V. ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

A. PHASEOUT AND REPEAL OF ESTATE AND GENERATION-SKIPPING TRANSFER TAXES; INCREASE IN GIFT TAX UNIFIED CREDIT EFFECTIVE EXEMPTION (SECS. 101, 201, 301, AND 401–402 OF H.R. 8, SECS. 501–542 OF THE SENATE AMENDMENT, SECS. 121, 684, 1014, 1040, 1221, 2001–2210, 2501, 2502, 2503, 2505, 2511, 2601–2663, 4947, 6018, 6019, AND 7701 OF THE CODE, AND NEW SECS. 1022, 2058, 2210, 2664, AND 6716 OF THE CODE)

PRESENT LAW

Estate and gift tax rules

In general

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

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $10,000 (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2001 remains at $10,000) of transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $20,000. Unlimited transfers between spouses are permitted without imposition of a gift tax.

Unified credit

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

Transfers to a surviving spouse

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

Transfers to surviving spouses who are not U.S. citizens.—A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

There is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Expenses, indebtedness, and taxes

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

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

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

Basis of property received

In general.— Gain or loss, if any, on the disposition of the property is measured by the taxpayer's amount realized (e.g., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. ‘‘Carryover basis’’ means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of gift.

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

Special rule for community property.—In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent, and thus is eligible for stepped-up basis. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Special rules for interests in certain foreign entities.—Stepped-up basis treatment generally is denied to certain interests in foreign entities. Under present law, stock or securities in a foreign personal holding company take a carryover basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of the company's accumulated earnings and profits. In addition, stock in a passive foreign investment company (including those

[47] Elementary and secondary schools are defined by reference to section 14101 of the Elementary and Secondary Education Act of 1965.

for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Provisions affecting small and family-owned businesses and farms

Special-use valuation.—An executor can elect to value for estate tax purposes certain ''qualified real property'' used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2001 is $800,000). Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

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

Family-owned business deduction.—An estate is permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to $675,000.[48] A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income. In the case of a trade or business that owns an interest in another trade or business (i.e., ''tiered entities''), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

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

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

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

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

State death tax credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, the top rate of which is 16 percent, based on the size of the decedent's adjusted taxable estate. Most States impose a ''pick-up'' or ''soak-up'' estate tax, which serves to impose a State tax equal to the maximum Federal credit allowed.

Estate and gift taxation of nonresident noncitizens

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

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

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

Generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a ''skip person'' (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. The generation-skipping transfer tax is imposed at a flat rate of 55 percent (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of $1 million (indexed for inflation occurring after 1997; the inflation-adjusted amount for 2001 is $1,060,000).

Selected income tax provisions

Transfers to certain foreign trusts and estates

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

Net operating loss and capital loss carryovers

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

Transfers of property in satisfaction of a pecuniary bequest

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

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

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

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

Excise tax on non-exempt trusts

Under present law, non-exempt split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income, estate, or gift tax charitable deduction was allowed with respect to the trust. A non-exempt split-interest trust subject to these rules would be prohibited from

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

engaging in self-dealing, retaining any excess business holdings, and from making certain investments or taxable expenditures. Failure to comply with these restrictions would subject the trust to certain excise taxes imposed on private foundations, which include excise taxes on self-dealing, excess business holdings, investments which jeopardize charitable purposes, and certain taxable expenditures.

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, provides as follows:

Overview of H.R. 8

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

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

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

In general

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

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

Replace unified credit with unified exemption

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

Basis of property acquired from a decedent

In general

Beginning in 2011, after the estate, gift, and generation-skipping transfer taxes have been repealed, the present-law rules providing for a fair market value basis for property acquired from a decedent are repealed. Instead, a modified carryover basis regime generally takes effect. Recipients of property transferred at the decedent's death will receive a basis equal the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death.

The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the present law rules apply.[49]

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

Property to which the modified carryover basis rules apply

The modified carryover basis rules apply to property acquired from the decedent. Property acquired from the decedent is (1) property acquired by bequest, devise, or inheritance, (2) property acquired by the decedent's estate from the decedent, (3) property transferred by the decedent during his or her lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust,[50] (4) property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust,[51] (5) property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties), and (6) the surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.

Basis increase for certain property

Amount of basis increase.—The bill allows an executor to increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death. Under this rule, each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain ''built-in'' losses of the decedent. In addition, the basis of property transferred to a surviving spouse can be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million. Nonresidents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2010.

Property eligible for basis increase.—In general, the basis of property may be increased above the decedent's adjusted basis in that property only if the property is owned, or is treated as owned, by the decedent at the time of the decedent's death. In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated having been owned by the decedent and is thus eligible for the basis increase. In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase. The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust that pays all of its income during the decedent's life to the decedent or at the direction of the decedent. The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent.[52] The decedent shall not, however, be treated as owning any property solely by reason of holding a power of appointment with respect to such property.

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

Rules applicable to basis increase.—Basis increase will be allocable on an asset-by-asset basis (e.g., basis increase can be allocated to a share of stock or a block of stock). However, in no case can the basis of an asset be adjusted above its fair market value. If the amount of basis increase is less than the fair market value of assets whose bases are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase.

Reporting requirements

Lifetime gifts

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

The name and taxpayer identification number of the donee,

An accurate description of the property,

The adjusted basis of the property in the hands of the donor at the time of gift,

The donor's holding period for such property,

Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,

And any other information as the Treasury Secretary may prescribe.

[49] Sec. 1014(b)(2) and (3).

[50] This is the same property the basis of which is stepped up to date of death fair market value under present law sec. 1014(b)(2).

[51] This is the same property the basis of which is stepped up to date of death fair market value under present law sec. 1014(b)(3).

[52] Thus, similar to the present law rule in sec. 1014(b)(6), both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase.

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

Transfers at death

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

The name and taxpayer identification number of the recipient of the property,

An accurate description of the property,

The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,

The decedent's holding period for the property,

Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,

The amount of basis increase allocated to the property, and

Any other information as the Treasury Secretary may prescribe.

Penalties for failure to file required information

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

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

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

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

Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax. Because repeal of the estate tax is effective for decedents dying after December 31, 2010, these estate tax recapture provisions will continue to apply to estates of decedents dying before January 1, 2011.

Qualified conservation easements

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

Special-use valuation

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

Qualified family-owned business deduction

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

Installment payment of estate tax for estates with an interest in a closely-held business

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

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

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

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

Transfers of property in satisfaction of a pecuniary bequest

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

Transfer of property subject to a liability

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

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

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

Excise tax on nonexempt trusts

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

Anti-abuse rules

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

Study mandated by the bill

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

Interaction of the bill with death tax treaties

The Committee expects that, where applicable, references in U.S. tax treaties to the unified credit under section 2010 (as in effect prior to January 1, 2002) will be construed as applying, in a similar manner, to the unified exemption amount (as in effect for decedents dying and gifts made after December 31, 2001).[53]

Effective date

The unified credit is replaced with a unified exemption, the 5-percent surtax is repealed, and the rates in excess of 53 percent are repealed for estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2001. The estate and gift tax rates in excess of 50 percent are repealed for estates of decedents dying and

[53] See, e.g., Article 3, Protocol Amending the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Estates, Inheritances, and Gifts (Senate Treaty Doc. 106–13, September 21, 1999.) Under the protocol, a pro rata unified credit is provided to the estate of an individual domiciled in Germany (who is not a U.S. citizen) for purposes of computing U.S. estate tax. Such an individual domiciled in Germany is entitled to a credit against U.S. estate tax based on the extent to which the assets of the estate are situated in the United States.

gifts and generation-skipping transfers made after December 31, 2002.

The additional reductions in estate and gift tax rates and of the State death tax credit occur for decedents dying and gifts and generation-skipping transfers made in 2004 through 2010.

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

The provisions relating to purported gifts and recognition of gain on transfers to nonresidents who are not U.S. citizens are effective for transfers made after December 31, 2010.

SENATE AMENDMENT

The Senate amendment is similar to the provision in H.R. 8; however, under the Senate amendment, the gift tax will not be repealed.

The Senate amendment also includes the following modifications:

Phaseout and repeal of estate and generation-skipping transfer taxes; modifications to gift tax

The Senate amendment provides that the unified credit effective exemption amount will be increased and the estate and gift tax rates will be reduced over time. The unified credit effective exemption amount (for estate and gift tax purposes) will be increased to $1 million in 2002. For gift tax purposes, the unified credit effective exemption amount will remain at $1 million in 2002 and thereafter. For estate tax purposes, the unified credit effective exemption amount and generation-skipping transfer tax exemption will increase over time.

TABLE 18.—UNIFIED CREDIT EXEMPTION AMOUNTS AND HIGHEST ESTATE AND GIFT TAX RATES

Calendar year	Estate and GST tax deathtime transfer exemption	Highest estate and gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$2 million	48%
2005	$3 million	47%
2006	$3 million	46%
2007	$3 million	45%
2008	$3 million	45%
2009	$3.5 million	45%
2010	$4 million	45%
2011	N/A (taxes repealed)	40% (gift tax only)

Under the Senate amendment, except as provided in regulations, a transfer to a trust will be treated as a taxable gift beginning in 2011, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

After repeal of the estate tax, the modified carryover basis rules provided in the House bill also apply under the Senate amendment.

Reduction in State death tax credit; deduction for State death taxes paid

The Senate amendment provides that, from 2002 through 2004, the top State death tax credit rate is decreased from 16 percent as follows: to 8 percent in 2002, to 7.2 percent in 2003, and to 7.04 percent in 2004. In 2005, after the state death tax credit is repealed, there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has been filed becomes final.

Reporting requirements

In general

For transfers at death, the Senate amendment contains reporting requirements identical to those provided in the House bill. For transfers during life, the Senate amendment provides that a donor is required to provide to recipients of property by gift the information relating to the property (e.g., the fair market value and basis of property) that was reported on the donor's gift tax return with respect to such property.

Penalties for failure to comply with the reporting requirements

Any donor required to provide to recipients of property by gift the information relating to the property that was reported on the donor's gift tax return (e.g., the fair market value and basis of property) with respect to such property who fails to do so is liable for a penalty of $50 for each failure to report such information to a donee.

Any person required to report to the IRS transfers at death of non-cash assets in excess of $1.3 million in value who fails to do so is liable for a penalty of $10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property acquired by the decedent within three years of death for which a gift tax return was required to have been filed by the donor who fails to do so is liable for a penalty of $500 for the failure to report such information to the IRS. There also is a penalty of $50 for each failure to report such information to a beneficiary.

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

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

As under the House bill, there will continue to be (1) the additional estate tax for those with a retained development right with respect to property for which a conservation easement was claimed, (2) the additional estate tax imposed under the special-use valuation rules, (3) the additional tax imposed under the qualified family-owned business deduction rules, and (4) acceleration of tax under the installment payment of estate tax provisions.

In addition, under the Senate amendment, there will continue to be an estate tax imposed on (1) any distribution prior to January 1, 2022, from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2011.

Effective date

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount, and reductions in and repeal of the state death tax credit are phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2001. The repeal of the qualified family-owned business deduction is effective for estates of decedents dying after December 31, 2003.

The estate and generation-skipping transfer taxes are repealed, and the carryover basis regime takes effect for estates of decedents dying and generation-skipping transfers made after December 31, 2010. The provisions relating to recognition of gain on transfers to nonresident noncitizens are effective for transfers made after December 31, 2010.

The top gift tax rate will be 40 percent, and transfers to trusts generally will be treated as a taxable gift unless the trust is treated as wholly owned by the donor or the donor's spouse, effective for gifts made after December 31, 2010.

An estate tax on distributions made from a qualified domestic trust before the date of the death of the surviving spouse will no longer apply for distributions made after December 31, 2021. An estate tax on the value of property remaining in a qualified domestic trust on the date of death of the surviving spouse will no longer apply after December 31, 2010.

CONFERENCE AGREEMENT

Overview

The conference agreement follows the Senate amendment with modifications. Under the conference agreement, the estate, gift, and generation-skipping transfer taxes are reduced between 2002 and 2009, and the estate and generation-skipping transfer taxes are repealed in 2010.

Phaseout and repeal of estate and generation-skipping transfer taxes

In general

Under the conference agreement, in 2002, the 5-percent surtax (which phases out the benefit of the graduated rates) and the rates in excess of 50 percent are repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to $1 million. In 2003, the estate and gift tax rates in excess of 49 percent are repealed. In 2004, the estate and gift tax rates in excess of 48 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $1.5 million. (The unified credit effective exemption amount for gift tax purposes remains at $1 million as increased in 2002.) In addition, in 2004, the family-owned business deduction is repealed. In 2005, the estate and gift tax rates in excess of 47 percent are repealed. In 2006, the estate and gift tax rates in excess of 46 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $2 million. In 2007, the estate and gift tax rates in excess of 45 percent are repealed. In 2009, the unified credit effective exemption amount is increased to $3.5 million. In 2010, the estate and generation-skipping transfer taxes are repealed.

From 2002 through 2009, the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes are as follows:

Calendar year	Estate and GST tax deathtime transfer exemption	Highest estate and gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	N/A (taxes repealed)	top individual rate under the bill (gift tax only)

The generation-skipping transfer tax exemption for a given year (prior to repeal) is equal to the unified credit effective exemption amount for estate tax purposes. In addition, as under present law, the generation-skipping transfer tax rate for a given year will be the highest estate and gift tax rate in effect for such year.

Repeal of estate and generation-skipping transfer taxes; modifications to gift tax

In 2010, the estate and generation-skipping transfer taxes are repealed. Also beginning in 2010, the top gift tax rate will be the top individual income tax rate as provided under the bill, and, except as provided in regulations, a transfer to trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Reduction in State death tax credit; deduction for State death taxes paid

Under the conference agreement, from 2002 through 2004, the State death tax credit allowable under present law is reduced as follows: in 2002, the State death tax credit is reduced by 25 percent (from present law amounts); in 2003, the State death tax credit is reduced by 50 percent (from present law amounts); and in 2004, the State death tax credit is reduced by 75 percent (from present law amounts). In 2005, the State death tax credit is repealed, after which there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Basis of property acquired from a decedent

The conference agreement includes the rules regarding the determination of basis of property acquired from a decedent after repeal of the estate tax included in H.R. 8 and the Senate amendment; however, these rules will be in effect beginning in 2010 (i.e., when the estate tax is repealed under the conference agreement).

Reporting requirements

The conference agreement follows the Senate amendment.

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

The conference agreement follows the Senate amendment, with a modification regarding property in a qualified domestic trust. There will continue to be an estate tax imposed on (1) any distribution prior to January 1, 2021, from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2010.

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

The conference agreement follows H.R. 8 and the Senate amendment, with a modification. Under the conference agreement, beginning in 2010, only a transfer by a U.S. person's estate (i.e., by a U.S. person at death) to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor.

Transfers of property in satisfaction of a pecuniary bequest

The conference agreement follows H.R. 8 and the Senate amendment.

Transfer of property subject to a liability

The conference agreement follows H.R. 8 and the Senate amendment.

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

The conference agreement follows H.R. 8 and the Senate amendment, with a modification. Under the conference agreement, the income tax exclusion for the gain on the sale of a principal residence applies to property sold by a trust that was a qualified revocable trust under section 645 of the Code immediately prior to the decedent's death. The decedent's period of occupancy of the property as a principal residence can be added to an heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence, regardless of whether the residence was owned by such trust during the decedent's occupancy.

Excise tax on non-exempt trusts

The conference agreement follows H.R. 8 and the Senate amendment.

Effective date

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount, and reductions in and repeal of the state death tax credit are phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers after December 31, 2001. The repeal of the qualified family-owned business deduction is effective for estates of decedents dying after December 31, 2003.

The estate and generation-skipping transfer taxes are repealed, and the carryover basis regime takes effect for estates of decedents dying and generation-skipping transfers after December 31, 2009. The provisions relating to recognition of gain on transfers by the estate of a U.S. person (i.e., at death) to nonresidents who are not U.S. citizens is effective for transfers made after December 31, 2009.

The top gift tax rate will be the top individual income tax rate as provided in the bill, and transfers to trusts generally will be treated as a taxable gift unless the trust is treated as wholly owned by the donor or the donor's spouse, effective for gifts made after December 31, 2009.

An estate tax on distributions made from a qualified domestic trust before the date of the death of the surviving spouse will no longer apply for distributions made after December 31, 2020. An estate tax on the value of property remaining in a qualified domestic trust on the date of death of the surviving spouse will no longer apply after December 31, 2009.

B. EXPAND ESTATE TAX RULE FOR CONSERVATION EASEMENTS (SEC. 501 OF H.R. 8, SEC. 551 OF THE SENATE AMENDMENT, AND SEC. 2031 OF THE CODE)

PRESENT LAW

In general

An executor can elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

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

Retained development rights

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

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the House expands the availability of qualified conservation easements by modifying the distance requirements. Under the bill, the distance within which the land must be situated from a metropolitan area, national park, or wilderness area is increased from 25 to 50 miles, and the distance from which the land must be situated from an Urban National Forest is increased from 10 to 25 miles. The bill also clarifies that the date for determining easement compliance is the date on which the donation was made.

Effective date.—The provisions are effective for estates of decedents dying after December 31, 2000.

SENATE AMENDMENT

The Senate amendment expands availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. Thus, under the Senate amendment, a qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. The Senate amendment also clarifies that the date for determining easement compliance is the date on which the donation was made.

Effective date.—The provisions are effective for estates of decedents dying after December 31, 2000.

CONFERENCE AGREEMENT

The conference agreement follows the Senate amendment.

C. MODIFY GENERATION-SKIPPING TRANSFER TAX RULES

1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips (sec. 601 of H.R. 8, sec. 561 of the Senate amendment, and sec. 2632 of the Code)

PRESENT LAW

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a ''skip person'' (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999; the inflation-adjusted amount for 2001 is $1,060,000) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

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

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

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

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

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

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the house provides that generation-skipping transfer tax exemption will be automatically allocated to transfers made during life that are ''indirect skips.'' An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

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

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

The trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;

The trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals;

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

The trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or

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

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

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

Effective date.—The provision applies to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

SENATE AMENDMENT

The Senate amendment is the same as the provision in H.R. 8.

CONFERENCE AGREEMENT

The conference agreement follows H.R. 8 and the Senate amendment.

2. Retroactive allocation of the generation-skipping transfer tax exemption (sec. 601 of H.R. 8, sec. 561 of the Senate amendment, and sec. 2632 of the Code)

PRESENT LAW

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

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, provided that generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The provision allows a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption is allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

Effective date.—The provision applies to deaths of non-skip persons occurring after December 31, 2000.

SENATE AMENDMENT

The Senate amendment is the same as the provision in H.R. 8.

CONFERENCE AGREEMENT

The conference agreement follows H.R. 8 and the Senate amendment.

3. Severing of trusts holding property having an inclusion ratio of greater than zero (sec. 602 of H.R. 8, sec. 562 of the Senate amendment, and sec. 2642 of the Code)

PRESENT LAW

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a ''skip person'' (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999; the inflation-adjusted amount for 2001 is $1,060,000) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

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

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, provides that a trust can be severed in a ''qualified severance.'' A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the provision, a trustee may elect to sever a trust in a qualified severance at any time.

Effective date.—The provision is effective for severances of trusts occurring after December 31, 2000.

SENATE AMENDMENT

The Senate amendment is the same as the provision in H.R. 8.

CONFERENCE AGREEMENT

The conference agreement follows the provision in H.R. 8 and the Senate amendment.

4. Modification of certain valuation rules (sec. 603 of H.R. 8, sec. 563 of the Senate amendment, and sec. 2642 of the Code)

PRESENT LAW

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, provides that in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Effective date.—The provision is effective for transfers subject to estate or gift tax made after December 31, 2000.

SENATE AMENDMENT

The Senate amendment is the same as the provision in H.R. 8.

CONFERENCE AGREEMENT

The conference agreement follows H.R. 8 and the Senate amendment.

5. Relief from late elections (sec. 604 of H.R. 8, sec. 564 of the Senate amendment, and sec. 2642 of the Code)

PRESENT LAW

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, provides that the Treasury Secretary is authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

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

Effective date.—The provision applies to requests pending on, or filed after, December 31, 2000. No inference is intended with respect to the availability of relief from late elections prior to the effective date of the provision.

SENATE AMENDMENT

The Senate amendment is the same as the provision in H.R. 8.

CONFERENCE AGREEMENT

The conference agreement follows the provision in H.R. 8 and the Senate amendment.

6. Substantial compliance (sec. 604 of the House bill, sec. 564 of the Senate amendment, and sec. 2642 of the Code)

PRESENT LAW

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

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

Effective date.—The provision applies to transfers subject to estate or gift tax made after December 31, 2000. No inference is intended with respect to the availability of a rule of substantial compliance prior to the effective date of the provision.

SENATE AMENDMENT

The Senate amendment is the same as the provision in H.R. 8.

CONFERENCE AGREEMENT

The conference agreement follows H.R. 8 and the Senate amendment.

D. EXPAND AND MODIFY AVAILABILITY OF INSTALLMENT PAYMENT OF ESTATE TAX FOR CLOSELY-HELD BUSINESSES (SEC. 701 OF H.R. 8, SECS. 571 AND 572 OF THE SENATE AMENDMENT, AND SEC. 6166 OF THE CODE)

PRESENT LAW

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely-held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.[54] A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2001 is $1,060,000) in taxable value of a closely-held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely-held business in excess of $1 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

For purposes of these rules, an interest in a closely-held business is: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership is included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation is included in the decedent's gross estate or such corporation had 15 or fewer shareholders. The decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the 2-percent interest rate do not apply. The value of any interest in a closely-held business does not include the value of that portion of such interest attributable to passive assets held by such business.

HOUSE BILL

No provision. However, H.R. 8, as passed by the House, expands the definition of a closely-held business for purposes of installment payment of estate tax. The bill increases from 15 to 45 the number of partners in a partnership and shareholders in a corporation that is considered a closely-held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

Effective date.—The provision is effective for decedents dying after December 31, 2001.

SENATE AMENDMENT

The Senate amendment expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. The bill also provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

The Senate amendment also clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. The bill also provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

Effective date.—The provision is effective for decedents dying after December 31, 2001.

CONFERENCE AGREEMENT

The conference agreement includes the provision in H.R. 8 and the provisions in the Senate amendment.

No inference is intended as to whether one or more of the specified activities of a qualified lending and financing business would be a trade or business eligible for installment payment of estate tax under present law.

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