spouses is that the surviving spouse is not entitled to use the minimum basis provision contained in subsection (b)(1). The total basis for all transfers covered by subsection (a), determined under subsections (b), (c) and (d), is subtracted from the total value of such transfers on the date of death to arrive at the amount of net appreciation subject to the AET.

For basis purposes, the assets are divided into subsection (c) assets and all other assets. The basis of subsection (c) assets is their fair market value on the application valuation date. The basis of all other assets will be the greater of (i) the aggregate of the assets' individual bases in the hands of the decedent immediately before death or (ii) $100,000 reduced by the aggregate of the amounts previously allowed as a specific exemption under Section 12 with respect to transfers made more than two years prior to death. The minimum basis under (ii) may not, in contrast to the Proposal, be used against ordinary income items.

Subsection (c) exempts from the AET (i) each item of tangible personal property held by the decedent for personal use and having a value on the valuation date of no more than $5,000 and (ii) all other items of tangible personal property having a value on the valuation date of less than the decedent's basis. The effect of these two "exemptions" will be to remove substantially all tangibles from the operation of the AET. This removal is a two-way street in the sense that no gain <u>or</u> loss is involved on

exempted items. In applying (i), items normally sold as a unit would be treated as a single item. Examples would be a stamp or coin collection.

Consideration was given to imposing a dollar ceiling on the total value of tangibles held for personal use with net appreciation that would be exempted from the AET. Such a limitation was rejected because of the complexity that would be produced in cases where the tangibles were left to several persons and an allocation of the exemption would be required. Further, as a result of items normally sold as a set or collection being treated as one item the significance of a dollar ceiling is substantially reduced. As a practical matter, it would seem that the application of the AET to tangibles would be limited to works of art, jewelry, rare books, stamp and coin collections and rare furniture.

Certain other assets which are subject to special rules for income tax purposes, namely, life insurance (section 101), annuities (section 72), and income in respect of a decedent (section 691), are exempted from the AET. This exemption will have no effect on the income tax treatment of the exempted assets. A type of income in respect of a decedent, pension and profit sharing benefits, is specifically mentioned in order to make it clear that such benefits will continue to be subject to both income tax and transfer tax. The inclusion of pension and profit sharing benefits as income in respect of a decedent is consistent with the holding of Hess v. Comm'r, 271 F.2d 104 (3rd Cir. 1959). Cash is also referred to in order that it does not enter into the computation of the minimum base.

Subsection (d) provides a "start-up" date for the computation of the AET and gives a current basis for property acquired prior to the effective date of Section 2. The basis of all such property will be the fair market value of the property on the effective date of the section, as adjusted in the normal course under section 1016 for the period after the effective date up to the decedent's death. Thus, the use of actual basis is eliminated in this area. Those who have such records will suffer under subsection (d) if their capital assets depreciated in value prior to the effective date of Section 2, but the advantages to be gained through simplicity in the statute and through the minimization of problems in the proof of basis area for such previously acquired assets outweigh the hardship to those who have a provable basis for assets on the effective date in excess of an asset's fair market value on that date.

Section 3. Taxable Transfers Other Than at Death

This section is the general provision taxing transfers other than at death. It replaces section 2503(a), defining the term "taxable gifts", and includes the limitation of section 2512(b) with respect to transfers made for less than a full and adequate consideration in money or money's worth. Sections 2511(a), stating that the gift tax applies to all types of transfers of all types of property, and 2512(a), stating that the amount of a gift of property is the value of the property on the date of the gift, are omitted as unnecessary. Section 3 is supplemented by the specific provisions on includibility in Sections 4 through 10 of the Draft. Once the amount of transfers has been determined, taxable transfers are computed by reducing the value of such transfers by the amounts of any applicable annual exclusions under Section 11 and by the amounts deductible under the lifetime specific exemption, for transfers treated as transfers at death, and as marital or charitable deductions (Sections 12 through 15 of the Draft). The rate schedule of Section 1(b) is then applied to the resulting figure.

The last sentence of Section 3 provides that a promise to make a gift will not constitute a transfer under this section, whether or not the promise is enforceable under the applicable local law. The term "promise" includes a pledge and any other commitment to make a transfer deemed to be gratuitous, unfunded or unsupported by adequate consideration. The transfer occurs when the promise is fulfilled by an actual disposition of the subject property by the transferor. This provision is included in Section 3 to avoid problems similar to those posed by Rosenthal v. Commissioner, 205 F.2d 505 (2d Cir. 1952), Commissioner v. Estate of Copley, 194 F.2d 364 (7th Cir. 1952) and John D. Archbold, 42 B.T.A. 453 (1940). Current law remains unclear as to whether a promise to make a future transfer which is supported by consideration and is binding under state law is itself a transfer subject to the gift tax. See Treas. Reg. §25.2511-2; Revenue Ruling 69-347, 1969-1 Cum. Bull. 227. The ruling held that, at least where the value of the gift may be determined through recognized actuarial principles, the gift was complete for gift tax purposes in the year when the taxpayer became legally obligated to perform under the terms of his agreement.

The ALI Project (pages 79-80, 93-94, 157-61) proposed no changes with respect to the subject matter of Section 3. The Studies (pages 361, 369, 382) similarly proposed no changes in the subject matter of Section 3, except

for its recommendation of "grossing up" for lifetime transfers, which is discussed in connection with Section 1.

Section 4. Certain Property Settlements

Section 4 is based upon section 2516 and exempts from transfer tax certain lifetime transfers between spouses in settlement of marital and property rights and for the support of their minor children. As to transfers between spouses, it is needed because the Draft does not permit an unlimited marital deduction.

Section 4 provides that, where a husband and wife enter into a written agreement relative to their marital or property rights, any transfers pursuant to the agreement (1) to either spouse in settlement of those rights, or (2) to provide a reasonable allowance for the support of their children during minority will be deemed transfers made for a full consideration, and thus will not be taxable. In the case of a transfer under (1), Section 4 will be applicable only if the spouses live apart continuously for at least two years after the agreement is executed.

The general rule under current law is that a relinquishment or promised relinquishment of marital rights such as dower, curtesy, or a statutory election in lieu thereof does not constitute to any extent a consideration in money or money's worth. Treas. Regs. §25.2512-8. Thus a transfer in exchange for such a relinquishment or promised relinquishment is subject to the gift tax. If the spouses execute a written agreement, however, and a final decree of divorce is rendered within the two years following the execution, section 2516 provides that interspousal transfers pursuant to the agreement in settlement of marital rights or for the support of minor children will not be taxable as gifts.

Section 4 deletes the requirement of divorce from section 2516, and substitutes the requirement for interspousal transfers that the parties live separately for the two years immediately following the execution of the agreement. This conforms the lifetime consequences of these transfers with the treatment accorded them under Section 29 at death--in each case, they are not taxed. There is no sound reason for differing treatments of these payments dependent on when they are made.

The decision to exclude payments made pursuant to a written separation agreement from taxable transfers also brings their treatment under the transfer tax in line with

their income tax consequences - under the income tax law they are treated the same as payments made pursuant to a court decree. This liberalization of the current gift tax rule might be subject to some abuse in the form of "fake" separations in order to transfer property free of gift tax between spouses, but the two year requirement has been inserted to prevent this possibility.

Neither the Studies nor the ALI Project had to consider the status of _inter vivos_ payments between spouses by reason of their separation or divorce. Under the unlimited marital deduction each proposed, any transfer to the transferor's spouse, and any transfer "made to the other party in a divorce proceeding as a part of any property settlement, even though the transfer is made after the marriage has been dissolved by a final decree," would qualify for the deduction (Studies, page 380; ALI Project, page 143).

Section 5. Transfer by a Husband or Wife to Third Party

Section 5 is taken from section 2513 relating to "gift-splitting" of transfers by one spouse to a third party. Section 2513 represents an attempt to equalize the tax consequences of a gift to a third party by a spouse in a common law state with those of a gift of community property to a third party. Each spouse holds a one-half ownership interest in community property, so that a transfer of such property to a third party is made one-half by each spouse. Section 2513 permits the same result as to non-community property through an election by the non-donor spouse.

If the present rules of section 2056 and 2514 were changed to permit unlimited interspousal transfers at no tax cost, section 2513 would become unnecessary, since the same result could be obtained by simply making a transfer to the non-donor spouse prior to a joint transfer to the third party. Because Section 32 retains a limited (but expanded) marital deduction, a provision equivalent to section 2513 is required.

Sections 6 and 24. Joint Interests

A. Introduction

Sections 6 and 24 concern joint interests, defined in subsection (c) of each section as "an interest in property possessed by two or more individuals (1) jointly with right of survivorship ... or (2) by the entirety". A tenancy in common is not considered a joint interest. Joint interests

under which each co-owner may draw down the entire property for his own benefit (e.g., a joint bank account) are included under this definition. For purposes of these sections, it is immaterial that a right of survivorship is regarded as contingent under applicable local law prior to the death of a co-owner.

Under current law, the imposition of a gift tax upon the creation of joint interests turns on whether the transfer is deemed complete, and, if it is, on whether the right of survivorship is destructible during the lives of the joint owners by the unilateral action of one of them. If the jointly held property can be withdrawn in full by any joint owner, the creation of the joint interests is treated as an incomplete transfer not immediately taxable. Where this is not the case and the right of survivorship is destructible, so that a joint owner can withdraw the value of his interest by unilaterial action at any time prior to his death, the individual who contributed the consideration is deemed to make a transfer of the amount he furnished in excess of the proportionate value of his interest. If, however, the right of survivorship is destructible only by mutual consent of the joint owners, the value of each co-owner's interest will depend on his age in relation to those of the other co-owners - the younger owner has a greater chance of surviving and thus succeeding to all interests in the property. In such cases, actuarial tables must be used to determine the value of each co-owner's interest. Section 2515 provides an elective exemption from the gift tax with respect to the creation of a tenancy by the entirety in real property.

Upon the death of a joint owner, the full value of the property he holds jointly with another at his death is included in his gross estate under section 2040

> "except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth."

This rule, referred to as the "consideration-contributed" test, has created difficult problems of tracing. It also results in the taxation at death of property which may have been subject to the gift tax, with a gift tax credit being allowed under section 2012.

The ALI Project (page 11) has summarized the arguments in favor of substantial simplification in this area:

"It is very common for two people, particularly husband and wife, to own property jointly with the right of survivorship. The present transfer tax rules applicable to such jointly owned assets are complex, inconsistent and hard to work with. They require tracing of the source of the consideration that went into the acquisition of the jointly owned property. They treat property as passing by gift and then treat the same interest as passing again to the donee at the donor's death if the donor dies first. They frequently require resort to complicated actuarial tables to determine values."

Three issues must be considered with respect to joint interests (ALI Project, page 113): (1) to what extent is there a completed transfer upon the creation of joint interests; (2) when there is a completed transfer upon creation of the joint interests, how is each joint owner's interest valued in light of the right of survivorship each possesses; and (3) how is the maturing of the right of survivorship to be treated on the death of a joint owner. The resolution of these issues must result in a pattern of tax which is consistent with a general premise of the Draft that property should be taxed only once to each transferor thereof, whether during his life, at his death, or partly during life and partly at death. Under Sections 6 and 24, the transfer tax will be imposed either partly on the creation of joint interests and partly at the death of the transferor-joint owner, or wholly at the death of the transferor-joint owner. In either case, the full value of an individual's contributions to joint interests will be taxed only once by reason of the creation of the joint interests and the maturing of the right of survivorship.

The Draft does not include a provision equivalent to section 2515, which permits a tenancy by the entirety in real property to be created with no immediate gift tax, regardless of the contributions of each spouse. Because of the Draft's unlimited marital deduction for as much as $250,000 of interspousal transfers, such a provision would be superfluous in the overwhelming majority of cases to which section 2515 presently is applicable. We believe that a special provision is not warranted for the small number of situations where the filing of a transfer tax return and a possible tax payment would be involved.

The provisions of Section 6 will interact with the marital deduction sections where one spouse creates a tenancy by the entirety or any other joint interest and the right of survivorship is not unilaterally destructible. In these cases, the particular interest deemed owned by each spouse will be an undivided one-half interest in the

whole property, unless the interest of each is accorded a different characterization under local law. To illustrate, assume that an individual purchases real property with $100,000 of his own funds and has the title conveyed to himself and his spouse as joint owners. In the creation of the joint interest, the individual is treated as making a transfer of $50,000 to his spouse and this amount may be claimed in full as a marital deduction pursuant to the fixed dollar limitation of Section 15(a)(2). If the allowable marital deduction is subject to the percentage limitation, the deduction will be computed on the basis of a $50,000 transfer to the spouse.

Both the ALI Project (pages 11-15, 106-14) and the Studies (pages 363, 375, 379) recommend simplification along the lines of Sections 6 and 24 for transfers deemed complete when made - a tax upon the excess of an individual's contribution over his interest in the property immediately after the creation of the joint interests, and a later tax on the value of the individual's interest itself. This approach eliminates the consideration-contributed test with respect to completed transfers, and prevents the imposition of a second tax at death on property contributed to joint interests which was taxed to the transferor during his life. The advantage of simplification far outweighs the estimated "very small" loss of revenue (ALI Project, page 12) resulting from these changes.

B. Section 6

1. Subsection (a) - General Rule

Joint interests are of two types for transfer tax purposes -- (1) those where the transferor can regain his entire contribution without the consent of any other person, and (2) those where he cannot do so. The former are deemed imcomplete transfers when made, while the latter are treated as completed to the extent that the transferor's contribution exceeds his interest in the property immediately after the joint interests are created.

The creation of a joint interest which falls within the first category, e.g., the opening of a joint bank account, is not expressly covered by subsection (a). Because of the power to withdraw more than a proportional share of the total property, it will be treated as an incomplete transfer when made. Withdrawals by the transferor will not give rise to a transfer tax unless they exceed the amount he contributed. At death, when the right of survivorship matures in the other joint owners, the decedent is deemed to make a transfer under Section 24(b) of

a part of the total value of the joint interests determined on the basis of his contribution to the creation of such interests.

To summarize, current law is continued as to joint interests in the first category, e.g., Treas. Regs. §25.2511-1(h)(4); Rev. Rul. 69-148, 1969-1 Cum. Bull. 226, and the necessity to prove contribution remains. Since most joint tenancies fall in this category, the significance of the changes made by Sections 6 and 24 should not be overestimated. Notwithstanding the continued problems of recordkeeping and tracing required in maintaining a complete file of contributions and withdrawals, we believe that it is preferable to face these problems in order to preserve the "hard-to-complete" approach of the Draft than to endorse the adoption of a general "easy-to-complete" rule.

Transfers in the second category are expressly covered by subsection (a). The subsection provides that the transfers of an individual for the calendar quarter in which joint interests in property are created in himself and one or more other individuals shall include the excess of his contribution over the value of his interest immediately after their creation. In determining the value of an individual's interest, he is regarded as owning an equal undivided share of the total property subject to such interests. Thus, to the extent of the value of the individual's joint interest in the property, no transfer tax will be payable upon the creation of joint interests in property. For example, if A, B and C acquire property to be held jointly for a total consideration of $300, with A and B each contributing $125, A and B will each include $25 in his transfers, as the excess of his contribution ($125) over the value of his interest in the property ($100) immediately after the creation of the joint interests.

The rule of the preceding paragraph applies whether or not the right is destructible by unilateral action while A, B and C are alive and unless applicable local law directs a different allocation. Reference to applicable local law is based upon a recommendation of the ALI Project (page 106). The Studies (page 363) propose that this determination be based upon either local law or a direction of the transferor(s), and if neither is present, each holder of a joint interest would be deemed to possess an equal undivided share in the property. The elimination of the need to refer to actuarial tables in valuing a joint owner's interest where the right of survivorship is indestructible will not give rise to any serious possibilities of abuse or tax avoidance, and will simplify greatly the treatment of the creation of such interests.

The general provisions of the Draft would apply to an *inter vivos* termination of joint interests covered by subsection (a). Thus if A, in the above example, were to make a transfer of his joint interest to D when the property subject to the joint interests was valued at $450, $150 (one-third of $450) will be included in his transfers. In such a case, the effect of the transfer on the right of survivorship is not material to the treatment of the transfer.

2. Subsection (b) - Additions

This subsection provides that a contribution made after the creation of the joint interests in property will be treated as a separate creation of such interests to the extent of the contribution. Thus if, in the above example, A were to contribute an additional $150 at a later date he would be deemed to make a transfer to B and C of $100, the excess of his contribution ($150) over his interest in that amount immediately thereafter ($150 divided by 3).

C. Section 24

1. Subsection (a) - General Rule

This subsection is concerned with joint interests created in a transfer deemed complete when made. An individual's transfers at death include the value of his joint interest, immediately prior to his death, in any property. As under Section 6(a), each holder of a joint interest to which this subsection is applicable is regarded as owning an equal undivided share in the property, unless a different allocation is provided under applicable local law. It is immaterial that the right of survivorship may have been indestructible during the joint lives of the co-owners. To continue the example set out in the discussion of Section 6, upon the death of A, survived by B and C, at a time when the property held jointly had a value of $450, A will be deemed to make a transfer of $150, one-third of the total value of the property, to B and C, who take by reason of their surviving A.

The result of subsection (a) is the elimination of the "consideration-contributed" test. The ALI Project (pages 112-13) justifies this elimination as follows:

> "This result is clearly justified in the true joint tenancy situation, where either joint tenant can draw down his one-half at any time but cannot draw down any more. In such situation, each one in reality receives full control over one-half of

the property at the time the joint tenancy is created, and he passes that one-half to the other if he does not elect to destroy the right of survivorship and he dies first. How the consideration was furnished should be an irrelevant inquiry, because such joint tenancy is not a significant means of avoiding any tax under a unified tax.

"The abandonment of the consideration-furnished test, where neither concurrent owner can draw down free of the right of survivorship any of the concurrently owned property (the tenancy by the entirety is the principal example), also does not open the door to significant tax avoidance under a unified tax."

We concur in this reasoning and believe that the approach of subsection (a) has the additional substantial advantage of simplicity. As indicated previously, both the Studies and the ALI Project recommend this approach for the type of joint interests to which the subsection is applicable.

2. Subsection (b) - Exception

Where the creation of joint interests has been treated as an incomplete lifetime transfer, a different approach is required. No tax was imposed on the creation of those interests, and for the entire period they were in existence, the transferor-joint owner had the power to withdraw more than his proportionate share of the property held jointly. Subsection (b) requires that there be included in the transfers at death of a holder of such a joint interest that part of the total value of the property which bears the same proportion to such total value as his contributions bore to the total consideration furnished for the joint interests. Thus, the subsection continues current law in this regard. This position is the same as that recommended by the ALI Project (pages 109-11), and the Studies (page 375).

3. Subsection (c) - Definition

This subsection provides a cross-reference to Section 6(c) for the definition of a joint interest. Since both Sections 6 and 24 relate to the treatment of identical interests, repetition of the definition in Section 24 is unnecessary and the cross-reference will have the added benefit of insuring that definitional rules developed with respect to one section will be equally applicable to cases arising under the other.

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Sections 7 and 22. Powers

For the most part, Sections 7 and 22, relating to powers of appointment, continue sections 2514 and 2041. These sections apply exclusively to powers held by individuals other than a transferor of the property subject thereto - Sections 9 and 21 apply to powers retained by a transferor.

The most significant change made by Sections 7 and 22 relates to a power to consume, invade or appropriate property for the benefit of the holder of the power (the donee) which is limited by an ascertainable standard relating to his health, education, maintenance or support. Under current law, such a power is not a general power of appointment, and its exercise, release, lapse or termination is thus not taxable to him. Under Sections 7 and 22, such a power will be a general power. This change is consistent with the treatment of property subject to such a power under other sections of the Draft, which include for example Sections 8 and 25 (a person is considered as a beneficiary if the trustee has such a power to distribute trust property to him), and Section 21 (such a power retained by the transferor makes the transfer incomplete when made).

Section 22(a)(2) continues the rule of section 2041(a)(2) that the exercise or release of a general power during the donee's lifetime will result in inclusion of the property in his transfers at death when the property would be included under sections 2035 through 2038 if the donee were the transferor. Since the Draft does not contain a general contemplation of death provision equivalent to section 2035 and the substance of sections 2036, 2037 and 2038 has been replaced with Section 21, the relevant part of Section 22(a)(2) is phrased in terms of an exercise or release to which Section 21 would apply at death if the donee had been the transferor. This provision precludes a donee who is also an income beneficiary from releasing his power during his life, and being taxed only on the then value of the trust property reduced by the value of the income interest. Since Section 7 does not exclude from lifetime transfers an amount which may thus be includible in transfers at death as well, Section 22(c)(1) provides that the value taxed at death must be reduced by the amount previously taxed under Section 7. While this approach does not negate in full the effect of double taxation in these situations, it is preferable to retain the familiar provisions on powers to the extent feasible, rather than to attempt a correlation of Sections 7 and 22 with the provisions of Sections 9, 13, 21, 28 and 35 directed at interests in transferred property retained by the transferors. Since Section 22 may be applicable with respect to an <u>inter vivos</u> exercise, release or

lapse of a power, subsection (b)(2) refers to Section 7(e) for determining the consequences at death of such a lapse.

A lapse of a general power is, under sections 2514(e) and 2041(b)(2), deemed a release of the power; an exception is provided for a noncumulative annual power of withdrawal in a limited amount (a 5 and 5 power). Section 7 modifies the second sentence of section 2514(e) to provide that the exception applies only where the property subject to the power is not in excess of the $5,000 or 5% amount, i.e. if more than the allowable amount could have been withdrawn, no amount is excluded from the general rule of includibility. This is appropriate because the exclusion is intended to allow a transferor to include in the instrument a provision making available a minimum amount annually without adverse tax consequences arising from a failure to draw down that amount - it is not intended to insulate a minimum amount of a larger amount which could have been withdrawn. The change has the effect of overruling Fish v. United States, 291 F. Supp. 59 (D.C. Ore. 1968), aff'd, 432 F.2d (9th Cir. 1970).

The Draft includes a provision, Section 16, dealing with disclaimers. Accordingly, the sentences in sections 2041(a)(2) and 2514(b) providing that a disclaimer of a general power is not deemed a release of the power are omitted from Sections 7 and 22 as unnecessary.

No other changes in the current law on powers are made. The Studies (pages 362-63, 373) propose that current law be continued. The ALI Project (pages 18-19, 97-104, 163-65) also recommends that there should be no major change in this area, and has summarized its position on powers of appointment as follows (pages 18-19):

> "Powers of appointment in a transfer that create a succession of limited beneficial interests give a flexibility to the arrangement that permits adjustments to meet changed conditions. A rigid and inflexible plan of successive limited interests is likely to be inadequate to meet the conditions of the future under which it will operate. The present transfer tax law is quite liberal in the controls the owner of a limited interest can be given without causing him to be treated as the owner of the appointive assets for transfer tax purposes.
>
> "This liberality contributes to the generation-skipping problem later considered (see page 26). But a tightening of the power-of-appointment rules to cause the powerholder to be treated as the owner of

> the appointive assets in more situations than at present would simply tend to drive property arrangements into the more rigid mold, if the more rigid mold avoided the burdens of transfer taxation. Therefore, the generation-skipping problem should not be resolved by drawing a different line than now exists in the power-of-appointment area. Rather, a solution should be adopted that applies equally to the rigid and nonrigid arrangements."

We agree with this statement and believe the present "liberal" rule that a broad power of appointment is not taxable is socially useful and desirable. The impact of this flexibility on the "generation-skipping" problem is dealt with in Sections 8 and 25.

As previously mentioned, the lapse of a non-cumulative annual power of withdrawal over an amount not to exceed the greater of $5,000 or 5% of the trust property is not considered a release of a general power of appointment. However, under section 678 a donee of such a power will be taxed on a portion of the trust income and gains. See Treas. Regs. §§1.671-3(a)(3) and 1.671-3(b)(3); Rev. Rul. 67-241, 1967-2 Cum. Bull. 225. A closer correlation between the transfer tax and the income tax provisions is desirable. Section 678 should be amended to change current law so that the donee will not be treated as the owner of any part of the trust's principal solely because of the existence of the power if he is thereafter entitled to receive all income in the accounting sense of the trust during the balance of his life or until the earlier termination of the trust. The change could be accomplished by changing the caption of section 678(b) and adding to it:

> "or with respect to any power over corpus if the property, which could have been vested in the holder of such power by the exercise thereof, did not exceed in value the greater of the following amounts:
>
> (A) $5,000 or
> (B) 5 percent of the aggregate value of the assets out of which the exercise of the power could have been satisfied
>
> and the income from such corpus is required to be distributed currently to the holder of such power until his death or the earlier termination of the trust."

Our suggestion is the same as a part of a recommendation made by the Tax Section of the American Bar Association in its 1965 Annual Report except in one respect. The recommendation would change section 678 as to the lapse of all 5 and 5 powers whereas our proposal would limit the change to cases where the holder of the power is the sole income beneficiary of the trust. We believe this liberalization should not be available in cases where there may be opportunities for minimizing income taxes on the donee from the exercise of a 5 and 5 power by having accounting income paid to other members of the holder's family or accumulated and taxed to the trust.

Sections 8 and 25. Interest in a Trust or its Equivalent

A. Introduction

The current federal estate and gift tax laws permit property to be held in trust for the maximum period authorized by state law with the imposition of only one transfer tax upon the creation of the trust. During this period beneficial interests in the property may pass through several generations. Thus, through the use of trusts of long duration, several generations may presently share in the beneficial enjoyment of property without the payment of additional transfer taxes. Some people believe that present law is structurally unsound because it creates a tax preference (or tax incentive) for the use of trusts. The issue involved has become commonly known as the "generation-skipping" problem.

B. Proposed Solutions

Solutions have been suggested, but to date none has received anything approaching broad support. It is useful to consider these solutions as a prelude to discussing the approach taken in the Draft to this problem. This approach is contained in Sections 8 and 25 which for convenience will hereafter be referred to as "the Statute".

The most extreme and complex solution that has been proposed is the one suggested in the Studies. It has been put in statutory form in section 505 of S.3378 introduced in the Senate by Senator Gaylord A. Nelson during 1972. The complexity of the Studies proposal has been criticized even by advocates of significant change in this area. See, *e.g.*, Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 Harv. L. Rev. 986, at 1006-1013 (1970). This solution is, as pointed out below, not consistent with its underlying premise, which is that property should be subject to a transfer tax in each generation. In order to accomplish

this objective, a substitute (or additional) tax would be imposed upon an outright transfer, or a transfer in trust, of property to a person who is more than one degree below the transferor. The rate of tax would be 60% of the marginal transfer tax rate applicable to the transfers during the taxable period if made during life or to the transfers at death if made at death. Alternatively, the family would have the right to treat the transfer as if the property was first transferred to the skipped generation and, if this were done, the substitute tax would be the amount owed by the skipped generation.

The application of the proposal to transfers in trust is summarized as follows:

> "When the generation-skipping gift or bequest is by trust, there would be generally the same options as to when the tax must be paid as would be available to the skipped generation had he elected to pay the tax. Thus, the transferor or his representative (i.e., executor or trustee) may elect to treat the taxable event as occurring at the time of the original transfer or as of the first day of any calendar quarter thereafter. In no event, however, may the tax be postponed beyond the date of the death of the last survivor among the group consisting of the transferor, his children, and any beneficiaries under the trust who are not within the category of individuals to whom a gift would be considered a generation-skipping gift. At this time, it becomes certain that there is a generation-skipping transfer involved and no reason to further defer the tax.
>
> "The substitute tax would be computed on the value of the trust corpus as of the effective date of the election or the date of the taxable event. Thus, if an individual put $10,000 in trust, with the income payable to his son and the remainder to his grandchildren, and elected to pay the tax at the time he established the trust, he would be subject to a substitute tax on a transfer of $10,000. If, however, no election to pay the tax was made prior to the death of the transferor and his son, then at that time, a tax would be due computed upon the value of the trust corpus at that time. Since the transferor would be deceased at this time, the substitute tax in this case would be paid by the trustee out of the trust property. Any trust distributions prior to this time which skip a generation would also be subject to the substitute tax as applied to the amount of the

distribution.

"Once the substitute tax has been paid on the value of trust property, the substitute tax would be further applied as if the intervening generation was the transferor. Thus distributions to persons two degrees below the original transferor would not involve an additional substitute tax, but distributions to persons three or more degrees below (e.g., great grandchildren) would be subject to a second substitute tax." (Studies, page 392).

The proposal in the Studies fails to apply the every generation theory of taxation to all transfers. If the tax is to be imposed upon such a theory, transfers that do not move "downstream" (to a generation one or more levels below the transferor) but rather "upstream", usually to parents, or "sideways", usually to brothers and sisters, should be exempt from the tax. Yet the Studies' proposal does not contain such an exemption. In fact, it moves in the opposite direction by proposing the elimination of the previously taxed property credit allowed by section 2013, which has its primary significance in connection with transfers between brothers and sisters.

We believe the proposal is not appropriate as to either outright transfers or transfers in trust. With respect to outright transfers, we do not understand why a substitute tax is appropriate in connection with a gift to a grandchild. Why should such a gift be penalized? There has been no splitting of benefits between generations as there is in a trust transfer. If there is an abuse in the generation-skipping area, in our opinion it exists only where such a splitting is present. Further, we know of no country or state that has imposed an additional transfer tax on outright generation-skipping transfers. While the fact that an idea has not been tried before does not automatically justify its rejection, it does suggest that an additional or substitute tax on such transfers is alien to the basic concept of fairness in transfer taxation. We agree with the resolution adopted by the ALI Project that

"Under either a dual tax system or a unified tax, an additional tax should not be imposed on an outright transfer, or its equivalent." (page 7)

We also disagree with the approach of the Studies proposal to transfers in trust. The proposal imposes a tax at the "wrong" time on the "wrong" person and is objectionable in this regard for three specific reasons.

First, the additional tax is computed by multiplying the value of the taxable transfer by a percentage of the decedent's marginal tax rate applicable to his transfers at death or, in the case of a lifetime transfer, by a percentage of his marginal rate applicable to all transfers during the taxable period. This tax is inconsistent with the theory of the generation-skipping proposal because it is computed with reference to the rates applicable to the transferor. The tax should be computed with reference to the rates applicable to the estate of the deceased trust beneficiary, as is usually the case under the Statute.

Second, the amount of the additional tax is dependent upon the rate applicable to the transfer. Thus, if the first inter vivos transfer is subject to the additional tax, the amount thereof would be lower than it would be if the same transfer is made at death or later during life after other gifts had been made. It is inappropriate to create an incentive for making transfers subject to the additional tax at any particular time to the extent this result may be avoided. The Statute avoids this problem by, in general, computing the tax with reference to the estate of a deceased trust beneficiary.

Third, the election device is ill-advised and injects aspects of a lottery into the computation of tax because it permits the amount of the tax to be determined based upon the value at the time of transfer, or based upon the value at a subsequent time no later than the death of the last beneficiary who is no more than one generation below the transferor. This election, which is different from other elections now available to fiduciaries where it is possible to tell precisely at the time of the election what the tax effect of the election will be, places an undesired responsibility on the fiduciary with respect to the time of its exercise. No election is permitted under the Statute.

We have other objections to the Studies' proposal. The substitute tax would be applied to a distribution of current income as well as to a distribution of principal (including accumulated income). Such an approach produces complexity and is uncertain in its application. To illustrate, assume that a trust were to last until the death of the survivor of the transferor's children, when the property is to be distributed to his then living issue, per stirpes, and that during the trust term the trustee is to distribute income currently to the transferor's issue living from time to time, per stirpes. Every payment of income to a grandchild after his or her ancestor's death and prior to the death of the last surviving child would be subject to an additional tax

and transfer tax returns would have to be filed each quarter. What is the source of funds to be used for payment of the substitute tax? Is it the income actually payable to the grandchild or is it the trust principal? If it is income, the substitute tax and the income tax on the gross income payable to the grandchild may exceed this income. If it is principal, the shares of other beneficiaries are adversely and unfairly reduced. The Statute avoids these problems by not being applicable to distributions of current income.

Our estate tax law has always recognized a distinction between the limited interest of a trust beneficiary and the person who has outright ownership of property. If the income beneficiary of a trust is treated for estate tax purposes as if he owned the trust property outright, a determination is being made that the ownership rights are equivalent. They are not the same and should not be treated for transfer tax purposes as being the same, as they are under the Studies' proposal, merely because interests in a trust are given to successive generations below the transferor.

Professor David Westfall has proposed a much simpler way of handling generation-skipping transfers in trust. Westfall, Revitalizing the Federal Estate and Gift Taxes, 83 Harv. L. Rev. 986, at 1006-1013 (1970). It is to grant a "parental deduction" of forty percent for property transferred outright to a child or in such form that the property will be included in the child's estate at his death. The rationale behind this approach is that the incentive of the immediate tax deduction will be sufficient to prevent the use of generation-skipping transfers in trust. We believe there is considerable merit in this approach because it avoids the complexity inherent in any other approach, including that present in the Statute.

Unfortunately, Professor Westfall does not have sufficient confidence in his solution to ignore the multiple generation-skipping trust. For such trusts, his February 27, 1973 statement on estate and gift tax reform to the House Committee on Ways and Means says that the Statute is preferable to the proposal of the Studies, if coupled with an uncomplicated solution, such as in his view the parental deduction, for a single generation-skipping trust.* The multiple generation-skipping trust should be ignored if Professor Westfall's approach should be followed. Subject to this qualification and to the qualification that the deduction would be available for

* Professor Westfall's comments were based on a preliminary version of the Statute dated February, 1971. He raised four technical points which in his view required correction. Each of these points is met in the Statute.

trust property even though income payments to a grandchild were permitted during a child's life so long as the trust principal would be included in the child's estate at death, we have no real difficulty with this approach, which creates a tax preference for a non-trust disposition. We do, however, have reservations about the acceptance of the Westfall approach because Congress has not been willing as a matter of policy to attack problems in the trusts and estates areas indirectly through tax incentives. Also, while this approach is simple in the sense that a complicated statute would not be required, it would produce complexity of its own in the form of an inter-dependent computation. In any case where the tax is payable from property passing to or for the benefit of the child, the tax would apparently depend upon the amount so passing while the amount so passing is dependent upon the amount of the tax. On balance, we believe the Statute is a more viable solution to the generation-skipping problem.

The third recent proposal is contained in the following resolutions adopted by the ALI Project:

> "Under either a dual tax system or a unified tax, the additional tax should be applicable to the transfer of a limited interest if, but only if, distribution of benefits may be made under the transfer to a person more than one generation below the transferor at a time subsequent to the death of a person one generation below the transferor."*
>
> "Such additional tax should be: (a) imposed at the average rate applicable to all transfers by the transferor in the taxable period of the transfer, (b) imposed at the time of the transfer or at the time of distribution to a person more than one generation below the transferor, as the transferor or his personal representative may elect, and (c) collectible only out of the property on which the additional tax is imposed, unless the transferor specifies other funds out of which the additional tax is to be paid." (page 31)

The Institute approach as to the time of payment and the determination of the additional tax is similar to

* The Institute considered this resolution on the understanding that it meant that no additional tax would be imposed on a transfer under which final distribution is required to be made no later than the death of a person or persons one generation below the transferor, or in the same generation or in a higher generation than the transferor.

the Studies' proposal concerning these matters and is objectionable for the reasons stated above. Also, in imposing a single additional tax that is not related to the term of the trust or the number of generations skipped, the Institute approach encourages trusts for the full term of the rule against perpetuities permitted by local law. The Statute is neutral with respect to long-term trusts. The Institute approach regarding the types of trust transfers that are subject to the additional tax did, however, serve as the point of departure to the development of the position taken in the Statute.

In discussing possible solutions to the generation-skipping problem, the British experience should be noted. Although legislation has been enacted, it has been and remains largely ineffective. See Hawkins, A Discretionary Object's Interest, British Tax Review 351-376 (Nov. - Dec. 1968); The New Law Journal July 24, 1969 at 691, July 31, 1969 at 714, November 6, 1969 at 1014.

Finally, mention should be made of one other approach that has been discussed but which has not been developed in commentary. It is to impose an additional tax at a graduated rate that would be based upon the length of time the trust continues in existence. One school of thought is that tax would be payable only when principal is distributed and another says the tax should be paid at certain intervals even though principal has not been distributed. This approach presents obvious difficulties, not the least of which is determining an appropriate rate structure. After considering it at some length, we believe that it is an unrealistic approach to the generation-skipping problem. The Statute does, however, contain an element of this approach in subsection (d).

C. Rationale of Statute

In any estate plan a choice must be made between an outright transfer and a transfer in trust. The normal expectation of an heir is to receive property outright. Why then should an estate owner make a transfer in trust? It is not to create successive interests in property, because they can be created through legal life estates in combination with remainders or through life insurance and annuities or other contractual relationships.

A trust is used because it provides flexibility and enables the disposition of property to be altered to accommodate changes in circumstance. An estate plan may be created which will accomplish the estate owner's objectives for his family through the creation of various

powers in the trustee and/or beneficiary, such as investment powers, powers of appointment and powers to pay income and/or principal to a beneficiary or among the members of a class of beneficiaries. A trust is no more than a single fund in which beneficiaries have an interest which relates to their requirements.

The concept of "family" is important in a discussion of generation-skipping. In general, "family" means persons living at his death. If an individual lives out his actuarial life expectancy, "family" consists of spouse, children and grandchildren. In the case of outright transfers, an individual ought to be able to leave property to any member of his family at the price of a single transfer tax. In the case of transfers in trust, if an individual dies prior to the expiration of his actuarial life expectancy he ought not to be penalized by a narrower definition of family, and, similarly, if he outlives his actuarial life expectancy, he ought not to benefit from a broader definition of "family".

We believe that any change in the taxation of trust transfers should be accomplished in such a manner that a person may create a trust having his "family" - his ancestors, spouse, children and grandchildren - as its beneficiaries without the imposition of an additional transfer tax when compared with current law. Stated simply, the additional tax should be limited to the long term trust where the property does not "vest" for transfer tax purposes - by an outright distribution or a disposition in further trust but subject to a general power of appointment - in a child or grandchild at a time no later than the death of the last living child of the transferor. The tax should be paid from the trust property and should be determined by inclusion of the trust property in the transfers of the "skipped" beneficiary - usually a child of the transferor.

The effect of the Statute, in the context of a trust for descendants of the transferor, would be to shorten the period during which trust property may be kept outside of the transfer tax base from as much as 100 years to a period not to exceed the life or lives of children of the transferor. The Statute would not inhibit in any way the use of a flexible trust through the creation of various powers in the trustee and/or beneficiary, such as powers of appointment and discretionary powers to pay income or principal among a class of beneficiaries.

D. General Explanation of Statute

The Statute taxes certain transfers in trust (or their equivalents) upon the termination of beneficial interests therein and in doing so limits the period of time during which property can be held in trust without being subject to transfer tax upon the termination of a beneficiary's interest when his descendants are beneficiaries or possible beneficiaries after such termination. Generally speaking, the method employed to tax trusts that do not "vest" for transfer tax purposes within the permitted period is to impute ownership of the property to certain persons holding beneficial interests in the property on specific occasions, and to tax the "transfer" of the property from such a person to his descendants unless the transfer fits within one of the "excluded transfer" provisions. This succession tax approach has been used elsewhere and is suggested in Jantscher, Trusts and Estate Taxation, at 172-190 (1967). The Statute also subjects to transfer tax the distribution of trust property in situations that do not involve the splitting of trust benefits between successive generations but do involve the passing of trust property more than two generations below the grantor of the trust.

Excluded transfers have been defined in a manner that enables a person to create a trust which is flexible enough to meet the changing requirements of his "family" but which protects the federal revenue against multiple generation skips where each generation is given beneficial interests in the trust. The effect of the Statute on trust dispositions may obviously be expanded or contracted by expanding or contracting the types of excluded transfers. Hereafter, the terms "excluded transfer" and "included transfer" will be used as shorthand expressions for transfers which either are not or are taxable under the Statute.

The starting point in determining the period of time during which property held in trust will not be subject to transfer tax is a resolution of the ALI Project quoted above, but the Statute is broader in scope than this resolution. To illustrate, under the Institute approach, the ultimate recipient of the trust property is irrelevant. So long as the distribution is made no later than the death of a person no more than one generation below the transferor no additional tax is payable even though there may be a skip of several generations, say to great-grandchildren, upon the death of a child. Under the Statute, the relationship of the recipient to the transferor is relevant and a tax would be imposed if the recipient

is more than two generations below the transferor. Also, under the Institute approach, a person one generation below the transferor may be used as a measuring life for the duration of the trust without running afoul of the additional tax even though such person is not a beneficiary of the trust. Generally speaking, this is not possible under the Statute. If a trust is to continue after the death of a beneficiary and property may subsequently pass to such beneficiary's descendants, a tax will be imposed on the death of the beneficiary unless the measuring life or lives are persons no more than one generation below and also are beneficiaries of the trust, viz., they are entitled absolutely or in the discretion of the trustee to receive income or principal from the trust.

The imposition of a transfer tax under the Statute on a distribution of trust principal to a descendant of the transferor other than a child of the transferor is avoided only when the trust property passes to a grandchild of the transferor in a manner that it will be subject to transfer tax as a part of the grandchild's estate. Thus, a one generation skip at the nearest generation level without a transfer tax is not always permitted. Rather, it is permitted only as between children and grandchildren (or similarly related collaterals). To illustrate this point, assume a transfer in trust by X, with the income payable to his son A for life, remainder to A's then living issue, per stirpes. Upon A's death the trust property would not be subject to a transfer tax to the extent it passes to the son's children but would be subject to tax to the extent it passes to A's grandchildren (X's great-grandchildren) because a child of A predeceased him.

A long term trust continuing after the death of son A with contingent interests in A's issue would be subject to tax upon A's death. If the income were payable to son A for life, then to A's issue, per stirpes, living from time to time until the death of all of A's descendants living at the creation of the trust (including some grandchildren of A), remainder to A's then living issue, per stirpes, the entire trust property would be subject to tax upon the death of A. The trust would also be subjected to tax at a later time, such as the final distribution, to the extent the trust property passed to a descendant more remote than a grandchild of A.

The theory underlying the Statute is that it is not necessary to determine at the time of a transfer in trust that a particular generation may be skipped. It is only necessary to determine when that

generation is actually skipped. The latter approach is clearly advisable because it is consistent with the trend in trust dispositions towards flexibility by permitting discretionary powers until the death of a beneficiary of the trust whose descendants may receive benefits in the trust after his death. No attempt is made to dictate terms which must be contained in a trust instrument or to restrain a transferor in establishing a flexible trust plan through discretionary powers. The trend toward flexibility in trust arrangements is desirable and should not be discouraged by a tax statute imposing rigidity on or stringent requirements for trusts.

Professor A. James Casner recognized the importance of flexible trust dispositions when he stated:

> "Trusts which contain appropriate powers that enable beneficiaries to be determined from time to time are adaptable to meet the changing picture of the trust property and of beneficiary needs. Flexibility in conferring benefits under a trust is more likely to make it possible to meet current problems adequately than any fixed and rigid plan formulated in either the recent or ancient past.
>
> * * *
>
> "It should also be apparent from our discussion that the present tax laws do make power arrangements, as well as fixed and rigid trusts, more attractive than outright transfers. As I have said, I am opposed to a solution that treats mere power arrangements as the equivalent of outright ownership because that will simply drive trusts into the rigid and inflexible pattern. I think the only sensible solution is to narrow the gap that now exists by limiting the time that both power arrangements and rigid trusts can keep someone from being treated as the owner of the trust property for tax purposes." 25 Record of the Ass'n of the Bar of the City of New York, 62 at 63, 77 (1970).

The Statute does significantly "narrow the gap" by shortening the period during which trust property may avoid transfer tax from as much as 100 years to one generation.

The real test of any generation-skipping proposal is its handling of the discretionary trust where, for example, the trustee is authorized to distribute income or principal among the grantor's descendants living from time to time and to accumulate any income not so paid. Solutions that

have been tried or proposed for discretionary trusts have been found ineffective or would create administrative complexities. See Shoup, Federal Estate and Gift Taxes, at 46-49 (1966). The Statute recognizes that there are desirable social purposes to be served by a discretionary trust and does not penalize the flexibility during the lives of persons who are beneficiaries (or possible beneficiaries) and are no more than one generation below the transferor, but creates an irrebutable tax presumption that if the trust continues after the death of such persons it is motivated more by tax considerations than by other purposes.

The Statute applies to a transfer in trust or its "equivalent". Although this word is not used in the Statute but only in the heading, it is intended that the Statute apply to arrangements that are substantially the same as a formal trust. Illustrations of an "equivalent" would be an insurance settlement arrangement or an employment compensation agreement providing for benefits payable to other persons. It is contemplated that the Commissioner would issue regulations as to the meaning of this word pursuant to the authority granted to him by subsection (e).

Several Supreme Court cases have discussed the constitutionality of the imposition of an estate tax in connection with the shifting of incidents of ownership in property as a result of a decedent's death. These cases, and particularly Fernandez v. Wiener, 326 U.S. 340 (1946), indicate that Sections 8 and 25 would raise no constitutional problem.

There are five steps which may be required in determining the application of the Statute. First, it is necessary to ascertain whether the individual involved who has an interest in a trust is a "beneficiary" as defined in subsection (c)(1). If he is a beneficiary, it is then necessary to determine if propertysubject to the trust passes to his descendants as a result of a "termination" or "distribution", as defined in subsection (c)(3). If it does, the next step is to determine whether the transfer is an "excluded transfer" under subsection (c)(8). If it is not, a determination must then be made as to the precise amount passing to the descendants under subsection (c)(7); this amount is subject to tax. Finally, if there is no inclusion under the foregoing steps and a "distribution" is involved, subsection (d) must be considered to see if it is applicable.

General illustrations indicating the application of the Statute to common types of trust dispositions follow the detailed discussion below.

E. Detailed Analysis of Statute

1. Subsection (a) - General Rule.

This provision states the general rule - the value of property passing to a beneficiary's descendants upon a termination or distribution is a transfer by the beneficiary that is subject to transfer tax. Thus a succession tax approach is used. Section 8 applies to lifetime passing and Section 25 to passings at death. The key terms used in the general rule are defined in subsection (c).

There are two exceptions to the application of the general rule. First, it does not apply to the extent the trust property is otherwise subject to tax under the chapter. This avoids the possibility of a double tax on the trust property. Second, the general rule does not apply to the excluded transfers contained in subsection (c)(8). Thus, the framework is a general rule of broad application, but restricted in scope by the granting of exemptions for certain limited types of transfers.

2. Subsection (b) and subsection (a)(2) of Section 43 - Computation and Payment of Tax.

The tax imposed by the Statute is computed under the general provisions of the transfer tax. Therefore, the property includible in gross transfers is subject to the other transfer tax provisions, such as credits and deductions. Thus, for example, if an included transfer is involved the gross estate would be increased for the purpose of computing the maximum available marital deduction.

Payment of the tax from the property which is subject to the tax is required absent a contrary election in the case of a lifetime transfer or a contrary will provision in the case of a transfer at death. The tax to be paid from the trust property is the difference between the tax actually payable and the tax that would be payable if the Statute were not applicable. This marginal rate allocation, patterned after the method of computing the deduction under current section 691 (c) for the estate tax on income in respect of a decedent, minimizes the effect of the inclusion of the trust property in the beneficiary's gross transfers insofar as his own property is concerned.

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3. <u>Subsection (c) - Definitions.</u>

As mentioned previously, the definitions in subsections (c)(1) through (c)(8) set forth the meanings of terms used with reference to subsection (a). Although the approach is apparent from the general rule set forth in subsection (a), it is only after the definitions are mastered that the precise scope and impact of this rule may be understood. Subsection (c)(8), relating to excluded transfers, is particularly important.

a. <u>Subsection (c)(1) - Beneficiary.</u>

A key definitional provision is the word "beneficiary." It is defined broadly to mean any person who, immediately prior to a termination or distribution, is entitled to receive property subject to a transfer in trust or is a permissible recipient of such property pursuant to the exercise of a power held by any person. Since this definition uses other defined terms - "termination", "distribution" and "power" - reference must be made to those definitions for a full understanding of the scope of subsection (c)(1).

A person who has an interest in a trust which is such that he is subjected to tax under other provisions of this chapter (a "transferor" as defined in subsection (c)(5)) is excluded from the definition of beneficiary with respect to the property so taxed. Illustrations of situations where the person would be a beneficiary but for the exclusion are a trust where the person retains the income for life (Section 21) and a trust where the person involved has a general testamentary power of appointment with respect to the trust property (Section 22).

Subsection (c)(1) also excludes from the definition of beneficiary a person who succeeds to a beneficiary's interest by means of an assignment. Such an assignment can arise only in the context of a lifetime transfer. If the beneficiary receives consideration in money or money's worth, the assignee is in reality a purchaser for value and should not be considered a beneficiary. If the assignment is gratuitous, the beneficiary will be liable for payment of a transfer tax by reason of the assignment under other provisions. In either case, it is not appropriate to treat an assignee as a "beneficiary." This treatment contrasts with that accorded an assignee under the definition of the term "descendant", but is consistent with the purposes of the specific subsections: here, to exclude an inappropriate class from the category of beneficiary; with respect to descendants, to insure that the Statute cannot be avoided through an assignment of an interest held by a descendant to one who is not a descendant. Also, in

order to prevent avoidance, any assignment by a person interested in a trust is ignored in determining whether he or she is a beneficiary.

Although the definition of a "beneficiary" is broad, it does not cover all possible trust beneficiaries. For example, assume that X created two trusts for his sons A and B with income to the son for life, with the remainder distributable upon the son's death to the son's issue then living, per stirpes, and with a "cross-over" to the other trust or the other son's issue then living if A or B dies without issue. Each son and his issue have a contingent interest in the other son's trust. Also, each son's own issue have a contingent interest in their father's trust. Since neither A's own issue, B, nor B's issue will have an interest in A's trust during A's life, if one of this group should predecease A he will not be a "beneficiary" under subsection (c)(1) with respect to A's trust. A will, of course, be a "beneficiary".

If in the illustration the trustee of A's trust had authority to distribute income or principal to A or A's issue living from time to time, each such issue would be a "beneficiary". Thus, if one of such issue predeceased A leaving surviving issue it would be necessary to fit within one of the excluded transfer provisions to prevent the trust being included in such deceased issue's transfers at death.

The term "beneficiary" includes a "permissible recipient" of property pursuant to the exercise of a "power", as defined in subsection (c)(4). This raises the question of how the term "beneficiary" is to be interpreted in connection with contingent rights or powers. Although the importance of this issue is considerably reduced by the limited nature of the excluded transfer provisions, it still must be dealt with.

Treas. Regs. §20.2038-1(b) states:

> "However, section 2038 is not applicable to a power the existence of which was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's life). See, however, section 2036(a)(2) for the inclusion of property in the decedent's gross estate on account of such a power."

See also Estate of Cyrus C. Yawkey, 12 T.C. 1164 (1949). The intention is to have the case law and regulations under section 2038 apply in connection with contingent rights

or powers, except that a person to whom payments may be made pursuant to the exercise of a power limited by a determinable external standard is to be treated as a "beneficiary" whether or not the power is actually exercisable. See subsection (c)(4). To illustrate, if a trust provides that income or principal may in the trustee's discretion be paid to A if needed for support or maintenance, A will be a "beneficiary" even though at the time of his death A has sufficient property of his own to satisfy his needs for these purposes and therefore the power is not exercisable.

The following illustrations indicate how the definition of a "beneficiary" would apply regarding contingent rights or powers.

1. Case 1 - two trusts, X and Y, are created. Trust X provides that income is to be paid to A and gives the trustee a discretionary power to pay principal to A. Trust Y provides that the trustee may pay the income or principal to A if Trust X is exhausted. At A's death Trust X has not been exhausted. A is a "beneficiary" as to Trust X but not as to Trust Y.

2. Case 2 - same as Case 1, except that A has an unlimited right of withdrawal over Trust X. A is a "beneficiary" as to Trust Y as well as Trust X because his interest in Trust Y is not subject to a contingency beyond his control.

3. Case 3 - Trust X provides that A will be entitled to the income if he marries a girl of a certain religious faith. At A's death he has not so married. A is a "beneficiary" because his interest is subject to a contingency within his control.

4. Case 4 - Trust X gives A a non-cumulative annual power to withdraw the greater of $5,000 or 5% of the trust principal (see Section 22), or any person the right to distribute principal to A, but no other interest. A is a "beneficiary" because he is a permissible recipient of property subject to a power.

5. Case 5 - Trust X gives the trustee the right to pay income or principal to A's descendants living from time to time and states that income or principal may be paid to A if the original trustee resigns. The original trustee is A's wife B. While B is a trustee A is not a "beneficiary".

6. Case 6 - Trust X gives the trustee the right to pay income or principal to A's descendants living from time to time and gives A's father, C, a special testamentary power of appointment (including the right to appoint to A) over the trust property as it exists on C's death. A predeceases C. A is not a "beneficiary" because the special power was not exercisable at A's death. The power was only exercisable at C's death.

b. Subsection (c)(2)- Descendant.

As previously noted, subsection (a) is applicable only if property passes from a beneficiary to his "descendants". The term "descendant" is defined broadly to include issue in any degree of the beneficiary and issue in any degree of any spouse of the beneficiary and spouses of such issue. The words "any spouse of the beneficiary" are intended to include a person who was a spouse at any prior time even though this relationship did not exist while the "beneficiary" relationship existed. To illustrate, if A by his will creates a trust with the income payable to his second wife, W, and the remainder payable upon her death to his issue by a prior marriage, such issue are "descendants" of W in applying the Statute.

The reason for including spouses of issue is to prevent the avoidance of the Statute by creating trust remainder interests in spouses, such as a spouse of a great-grandchild. Adopted issue are included as descendants, but a proviso has been added to make it clear that the generational identity of a descendant will not be altered through adoption. Thus, a relative who is not a descendant, or a stranger, may be brought into the family line through adoption, but a great-grandchild, for example, of a beneficiary cannot be raised to the level of a child or grandchild of a beneficiary through adoption.

Subsection (c)(2) treats any person who succeeds to the interest of a descendant by means of an assignment as a descendant. Thus, for example, an assignee of a remainder interest previously held by a great-grandchild of a beneficiary is considered as a descendant of the beneficiary. This prevents evasion through the use of assignments for consideration to persons not otherwise descendants of a beneficiary. The scope of the provision is, however, broader in that it would also apply to assignments involving no consideration. In other words, the rule is that any person taking through a descendant is deemed to be a descendant.

c. <u>Subsection (c)(3) - Termination and Distribution</u>

The Statute applies to the value of property passing to a beneficiary's descendants upon a "termination" or "distribution". Since a termination or distribution triggers the application of the Statute, the scope of these terms is of primary importance. "Termination" is defined to mean any occurrence, other than a "distribution", whereby a person who is a beneficiary immediately prior to the occurrence ceases to be such. In most cases, death will be the terminating event.

"Distribution" is defined to mean a transfer pursuant to the terms of the governing instrument whereby property ceases to be a part of the trust. "Distribution" refers only to outright transfers or their equivalent and not to cases where the property is retained in further trust. If upon the death of A the trust property is to be divided into separate shares to be held in further trust, the death of A would be a "termination" rather than a "distribution" even though new trusts were created.

The exclusion of a payment of current income from being considered as either a "termination" or a "distribution" is a rule of convenience which makes the Statute much easier to administer and which limits the cases where the same payment is subject to both income tax and transfer tax to those involving the throwback rule, a point that is discussed in detail below. The words "current income" are meant to include not only income earned during the trust's year in which the distribution is made but income distributed after the close of that year as to which the trustee files an election under current section 663(b). "Income" is to be given the meaning set forth in current section 643(b) and Treas. Reg. §1.643(b)-1. The trustee's labeling of a particular payment to a beneficiary as being made from income or principal would be determinative in applying the "current income" rule.

Two terms - termination and distribution - have been used rather than including a distribution as a part of the definition of termination in order to simplify some of the other provisions, namely, the value of property passing to a descendant and the excluded transfers. When the occurrence of an event, such as the death of A (the income beneficiary of a trust), causes A to cease to be a beneficiary <u>and</u> a distribution of the trust property, a "distribution" rather than a "termination" is involved. A distribution may also occur during the trust term by a payment of principal.

Assume, for example, that X creates a trust, with one-half of the income to be paid annually to each of his

children, A and B. In A's case, the income interest is to continue for his life, with one-half of the remainder to his issue, per stirpes, then living; with respect to B, however, the income interest is to cease after 25 years, with one-half of the remainder to his issue, per stirpes, then living. A's death - which causes a payment of trust principal - will be a distribution. If A assigns his entire income interest, the assignment will not be a termination because A continues to be a beneficiary. See the definition of "beneficiary" in subsection (c)(1). The cessation of B's income interest after 25 years will be a distribution.

If X creates a trust, with so much of the income and principal to be paid to A and his descendants living from time to time as the trustee in his discretion determines, remainder to A's issue, per stirpes, living at the death of the survivor of A and his children, the death of A would result in a termination. The same result would follow upon the death of any of A's children, except the survivor when a distribution would occur. If the trustee exercises his power to pay principal to A or any descendant of A, the payment would be a distribution. With respect to each of the above illustrations, however, whether the termination results in an included transfer will depend on other factors, involving the other definitional provisions and particularly those relating to excluded transfers. For example, although a payment of principal to A would be a distribution no property would pass to A's descendants and therefore there would not be a transfer subject to tax. On the other hand, if a payment of principal were made to a descendant of A, there would be an included transfer unless the excluded transfer provision relating to distributions were satisfied.

Every cessation of an interest of a beneficiary in a trust will not be a "termination". To illustrate, if trust income is to be paid to A for ten years after which time the trustee is given discretion to pay income to A or his descendants living from time to time, A's income interest ceases at the end of the ten year period, but no "termination" occurs because A remains a beneficiary as a result of the trustee's discretionary power to distribute income to A. If, on the other hand, at the end of the ten year period the income became payable to A's children and the trustee had no discretionary power to pay income to A, a "termination" would occur as to A upon the expiration of the ten year period. Similarly, if all trust income is to be paid to A for five years and thereafter he is to receive only one-third of the income, there is no termination as to A upon the expiration of the five year period. This result does not permit avoidance of tax because the amount taxable bears no relationship to the nature of the beneficiary's interest at termination.

d. Subsection (c)(4) - Power

The term "power" is defined broadly to include an authority to do any act in relation to a beneficial interest in property. It encompasses powers held by any person, including a trustee, and includes discretionary powers to distribute income or principal even though the exercise is limited by a fixed or ascertainable standard which prevents the current exercise of the power.

e. Subsection (c)(5) - Transferor.

The term "transferor" is defined to mean any person to the extent that property is deemed to be transferred by him pursuant to the provisions of the transfer tax. The creator of a trust is, of course, a transferor. Also, when an amount is subject to tax under the Statute upon the termination of a beneficiary's interest, that beneficiary is considered a transferor with respect to such amount. The term "transferor" is used only in certain of the excluded transfer provisions of subsection (c)(8), in subsection (c)(6), which is relevant in connection with the excluded transfer provisions, in section (c)(1) so as to exclude such a person from the definition of a beneficiary and in subsection (d).

If any part of a trust is included in the gross estate of an individual, that individual replaces the original transferor as the "transferor" with respect to the future application of the Statute. To illustrate, assume that X created a trust to last until the death of the survivor of his son A and his son's wife, with the income and/or principal to be paid in the discretion of the trustee to A, his wife or his descendants living from time to time, with any income not so paid to be accumulated, and with A having a right to withdraw in each year 5% of the trust principal. Upon A's death, 5% of the trust principal will be included in his gross transfers and he will become the "transferor" as to this percentage of the trust principal. If thereafter during the life of A's wife a principal payment is made to a grandchild of A, 95% of such payment will be treated as coming from the original transferor and will be an included transfer and 5% will be treated as coming from A and will be an excluded transfer. If A's right of withdrawal was over a fixed dollar amount, this amount will be converted into a fraction of the trust principal for the later application of the Statute.

f. Subsection (c)(6) - Member of the Same Generation.

It is usually not difficult to determine whether a particular person is a member of the same generation as another

person when the persons involved are descendants of a close common ancestor. In other cases, particularly when the persons are not blood relatives, the problem is more difficult. Subsection (c)(6) resolves this problem by providing that a person who is no more than 25 years younger than the transferor is deemed to be of the same generation as the transferor. Descendants of a grandparent of the transferor or of a beneficiary, as the case may be, are excluded from this 25 year rule.

g. Subsection (c)(7) - Value of Property Passing to a Descendant.

Leaving subsection (d) aside for the moment, the Statute is applicable if trust property (including accumulated income but excluding current income) passes to a beneficiary's descendants. Absent such passing there is no generation-skipping and therefore no reason to include the trust property in the beneficiary's gross transfers. It is only generation-skipping, or more precisely the splitting of trust benefits between generations, that is the "evil" at which the Statute (other than subsection (d)) is directed.

In determining whether property passes to the beneficiary's descendants, a doctrine similar to the reciprocal trust doctrine is required to prevent temporary avoidance by "crossing" remainder interests, viz., giving the descendants of one child the remainder interest in another child's trust. A statement in the legislative history as to what was intended, particularly in the light of the recent Supreme Court decision in Estate of Grace v. United States, 395 U.S. 316 (1969), and the delegation of authority in subsection (e). for the issuance of regulations to effectuate the purpose of the Statute should be sufficient to avoid any "loophole" in this regard. It is contemplated that the regulations would specifically deal with and prevent a less blatant way of minimizing the effect of the Statute - creating separate trusts for each child and having the trust property distributed on the death of each child to all descendants of the creator rather than to only descendants of the deceased child. The significance of avoiding a tax under subsection (a) is substantially lessened by the fact that subsection (d) makes it impossible to avoid the application of the Statute - if subsection (a) is not applicable, subsection (d) will produce a tax upon a subsequent distribution.

Subsection (c)(7) states the manner in which the value of the property passing to the beneficiary's descendants is determined separately for a distribution or a termination. In either case the value of the property passing to the beneficiary's descendants is, under subparagraph (C), not to be reduced by reason of the tax imposed under the Statute. The

actual value of the property passing to the beneficiary's descendants upon a distribution is, under subparagraph (A), subjected to transfer tax. As previously noted, a transfer to another trust is, except in the limited cases referred to in subsection (c)(8)(C), not treated as a distribution but rather as a termination.

Subsection (c)(7)(B) is applicable to termination valuations. Subsection (c)(7)(B)(2) applies to a continuing trust which is subject to a power (as defined in subsection (c)(4)) held by any person. In determining the amount that may pass to the beneficiary's descendants a maximum exercise (or nonexercise) of the power in favor of his descendants is assumed. Thus all doubts are resolved in favor of the federal revenue. To illustrate, if the trustee is given the power to pay income or principal among a class consisting of the transferor's descendants living from time to time, the entire trust property will be considered as passing from a child to his descendants upon child's death because the trustee may exercise the power entirely in favor of such descendants.

To the extent that subsection (c)(7)(B)(2) does not apply, subsection (c)(7)(B)(1) provides that the value of property that would be distributed to the beneficiary's descendants as a final distribution, if the trust became distributable at the termination, shall be included in the term "value of property passing to a descendant". Thus, for example, if a trust were to continue after a termination and the trustee does not thereafter possess any discretionary power over the disposition of the trust property, the amount included under this subsection is the value of the interest that would have passed to the beneficiary's descendants if the trust had become distributable on the date of termination. In a few cases the beneficiary's descendants may not be entitled to any part of the trust principal at the time of final distribution but will have interests in the trust after the termination and prior to such distribution. This would occur when the descendants of the beneficiary were the recipients of a charitable remainder trust. See current section 664. Subsection (c)(7)(B)(1) covers such a situation by treating the full value of the trust property as passing to the beneficiary's descendants. The beneficiary would, however, be able to claim a charitable deduction for the remainder interest in the trust. Another possible approach would be to create a separate excluded transfer provision for charitable remainder trust terminations or distributions. The issue is of limited significance because it will be extremely rare when a person two generations below the transferor is made a beneficiary of such a trust.

The value of property passing to descendants of the

beneficiary at a termination is, pursuant to the last sentence of subsection (c)(7)(B), reduced by the value of any consideration in money or money's worth received by the beneficiary as a result of the termination. This will occur only in connection with a volitional assignment by a beneficiary during his life.* To illustrate, a beneficiary may sell his income interest for cash. Since amounts received by the beneficiary will become part of his estate and be subject to the transfer tax, no tax avoidance is possible. Although there may be a postponement of tax until the death of the beneficiary, this result does not seem objectionable since the descendants' possession of the trust property will be postponed until the death of the assignor-beneficiary. The term "consideration in money or money's worth" is taken from the present estate and gift tax laws and regulations. See e.g., sections 2043(a) and 2512(b).

Subsection (c)(7)(B) assumes that the trust property becomes distributable at termination or the power is exercisable at termination. These assumptions are inappropriate in valuing the property passing to a beneficiary's descendants when a fully vested interest or interests of persons other than the beneficiary's descendants take effect immediately upon the termination. To illustrate, assume that income is payable to A, then to B and then to C and upon the death of the survivor of A, B and C the trust property is to be distributed to A's descendants. It would be improper to include the full value of the trust property as passing to A's descendants upon his death if B or C survives him. In such a case the value of the property passing to the beneficiary's descendants is reduced by the value of the outstanding income interests. Normal valuation rules are to be applied in valuing such interests. See Treas. Regs. §§20.2031-7 and 25.2512-5. The word "outstanding" is taken from Treas. Regs. §20.2036-1(a).

Before leaving the valuation provision, it should be emphasized that the valuation of the property passing to a beneficiary's descendants upon a termination or distribution, which controls the amount treated as a transfer under the Statute, bears no relationship to the beneficiary's interest in the trust. To illustrate, if A is to be paid one-half of the trust income and the other one-half is to be accumulated or paid to individuals who are not A's descendants and upon A's death the entire trust property is to be distributed to A's descendants, the value of the property passing to A's descendants is the full value of the trust property even

* The assignor will remain a "beneficiary" after the assignment. See subsection (c)(1).

though A received only one-half of the trust income. The same result would follow if A were merely a possible recipient of income or principal through the exercise of a discretionary power. It may be argued that this result is not "fair". The answers to this contention are that fairness is produced by the excluded transfer provisions of subsection (c)(8) and any rule basing the amount treated as a transfer upon the nature of the beneficiary's interest in the trust would cause additional complexity. Also, in most cases there will be a direct relationship between the amount treated as a transfer under the Statute and the beneficiary's interest - the beneficiary will be entitled to all income of the trust or will be a permissible recipient of all income.

h. Subsection (c)(8) - Excluded Transfers.

(1) Introduction

If the Statute contained no excluded transfer provisions, the value of all property passing to a beneficiary's descendants would be included in his gross transfers and would be subject to tax. The excluded transfer provisions prevent this result by excepting certain specific types of terminations and distributions from the operation of the Statute. They are of three types. First, there is an exclusion (paragraph (A)) for transfers in trust made before the enactment of the Statute. Second, there is a "termination" exclusion (paragraph (B)) separately stated for descendants and collaterals. Two other "termination" exclusions relating to disclaimers (Section 16) and transfers for full consideration (Sections 3 and 18) are located elsewhere in the Draft. Third, there is one "distribution" exclusion (paragraph (C)). Paragraphs (B) and (C) are simple in concept and easily understood. Taken collectively, the exclusions permit an individual to establish a flexible scheme for the disposition of trust property among his "family" without having to worry about satisfying technical rules that significantly limit the utility of the trust device

Consideration was given to applying the Statute only to distributions as contrasted to terminations. If this were done, the Statute could be simplified and shortened. Such an approach was rejected because it would encourage the use of long term trusts measured by the rule against perpetuities so as to avoid a transfer tax on the trust property for as long as possible. Any legislative solution to the generation-skipping problem should not encourage the use of such trusts but rather should, insofar as possible, be neutral as between

long-term and short-term trusts.

(2) Subsection (c)(8)(A) - Transitional Rule.

This provision establishes a transitional rule regarding the application of the Statute to "pre-existing" trusts and, bearing in mind that the word "transferor" is defined in paragraph (5) of subsection (c), it is that the Statute will not apply until the trust property is included in the transfers of an individual under another provision of the Draft. This is the same approach as is taken in the Studies (page 401) and the ALI Project (pages 54-55).

The operation of the transitional rule may be illustrated as follows, based upon the enactment of the Draft effective January 1, 1974. Assume a trust was created in 1965 with income payable to A, the grantor's son, for his life, and thereafter to A's issue living from time to time until the death of the last survivor of A's descendants living when the trust was created and with the principal then to be distributed to A's living issue, *per stirpes*. Upon A's death in 1975, subsection (c)(8)(A) will be applicable and the trust property will not be subject to Section 25 -- the property will not be includible in A's transfers at death because no other section of the Draft will be applicable to the trust property and thus A will not be considered a transferor within the meaning of subsection (c)(5). Similarly, the property will not be taxed upon the death of any of A's children. The result would not be different if A had, in addition to his income interest, a special power of appointment or any other interest or power which did not result in the inclusion of the property in his transfers under any other section of the Draft.

If A held a general testamentary power of appointment over the trust property, that property would be included in his transfers at death pursuant to Section 22(b)(1) of the Draft. A would, accordingly, be deemed a transferor of the property, and the exception of subsection (c)(8)(A) would no longer be applicable. The same result would occur if A's power is a special power of appointment which is taxed in his transfers under current sections 2041(a)(3) and 2514(d) relating to appointments which unduly postpone vesting, ownership or an absolute power of alienation in a beneficiary.

To sum up, after property held in trust prior to the effective date of the Draft is included in an individual's transfers under a provision other than the Statute, it is subject to the Statute; until such time, it is not.

(3) Subsection (c)(8)(B)(i) and (ii) - Terminations During Fixed Terms.

Subsection (c)(8)(B)(i) and (ii) describe terminations which are exempt from the application of the general rule in subsection (a). A liberal termination rule is appropriate, bearing in mind that distributions are treated separately. Only one limitation is placed upon the use of a trust term measured by multiple lives of persons who are no more than one generation below the transferor. It is that immediately after a termination each person who is used to a measuring life is a beneficiary and at least one of such persons is no more than one generation below the transferor. The nature of the beneficiary's interest is, however, irrelevant. It is inappropriate to create an excluded transfer provision measured by the life of a person who is not a beneficiary since, except in rare cases, there is no reason to create such a trust other than to postpone the payment of the tax as long as possible. The exception is inapplicable to trusts whose duration is measured solely by a term of years.

There are two permitted classes of measuring lives, one relating to descendants - (i) - and the other to collaterals - (ii) -, with ancestors and the transferor's spouse included in each class. The words "prior to" rather than "no later than" have been used to insure that upon the death of the last measuring life the termination exception will not apply.

(4) Subsection (c)(8)(C) - Distributions.

Under this subsection outright transfers of property to a child or grandchild of the transferor are excluded from the operation of the Statute. The last sentence of this subsection permits certain specified dispositions in further trust for a grandchild to be treated as an outright distribution to the grandchild. In order for the trust disposition to be treated as an outright transfer, the grandchild must, subject to one exception, be the sole beneficiary of the trust and be treated as the "owner" of the trust property for purposes of the transfer tax under other provisions of the chapter.

The exception permits vesting of the trust property in the grandchild under other transfer tax provisions to be postponed until he attains an age not to exceed 35 years. There are a considerable number of cases in which grantors desire to postpone vesting of trust property, upon a child's death, in a grandchild until the attainment of an age in

excess of 21. Use of age 35 will cover most of these cases. Although postponement of vesting may be obtained to any age by giving the grandchild a general power of appointment, many grantors do not want to give the grandchild such a power. The objection is not based upon tax considerations (the grandchild will in almost all cases attain the desired age) but rather upon the fact that the general power gives the grandchild complete control over the property at death under the stated age and the grantor wants to avoid such control until the grandchild attains an age which is considered mature enough to assume that the power will be exercised "wisely". Under subsection (a), if the grandchild in whom the vesting is postponed should die before reaching age 35, there will be a termination or distribution at that time and the trust property will be subject to transfer tax at that time unless no property passes to his descendants. Thus, in the case of the death of a grandchild under age 35, the exception does not permit avoidance of tax, but rather only postponement of the tax until his death.

4. Subsection (d) - Trust Transfers Not Subject to Subsection (a)

Subsection (d) is directed at situations that will arise only infrequently - where because of the failure of issue or an unusual order of deaths a person receiving a distribution did not have an ancestor who was a beneficiary immediately prior to the distribution or where the transferor might desire to make an unnatural disposition in order to avoid the other provisions of the Statute. Subsection (d) makes it impossible for any distribution of trust property to a person more than two generations below the transferor to avoid the application of the Statute.

A few examples will illustrate the scope of subsection (d), which applies to distributions but not to terminations:

Example 1 - unusual order of deaths - if X creates a trust for his son A's life with the income to be paid to A and the principal to be distributed upon A's death to his then living issue, *per stirpes*, and a child of A predeceases A leaving issue who survive A, the value of the property passing to such issue will be an included transfer by A. Similarly, if X creates a trust to continue until the death of the survivor of his children with the income payable to his issue, *per stirpes*, living from time to time and with the principal to be distributed to such issue living at the termination of the trust and the last surviving child, A, has a

child who predeceases A leaving issue living at the termination, the property passing to such issue is an included transfer by A. If, however, A was not the last surviving child there would not, absent subsection (d), be an included transfer with respect to the property passing to A's issue because such issue are "beneficiaries" and no property passes to their descendants. Subsection (d) applies in such a case.

Example 2 - death without issue - X creates a trust for each of his two sons A and B with the income to be paid to the son for life and the principal to be distributed upon his death to his then living issue, *per stirpes*, or, if none, to the other son's trust or, if the other son is not living, to his then living issue, *per stirpes*. A has no issue and B has two children, one of whom predeceased B leaving issue who survive B and A. Under the Statute, exclusive of subsection (d), the property passing to the issue of the deceased child of B upon B's death is an included transfer by B but the property passing to those same issue upon A's later death is an excluded transfer because no property passes to a beneficiary's descendants. Subsection (d) does, however, apply to the passing of the trust principal to the issue of the deceased child of B upon the death of A.

Example 3 - "game playing" - absent subsection (d) the Statute could be avoided by terminating a beneficiary's interest before the expiration of the period permitted for termination under subsection (c)(8)(b)(i) or (ii) so that at the first termination subject to the Statute trust property would pass to a beneficiary rather than to his descendants. For example, assume that X created a trust to last until the death of the survivor of his children A, B and C and that until the death of the first two of his children the income is to be paid to his issue, *per stirpes*, living from time to time and thereafter until the death of the survivor of the children the income is to be paid to the grandchildren of the two deceased children and the living child and upon the death of the survivor the trust principal is to be distributed to such grandchildren (great-grandchildren of X) and the surviving issue, *per stirpes*, of the last surviving child of X. Without subsection (d), the property distributed to the great-grandchildren of X would not be subject to tax because no property passed to the descendants of such great-grandchildren. The subsection prevents any abuse in this regard and applies to the distribution made to the great-grandchildren.

Subsection (d) would also apply to a mandatory accumulation trust with no "beneficiary". To illustrate, if X created a trust to continue until 21 years after the

death of the last survivor of all his descendants living at the creation of the trust, at which time the trust property is to be distributed to his issue then living, per stirpes, and if at termination the property becomes distributable to seven great-grandchildren of X, the subsection will apply to the entire trust property.

When the person to whom the distribution of trust property is made had an ancestor who was a beneficiary of the trust, the tax imposed on the transfer could be based upon such ancestor's transfers by applying the theory of "once a beneficiary always a beneficiary". The difficulty with this approach is twofold. First, in some cases the ancestor will have died and opening up his final transfer tax return would be required. Second, and more important, in other cases it would not be available because no ancestor was a beneficiary of the trust. For these reasons the approach was rejected and a simple accessions concept is applied in determining the amount of the transfer tax payable in connection with the trust distribution - the person receiving the property is deemed to have made a transfer to himself.

An inclusion of something less than the entire value of the property that is distributed to the recipient is appropriate since the amount subjected to tax will increase his rate of tax on subsequent transfers and the property received by the recipient (reduced by the transfer tax) will be taxed a second time upon its transfer during life or at death. The percentage selected, 60%, seems reasonable bearing these factors in mind, but could, of course, be varied. The amount of the tax is determined as of the date of the event that causes the distribution. However, a delay in payment is permitted for a "winding up" period of the trust by treating the transfer as occurring in the third calendar quarter commencing after such event.

The amount of the transfer tax imposed upon or connected with a "tainted" trust disposition will vary depending upon whether the Statute (excluding subsection (d)) or that subsection is applicable. Generally speaking, the application of subsection (d) will be more severe because the distributed property is both taxable as a transfer by the recipient and increases the rate applicable to his subsequent transfers, including a transfer of the same property.

An illustration may be helpful. Assume that property having a value of $250,000 is distributed to a person who is treated as making a transfer to himself under

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subsection (d) and that such person has not made any prior transfers subject to the transfer tax. Such person would file a transfer tax return reporting a transfer of 60% of $250,000, or $150,000. His subsequent taxable transfers would be taxed from the base of $150,000 less any available exemptions.

The approach of treating the recipient of a distribution of trust property as making a transfer to himself should not create a problem in connection with subsequent transfers by him to his spouse. While his transfer tax rate will be higher, this rate is irrevlevant in connection with transfers that qualify for the marital deduction (Sections 15 and 32). Further, the transfer by the recipient to himself will permit an increased marital deduction as to subsequent transfers where the minimum $250,000 figure is exceeded since it increases his transfers and the amount available under the limitation to one-half of his transfers.

5. Subsection (e) - Regulations.

Subsection (e) specifically empowers the Treasury to promulgate such regulations as may be necessary to implement the Statute. The regulations would deal with several matters not specifically set forth in the Statute that are mentioned above, including the definition of the "equivalent" to a transfer in trust, the "crossing" of remainder interests and the meaning of the term "current income" used in subsection (c)(3). Also, when subsection (a) is applicable to two individuals at the same time, the regulations would state that the subsection will be applied to the eldest ancestor or, put another way, to the nearest descendant of the transferor. For example, if a distribution is made from a trust to a great-grandchild of the transferor and both his parent and grandparent in his line of descent from the transferor are living the transfer will be deemed to have been made by the grandparent (the child of the transferor) rather than the parent.

6. Relationship with Throwback Rules.

In the case of a distribution taxed under the Statute, the person receiving the distribution may be deemed to have received undistributed net income (UNI) or undistributed capital gain (UCG) that is subject to the throwback rules of sections 665 through 669. In the case of a termination taxed under the Statute, a person later receiving a distribution from the trust may be in the same position. In either case, the same property would be subject to both transfer tax and income tax. Some adjustment is necessary in order

to prevent a second tax being imposed upon the full amount that is subject to the first tax. If this occurred, the two taxes could, depending upon the tax rates, exceed 100% of the value of the distributed property.

Section 691 provides that if the same property is subject to both estate tax and income tax the recipient of such property is entitled to claim an income tax deduction for the estate tax attributable thereto. Property subject to both estate tax and income tax is referred to as income in respect of a decedent (or 691 income).

The double tax problem caused by the application of the Statute and the throwback rules is handled in the same manner as 691 income. This is done by permitting a trust beneficiary who is deemed to have received UNI or UCG to claim an income tax deduction for the transfer tax (whether imposed under subsection (a) or (d) of the Statute) attributable to the UNI or UCG, determined under the "incremental" approach of section 691 (c)(2)(C) - the transfer tax attributable to the aggregate of the UNI and UCG is the difference between the transfer tax actually paid and the transfer tax that would have been paid if an amount equal to the UNI and UCG had not been subjected to tax under the Statute. The "deduction" provision would be inserted in subpart D as a new section 667(b)(2)(D) to read as follows:

> "If a transfer tax has been imposed upon trust property, which includes undistributed net income or undistributed capital gain, pursuant to section [8 or 25], each beneficiary deemed to receive all or any part of such undistributed net income or undistributed capital gain shall be entitled to claim a deduction for the transfer tax attributable thereto determined in accordance with the method prescribed in section 691 (c)(2)(C) (relating to income in respect of decedents) and regulations prescribed by the Secretary or his delegate."

A beneficiary deemed to have received UNI or UCG may alect to compute his tax on the throwback under either an "exact" method or a "short-cut" method. If he uses the exact method, he will claim his transfer tax deduction attributable to UNI or UCG for the same year or years in which the UNI or UCG thrown back was accumulated in the trust. To illustrate, if upon a distribution in 1980 there was a throwback to years 1970 and 1971 the deduction for the transfer tax would be claimed in the recomputation for those two years. If, however, the beneficiary uses the short-cut method, the deduction will be prorated against

all throwback years, including those occurring after the imposition of the transfer tax. To illustrate, assume that a transfer tax of $50,000 is imposed upon a trust under section 25, of which $10,000 accumulated in 15 years; that after the imposition of this tax the trust accumulated $15,000 of UNI and $7,500 of UCG in 10 more years; and that a single beneficiary receiving all trust property at the end of the trust term elected to use the short-cut method. The number of years in which UNI or UCG was accumulated totals 25. This figure is divided into $10,000, the transfer tax attributable to UNI and UCG, to produce an annual deduction of $400 in computing the beneficiary's tax under the short-cut method for each of his three years immediately preceding the year of payment.

A few other points concerning section 667(b)(2)(D) would be covered by regulations. The word "imposed" is intended to refer to the event causing the transfer tax and not the later time of payment of the tax. Second, only beneficiaries that receive a distribution simultaneously with the imposition of the transfer tax or thereafter may claim a deduction for the tax. In some cases a beneficiary may receive an accumulation distribution of UNI or UCG during a taxable year in which a later termination, as contrasted to a distribution, under the Statute occurs. Such a beneficiary would not be entitled to claim any part of the deduction for the transfer tax since the property distributed to him was not subject to both transfer tax and income tax. Third, the deduction is to be allocated between UNI and UCG proportionately since each dollar of UNI or UCG generated the same transfer tax. Thus, the deduction per dollar of UNI or UCG will simply be the total transfer tax attributable to UNI and UCG divided by the aggregate amount of UNI and UCG in the trust when the transfer tax is imposed. Fourth, in determining this amount a "look back" approach would be used. If an accumulation distribution is deemed to have been made to a beneficiary and later in the trust's same taxable year an event occurs causing the Statute to apply, the UNI and UCG will be adjusted from the cumulative UNI and UCG as of the close of the preceding taxable year to reflect any amounts of UNI or UCG deemed paid to such beneficiary as a result of such distribution. Fifth, although the deduction for the transfer tax attributable to UNI or UCG is to be determined in the same manner as the section 691(c) deduction, the distribution is not to be treated as 691 income to the extent that it is deemed to consist of UNI or UCG. This point is important in determining the beneficiary's basis for the property distributed - the normal basis rules will be applicable rather than the special basis rule of current section 1014(c).

7. Examples.

(1) X creates a trust with income to his wife for life, remainder to his issue, per stirpes, who survive his wife. Any distribution upon the wife's death to a child or grandchild of X would be an excluded transfer under subsection (c)(8)(C). Any distribution to a more remote descendant of X would be an included transfer by the wife regardless of whether such descendant is an issue of hers. See the definition of "descendant" in subsection (c)(2).

(2) X creates a trust with income to his wife for life, then to his issue, per stirpes, living from time to time until the death of the last to die of his children when the trust property will be conveyed to his then living issue, per stirpes. The terminations upon the wife's death and upon the death of each child (other than the survivor) would be excluded transfers under subsection (c)(8)(B)(i). The distribution upon the death of the last surviving child would be an excluded transfer under subsection (c)(8)(C) or subsection (d) to the extent the trust property was conveyed to grandchildren of X, but an included transfer to the extent such property was conveyed to more remote descendants of X. Inclusion would be under subsection (a) in the case of a grandchild or more remote descendant of the last surviving child, who would be treated as making the included transfer, or under subsection (d) in the case of a grandchild or more remote descendant of any other child.

(3) X creates a trust to last until the death of the survivor of his wife, his children and the spouses of his children, at which time the trust property is to be conveyed to his issue then living, per stirpes. During the trust term the trustee is authorized to pay income and/or principal among a class consisting of X's wife, his descendants and the spouses of any deceased descendants living from time to time or to accumulate income.

a. A termination by the death of the wife, a child, a child's spouse or a grandchild or more remote descendant of X prior to the expiration of the trust term would be an excluded transfer under subsection (c)(8)(B)(i).

b. A distribution by a payment of principal to X's wife, a child, a grandchild or a spouse of a deceased child or grandchild would be an excluded transfer under subsection (c)(8)(C) or subsection (d).

c. A distribution by a payment of principal to

a great-grandchild or more remote descendant of X or a spouse of a deceased great-grandchild or more remote descendants of X would be an included transfer, even though the recipient was a nearest descendant, by right of representation of X, or a spouse of such descendant, at the time of the distribution. The distribution would be treated as a transfer by the great-grandchild's most remote ancestor who is a descendant of X and a beneficiary or, if there were no such ancestor, as a transfer under subsection (d).

(4) Same case as 3 except the trust is to continue until the death of the survivor of X's wife and all of his descendants living at his death, including some grandchildren. Upon the death of the survivor of X's wife and the children, the entire trust property would be an included transfer and be deemed to have been transferred by such survivor since the entire trust property may thereafter be paid to the descendants of such survivor. Subsection (c)(8)(B)(i) is not applicable, even though the trustee may thereafter distribute the entire trust property to X's grandchildren.

(5) X creates a trust with income to his wife for life. Upon her death separate trusts are created for his children (or issue, per stirpes, of a deceased child) with income to the child (or individual issue) for life and the trustee having discretion to pay principal to an income beneficiary. Upon a child's death (or the death of an individual issue of a deceased child) the trust property is to be conveyed to the then living issue, per stirpes, of the deceased income beneficiary. The termination upon the wife's death would be an excluded transfer under subsection (c)(8)(B)(i), except that if a child predeceased X's wife and a trust was created for a grandchild upon the wife's death, the termination upon the wife's death would be an included transfer by the wife to the extent of the property passing in trust for the grandchild since the grandchild is not a permissible measuring life. This result could be avoided by giving the grandchild a general testamentary power of appointment. The distribution upon the death of a child would be an excluded transfer under subsection (c)(8)(C) to the extent the property passes outright to a grandchild, but an included transfer by the child to the extent the property passes to a more remote descendant. If upon the death of a child his trust was to continue for each of his children (grandchildren of X) until the child attained an age not to exceed 35 years, the disposition upon the death of the child of X would still be an excluded transfer under subsection (c)(8)(C), but

if the grandchild died under the age of 35 years and trust property passed to the grandchild's issue upon the grandchild's death there would be an included transfer by the grandchild to the extent of such property.

(6) Same case as 5 except that if a spouse of a child survives the child the trust is to continue for the spouse's life with the income paid to the spouse and upon the spouse's death the trust property is to be conveyed to the child's then living issue, per stirpes. The distribution upon the death of the spouse would be an excluded transfer under subsection (c)(8)(C) to the extent the property passes to grandchildren of X but an included transfer by the spouse to the extent the property passes to more remote descendants of X.

(7) Same case as 5 except that the child is given a special power to appoint the trust property upon his or her death.

a. If the child appoints the trust property outright in any manner among his children the distribution on the child's death would be an excluded transfer under subsection (c)(8)(C).

b. If the child exercised his power by appointing the trust property in further trust during the life of his wife with the income and principal to be paid among a class consisting of his wife and his descendants living from time to time and any income not so paid to be accumulated and gave his wife a special power to appoint the trust property upon her death, the termination on the child's death would be an excluded transfer under subsection (c)(8)(B)(i) since immediately after the child's death his wife (the measuring life) is a beneficiary. The fact that the wife may appoint in further trust upon her death is irrelevant in determining the application of subsection (c)(8)(B)(i) upon the child's death.

c. If the child exercised his power by appointing the trust property in further trust for his grandchildren during their lives with remainder to his great-grandchildren, the termination on the child's death would be an included transfer by the child, but the distribution upon the later death of a grandchild to a great-grandchild would then be an excluded transfer under subsection (c)(8)(C).

Sections 9, 13, and 21. Deferral of Transfer Tax on Certain Inter Vivos Transfers.

A. Introduction

Under the current dual gift and estate tax laws, an inter vivos transfer involving retained rights or powers in the transferor may give rise to a gift tax upon the transfer and, under sections 2036, 2037 and 2038, an estate tax upon his death. Section 2036 applies where the transferor retains an income interest in or the right to use the transferred property, or where he retains a right to designate the beneficiary to receive the income from or the use of such property. Section 2037 is applicable where possession or enjoyment of the property can be obtained only by surviving the transferor and the transferor retains a reversionary interest in the property exceeding, immediately prior to his death, 5% of the value of the property. Section 2038 requires inclusion in a transferor's estate of the value of an interest in property over which he retains a power to alter, amend, revoke or terminate. Double taxation of overlapping transfers is avoided by allowing a credit under section 2012 against the estate tax for the gift tax. The operation of the credit is complex and in some cases illogical.

Sections 9, 13 and 21 contain the Draft's approach to the important issue of the time of payment of the transfer tax upon transfers under which the transferor retains a limited interest in, or power over, the transferred property. They respond to Recommendation 23 of the ALI Project, which is (page 8):

> "A line between completed and uncompleted gifts should be definitely established, so that all lifetime arrangements would fall on one side of the line or the other, and so that there would be no area where the same transfer is subject to transfer taxation both as a lifetime transfer and a deathtime transfer, under either a dual tax system or a unified tax."

The objective is to establish clear rules assuring that a given transfer will be taxed only once and thereby eliminate the overlap and much of the complexity which exists under current law. This necessarily involves taking a position on where the "line" should be drawn and whether a "hard-to-complete" or "easy-to-complete" approach should be used.

B. Elimination of Overlap.

It is not easy to draft a statute insuring that