[JOINT COMMITTEE PRINT]

DESCRIPTION OF GENERATION-SKIPPING TRANSFER TAX SIMPLIFICATION PROPOSALS (H.R. 6260 and H.R. 6261) AND BACKGROUND INFORMATION

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON OCTOBER 2, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Committee on Ways and Means has scheduled a hearing on October 2, 1984, to examine proposals to simplify the generation-skipping transfer tax. The two proposals specifically being examined are H.R. 6260 (the Treasury Department Discussion Draft) and H.R. 6261 (the Discussion Draft of the American Law Institute). Both Drafts have been introduced (by request) by Chairman Rostenkowski and Mr. Conable.

The first part of this pamphlet is a summary of the bills. The second part contains background information concerning the Federal gift, estate, and generation-skipping transfer taxes, including an overview of present law, a summary of the legislative history of those taxes, and statistical information concerning the burdens and revenues from those taxes. The third part contains a discussion of some of the significant issues that arise when alternative proposals to the present generation-skipping transfer tax are considered. The fourth part is a more detailed description of the bills that are the subject of the hearing, including a description of present law and explanation of provisions.

I. SUMMARY

Present Law

Under present law, a tax is imposed on generation-skipping transfers under a trust or similar arrangement having beneficiaries in more than one generation below that of the grantor upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the grantor of the trust) or upon termination of an intervening interest in the trust (for example, upon termination of a life income interest in the trust held by the grantor's grandchild). The tax generally is effective for generation-skipping transfers made after June 11, 1976.

A transition rule is included in present law for generation-skipping transfers occurring pursuant to revocable trusts or wills in existence on June 11, 1976, if the instrument is not amended after that date to create or increase the amount of a generation-skipping transfer, and if the grantor or testator died before January 1, 1983. Generation-skipping trusts that were irrevocable on June 11, 1976, are not subject to the tax.

H.R. 6260

(Treasury Department Discussion Draft)

H.R. 6260, the Treasury Department Discussion Draft, would amend the existing generation-skipping transfer tax, which attempts to determine the additional gift or estate tax that would have been paid if property had been transferred directly from one generation to another, to impose a simplified tax determined at a flat rate.

Transfers of up to $1 million per grantor would be exempt from tax. Additional exemptions would be provided for certain transfers that are not subject to gift tax and for distributions of up to $10,000 per year to certain trust beneficiaries.

The generation-skipping transfer tax would be expanded to include direct generation-skipping transfers (e.g., a direct transfer from a grandparent to a grandchild) as well as transfers in which benefits are "shared" by beneficiaries in more than one younger generation. Also, the tax would be imposed on distributions of current trust income as well as trust corpus.

H.R. 6261

(Discussion Draft of the American Law Institute)

H.R. 6261, the Discussion Draft No. 1 of the American Law Institute, would replace the existing generation-skipping transfer tax with three taxes, each determined at a flat rate. The three taxes would be a tax on taxable distributions from generation-skipping trusts, a tax on taxable terminations of generation-skipping trusts, and a tax on outright generation skips.

In essence, each generation-skipping trust created by a transferor would be treated as a separate taxpayer for gift and estate tax purposes. Distributions to persons assigned to generations lower than the children of the transferor would be subject to a gift tax. An estate tax generally would be imposed when all of the interests in a trust of the grandchildren (and higher generations) terminated. A gift tax also would be imposed on the outright transfer from a transferor to his or her grandchildren or to persons in lower generations.

The tax rate would be the maximum Federal gift or estate tax rate (i.e., 55 percent until 1988 and 50 percent thereafter). In lieu of the unified credit and grandchild exclusion of present law, each transferor would be granted a generation-skipping transfer tax credit of $417,000.

In addition, trusts exclusively for the benefit of a single beneficiary would be treated as owned by that beneficiary for gift and estate tax purposes, unless the grantor of the trust elected otherwise.

II. BACKGROUND INFORMATION

A. Overview of the Present-Law Gift, Estate and Generation-Skipping Transfer Taxes

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on deathtime transfers. Under the Tax Reform Act of 1976, the gift and estate taxes were unified so that a single progressive rate schedule is applied to cumulative lifetime and deathtime transfers. The 1976 Act also imposed a tax on generation-skipping transfers. The generation-skipping transfer tax is imposed on transfers, the benefits of which are shared by more than one younger generation and which would otherwise escape gift or estate tax at least one generational level.

1. Rates, unified credit, and computation of tax

Under the unified gift and estate tax rate schedule, rates range from 18 percent on the first $10,000 in taxable transfers to 55 percent on taxable transfers in excess of $3 million. The maximum tax rate is scheduled to decline to 50 percent on transfers in excess of $2.5 million, effective on January 1, 1988.[1]

The amount of gift tax payable (for any calendar year) is determined by applying the unified rate schedule to cumulative lifetime taxable transfers and then subtracting the taxes payable on the lifetime transfers made for past taxable periods. This amount then is reduced by any available unified credit (and certain other credits) to determine the amount of gift tax liability for that period.

The amount of estate tax generally is determined by applying the unified rate schedule to the aggregate cumulative post-1976 lifetime and deathtime transfers and then subtracting the post-1976 gift taxes payable on the lifetime transfers. (In essence, deathtime transfers are treated as the last taxable gift by the decedent.) This amount then is reduced by any remaining unified credit and by certain other credits (discussed below) in determining the amount of estate tax liability.

The unified credit presently is $96,300.[2] With a unified credit of $96,300 and the existing rate schedule, there is no gift or estate tax

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[1] Prior to the Tax Reform Act of 1976, there were separate rate schedules for the gift and estate taxes. The gift tax rates were approximately three-fourths of the estate tax rates. The Tax Reform Act of 1976 combined the separate rate schedules into a unified transfer rate schedule.

[2] Prior to the enactment of the Tax Reform Act of 1976, there was a $30,000 lifetime exemption for gift tax purposes and a $60,000 exemption for estate tax purposes. The Tax Reform Act of 1976 converted the gift and estate tax exemptions into a unified credit. With a unified credit, the gift or estate tax first is computed without any exemption and then the unified credit is subtracted to determine the gift or estate tax liability. The $47,000 unified credit established by the Tax Reform Act of 1976 was phased in over a five-year period as follows: $30,000 for 1977, $34,000 for 1978, $38,000 for 1979, $42,500 for 1980, and $47,000 for 1981.

on transfers of up to $325,000.[3] The unified credit is scheduled to increase to $121,800 (effective on January 1, 1985), to $155,800 (effective on January 1, 1986) and to $192,800 (effective on January 1, 1987). The amounts that can be transferred free of tax with each of these credit amounts are $400,000, $500,000 and $600,000, respectively.

2. Transfers subject to tax: taxable gifts and the gross estate

Gift tax

The gift tax is imposed on any transfer of property by gift whether made directly or indirectly and whether made in trust or otherwise (Code sec. 2501). The amount of the taxable gift is determined by the fair market value of the property on the date of gift. In addition, the exercise or the failure to exercise certain powers of appointment are also subject to the gift tax.

Present law provides an annual exclusion of $10,000 ($20,000 where the nondonor spouse consents to split the gift) of transfers of present interests in property for each donee. In addition, unlimited transfers between spouses are permitted without imposition of a gift tax.

Estate tax

Under present law, all property included in the "gross estate" of the decedent is subject to tax (sec. 2001). The gross estate generally includes the value of all property in which a decedent has an interest at his or her death (sec. 2031).[4] The amount included in the gross estate generally is the fair market value of the property at the date of the decedent's death, unless the executor elects to value all property in the gross estate at the alternate valuation date (which is six months after the date of the decedent's death).[5]

In addition, the gross estate includes the value of certain properties not owned by the decedent at the time of his or her death if certain conditions are met. These conditions include, generally, transfers for less than adequate and full consideration if (1) the decedent retained the beneficial enjoyment of the property during his or her life (sec. 2036) or the power to alter, amend, revoke, or terminate a previous lifetime transfer (sec. 2038), (2) the property was transferred within three years of death (under certain limited circumstances) (sec. 2035), (3) the property was previously transferred during the decedent's lifetime but the transfer takes effect at the death of the decedent (sec. 2037). In addition, the gross estate includes the value of property subject to certain general powers of appointment possessed by the decedent (sec. 2041), and lastly the gross estate includes the proceeds of life insurance on the decedent if the insurance proceeds are receivable by the executor of the decedent's estate or the decedent possessed an incident of ownership in the policy (sec. 2042).

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[3] Note that the effect of the unified credit is, in essence, to reduce the rates of tax on the first $325,000 of transfers to zero and to subject transfers in excess of that amount to tax at the rates based upon cumulative transfers including that amount. Thus, the lowest rate at which tax liability is actually incurred under the gift and estate tax presently is 34 percent.

[4] Special rules (discussed below in Part II.A.3.) are provided for jointly held property.

[5] See below (Part II.A.4.) for a discussion of the special method permitted for the valuation of real estate used in certain farming and other closely held businesses under section 2032A.

3. Jointly held property

The present estate tax provisions contain several special rules governing the treatment of jointly held property for estate tax purposes. These rules apply to forms of ownership where there is a right of survivorship upon the death of one of the joint tenants. They do not apply to community property or property owned as tenants in common.

In general, under these rules, the gross estate includes the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship, except that portion of the property that was acquired by the other joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party. The decedent's estate has the burden of proving that the other joint owner, or owners, acquired their interests for consideration, or by bequest or gift. Consideration furnished by the surviving joint owner, or owners, does not include money or property shown to have been acquired from the decedent for less than a full and adequate consideration in money or money's worth.

The Economic Recovery Tax Act of 1981 (ERTA) provided special rules for certain qualified interests held in joint tenancy by the decedent and his or her spouse. If a decedent owns a qualified joint interest, one-half of the value of such interest is included in the gross estate of the decedent, valued as of the date of the decedent's death (or alternate valuation date), regardless of which joint tenant furnished the consideration. An interest is a qualified joint interest only if the interest was created by the decedent or his or her spouse, or both, and there are no joint tenants other than the decedent and the spouse.

4. Current use valuation

If certain requirements are met, present law allows real property used in family farms and other closely held businesses to be included in a decedent's gross estate at the property's current use value, rather than its full fair market value, provided that the gross estate may not be reduced more than $750,000 (sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at the time of his or her death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by secured debts attributable to the real and personal property), is at least 50 percent of the decedent's gross estate (reduced by secured debts); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[6] (4) the real property qualifying for current use valuation passes to a qualified heir;[7] (5) such real property has been owned by the decedent or a member of his or her family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6)

[6] For purposes of the 50-percent and 25-percent tests, the value of property is determined without regard to its current use value.

[7] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and their descendants.

there has been material participation in the operation of the farm or closely held business by the decedent or a member of his or her family for periods aggregating 5 years out of the 8 years immediately preceding the earliest of the decedent's death or continuous disability or retirement lasting until that date (secs. 2032A (a) and (b)).[8]

If, within 10 years after the death of the decedent (but before the death of the qualified heir), the specially valued real property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purposes based upon which it was valued, all or a portion of the Federal estate tax benefits obtained from the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

5. Allowable deductions

Charitable deduction

Present law allows a deduction for certain amounts transferred for charitable, etc., purposes in computing both the amount of taxable gifts and the taxable estate. The deduction is allowed for amounts transferred to the United States or any State or local government, to certain organizations organized and operated exclusively for charitable, etc., purposes, and to certain organizations of war veterans. Where the charitable transfer is an interest that is less than the donor/decedent's entire interest in the transferred property (e.g., a remainder interest), present law requires that the gift or bequest take certain specified forms in order to be deductible.

Marital deduction

Both the gift tax and the estate tax allow an unlimited deduction for certain amounts transferred from one spouse to another spouse. The Economic Recovery Tax Act of 1981 repealed the former quantative limits on the marital deduction so that no gift or estate tax is imposed on transfers between spouses. This provision was effective on January 1, 1982. ERTA further made certain terminable interests (commonly referred to as "QTIP" interests) eligible for the marital deduction and provided that those interests are includible in the estate of the surviving spouse. Terminable interests generally are created when an interest in property passes to the spouse and another interest in the same property passes to some other person for less than adequate and full consideration. For example, an income interest to the spouse where the remainder interest is transferred to a third party is a terminable interest.

Under the marital deduction as first adopted in 1948, a donor was allowed a marital deduction for gift tax purposes equal to one-half of the property transferred to his or her spouse. For estate tax purposes, the estate was allowed a deduction for property transferred to the spouse of the decedent up to one-half of the adjusted

[8] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

gross estate.[9] The adoption of the marital deduction allowed one spouse to transfer one-half of his or her wealth to the other spouse free of gift or estate taxes and, thus, residents of common-law States could achieve roughly the same tax treatment as residents of community-law States.[10]

Expenses, indebtedness, taxes, and losses

In addition to the charitable and marital deductions, estate tax deductions are allowed for certain administrative expenses of the estate, certain indebtedness of the decedent, and certain taxes other than estate, succession, legacy, or inheritance taxes (sec. 2053). A deduction also is allowed for casualty losses incurred by the decedent's estate (sec. 2054).

6. Credits against tax

In addition to the unified credit, several credits allowed to estates which directly reduce the amount of the estate tax. Two of the most important are the credit for tax on prior transfers and the credit for State death taxes.

Credit for tax on prior transfers

Where property includible in the decedent's gross estate recently has been subject to a previous Federal estate tax, a credit is allowed for all or a portion of that previous Federal estate tax. The amount of the credit is reduced the longer the period of time between the previous Federal estate tax and the death of the decedent. After 10 years, no credit is allowed (sec. 2013).

State death tax credit

A limited credit is allowed against the Federal estate tax for the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia on account of any property included in the gross estate (sec. 2011). The amount of the credit varies with the size of the taxable estate and ranges from no credit on small estates to 16 percent on estates exceeding approximately $10 million.[11]

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[9] The Tax Reform Act of 1976 modified the marital deduction for both gift and estate tax purposes to allow a full marital deduction for certain limited amounts of property passing between spouses.

[10] The original purpose of the marital deduction was to equate generally the tax treatment of property ownership in common-law States with the tax treatment in community-law States. In a community-law State, one-half of all community property generally is considered owned for tax purposes by each spouse even though only one spouse generated the income to acquire the property. In a common-law State, the property generally is considered owned for tax purposes by the spouse who generated the income to acquire the property. Because a progressive rate structure taxes one large accumulation of wealth more heavily than two smaller accumulations, residents in community-property States were taxed less heavily than residents in common-law States prior to the adoption of the marital deduction.

[11] The maximum limitation on the amount of the State death tax credit is essentially a percentage of the rates of Federal estate tax that existed after World War I. After that war, there was pressure to repeal the estate tax. Instead of repealing the tax, Congress adopted the State death tax credit. The effect of the credit is to provide additional revenues to the States. Indeed, most States impose an additional tax commonly referred to as a "pick up" or "make up" tax, equal to the difference between the maximum State death tax credit and any inheritance or other succession taxes the State imposes. The effect of the "pick up" tax is to ensure maximum revenues for the State without otherwise increasing the total death taxes paid by the decedent's estate and heirs.

7. Generation-skipping transfer tax

In order to prevent the avoidance of the Federal gift or estate taxes through the use of generation-skipping arrangements, Congress enacted generation-skipping transfer tax provisions as part of the Tax Reform Act of 1976. The tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping beneficiary (for example, a grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor's child).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations which are younger than the generation of the grantor of the trust (e.g., a child and grandchild). The generation-skipping transfer tax is not imposed in the case of outright transfers. In addition, the tax is not imposed if the child has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation. A more complete discussion of the present-law generation-skipping transfer tax provisions is contained in section IV. A., following.

8. Taxation of nonresident aliens

Gift tax

The Federal gift tax is imposed on nonresident aliens with respect to tangible real and personal property located within the United States. The regular gift tax rates apply. The rules are essentially the same as for citizens, except that the charitable deduction generally is allowed only for transfers to domestic charities and no marital deduction is allowed.

Estate tax

Present law imposes a separate estate tax on nonresident aliens (secs. 2101 to 2108). The tax is imposed only on the part of the gross estate that is situated in the United States. Deductions for expenses, indebtedness, taxes, and losses are allowed only for the proportion of the gross estate located within the United States. As in the case of the gift tax, the charitable deduction is allowed only for transfers to domestic charities and no marital deduction is allowed. There is a separate rate schedule which ranges from 6 percent on the first $100,000 in taxable estate to 30 percent on taxable estates of over $20 million. The unified credit is $3,600. Present law also imposes a special tax if an individual changes his or her United States citizenship within 10 years of death and one of the principal purposes of the citizenship change was to avoid Federal gift, estate, or income taxes.

B. Summary of Legislative History [12]

1. 1797 to 1915

The first Federal involvement with an estate tax began in 1797 when Congress enacted a stamp tax on legacies, probates of wills and letters of administration. The stamp tax lasted until 1802 when it was repealed.

As a method of raising revenue to finance the Civil War, Congress enacted an inheritance tax[13] in 1862. Rates ranged up to 5 percent. The tax was repealed in 1870.

The next Federal estate tax[14] was imposed by the War Revenue Act of 1898. Rates ranged to 15 percent; an exemption of $10,000 was provided. The tax was repealed in 1902.

2. 1916 to 1975

1916-1942

The Revenue Act of 1916 imposed an estate tax that has remained in force until the present time, although it has been modified in numerous ways since then. The 1916 estate tax rates ranged from one percent on small estates to 10 percent on estates over $5 million. An exemption of $50,000 was allowed.

Between 1916 and 1942, the estate tax rates were raised or lowered on several occasions. The estate tax rates were raised twice in 1917. After these changes, the rates ranged from 2 percent on small estates to 25 percent on estates over $10 million. The Revenue Act of 1918 modified the estate tax by exempting estates of less than $1 million from the tax.

The Revenue Act of 1924 made several changes to the estate tax. It raised the top estate tax rate to 40 percent on estates over $10 million. It allowed a limited credit for State death taxes. The Revenue Act of 1924 also imposed a gift tax for the first time.

The Revenue Act of 1926 reduced the estate tax rates and repealed the gift tax. The maximum rate was reduced to 20 percent for estates over $10 million. The estate tax exemption was increased from $50,000 to $100,000, and the maximum credit for State death taxes was increased to 80 percent of the Federal estate tax.

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[12] For a more detailed history of the Federal gift and estate taxes, see Howard Zaritsky, "Federal Estate, Gift and Generation-Skipping Taxes: A Legislative History and a Description of Current Law", Congressional Research Service Report No. 80-76A (April 10, 1980).

[13] An inheritance tax is a tax imposed upon an individual's privilege of inheriting property from a decedent. Typically, the rates of an inheritance tax vary with the closeness of the familial relationship between the decedent and the heir. The rate schedule is applied separately to each heir. In contrast, an estate tax is a tax imposed on the decedent upon the privilege of leaving property to his or her heirs. The rate schedule is applied once to all property passing (or deemed to pass) at the decedent's death, regardless of the number of heirs or their familial relationship to the decedent.

[14] The Income Tax Act of 1894 treated gifts and inheritances as income and, thus, the tax was technically not an estate tax. The 1894 income tax act was held unconstitutional in 1895.

The Revenue Act of 1932 increased the estate tax rates, reduced the exemption to $50,000, and reenacted the gift tax. The top marginal rate under the 1932 Act was 45 percent on estates over $10 million. The gift tax rates were established at three-fourths of the estate tax rates, and an annual exclusion of $5,000 and a lifetime exemption of $50,000 were provided.

The Revenue Act of 1934 increased the top marginal estate tax rate to 60 percent on estates over $10 million. The Revenue Act of 1935 increased the top marginal rate to 70 percent on estates over $10 million and reduced the gift and estate tax exemptions to $40,000.

The Revenue Act of 1941 increased the gift and estate tax rates, imposing rates ranging from 3 percent on small estates to 77 percent on estates over $10 million. The Revenue Act of 1942 modified the gift and estate exemptions and exclusions. Under the 1942 Act, the estate tax exemption was set at $60,000 and the gift tax exemption was set at $30,000. The annual gift tax exclusion was reduced from $5,000 to $3,000.

1943 to 1975

The rates and exemptions established by the Revenue Act of 1941 and 1942 remained in effect until the Tax Reform Act of 1976. The only other major change to the gift and estate taxes during this period was the introduction of the marital deduction by the Revenue Act of 1948. As stated above, the purpose of the marital deduction generally was to equate the tax treatment in common-law States with the tax treatment in community-law States.

3. 1976 to present

The Tax Reform Act of 1976 modified the gift and estate tax laws in a number of ways. The most significant are as follows:[15] (1) the Act unified the gift and estate tax laws into a single cumulative transfer tax system based on combined lifetime and deathtime transfers;[16] (2) the rates were changed so that they began at 18 percent on small estates and increased to 70 percent on estates of over $5 million; (3) the gift tax and estate tax exemptions were combined and changed into a unified credit of $47,000, which allowed combined lifetime and deathtime transfers of $175,625 to be free from estate or gift taxes; (4) the marital deduction was increased to 100 percent of the first $100,000 of gifts and the first $250,000 of legacies and bequests to the spouse; (5) special valuation methods were provided for the valuation of certain real property used in farming or in other closely held businesses; and (6) a generation-skipping transfer tax was imposed.

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[15] The Tax Reform Act of 1976 also revised the income tax treatment of inherited property by providing that the basis of inherited property in the hands of the heir was the same as the basis of the property in the hands of the decedent with certain adjustments (i.e., a "carryover basis"). Under prior law, the basis of inherited property was its fair market value on the date of the decedent's death (or alternate valuation date, if elected). The carryover basis rules of the 1976 Act were repealed retroactively by the Crude Oil Windfall Profits tax Act of 1980.

[16] Prior to enactment of the Tax Reform Act of 1976, the amount of lifetime transfers generally did not affect the amount of estate tax because there were separate rate schedules for both the gift tax and the estate tax. Under the unified system of the Tax Reform Act of 1976, deathtime transfers, in essence, are treated as the last gift of the decedent under a single rate schedule.

The Economic Recovery Tax Act of 1981 further modified the gift and estate tax laws in numerous significant ways. The Act increased the unified credit to an equivalent amount of $600,000 (phased in over 6 years), and reduced the maximum rate from 70 percent to 50 percent (phased in over 4 years). An unlimited marital deduction was provided and certain terminable interests became eligible for the deduction for the first time. The gift tax annual exclusion was increased from $3,000 to $10,000 per donee. Rules governing the installment payment of estate tax attributable to interests in closely held businesses and the current use valuation of certain real property were liberalized.

ERTA made a number of other modifications to the gift and estate tax rules, including repeal (for most purposes) of the rule that gifts made by an individual within three years of death must be included in the individual's gross estate; elimination of a step-up in basis if appreciated property is acquired by gift by the individual within one year of death and then is returned to the donor or the donor's spouse; repeal of the orphan's exclusion; annual filing of gift tax returns; one-year extension of the transition rule for certain wills or revocable trusts under the tax on generation-skipping transfers; and allowance of a charitable deduction for gift and estate tax purposes for certain bequests or gifts of copyrightable works of art, etc., when the donor retains the copyright.

The Tax Equity and Fiscal Responsibility Act of 1982 reduced the previously unlimited exclusion for certain annuities to $100,000.

Finally, the Tax Reform Act of 1984, delayed the scheduled reduction in the maximum gift and estate tax rate to 50 percent until 1988. The 1984 Act also liberalized the rules governing the installment payment of estate tax, repealed the $100,000 exclusion from the gross estate for certain annuities and made other technical modifications to these taxes.

C. Statistical Information

1. Federal revenues

Prior to 1916, estate taxes were used primarily to raise revenue. Since 1916, the gift, estate, and generation-skipping transfer taxes (the "transfer" taxes) have been used to raise revenues and for other purposes such as preventing undue concentrations of wealth and complementing the income tax to fulfill the goal of the progressive tax system. Table 1 compares the revenue from transfer taxes as a percent of all Federal revenues from the period 1925 to the present. As indicated, transfer taxes have accounted for less than 2 percent of Federal revenues since World War II. Table 2 provides estimates of the revenues from the transfer taxes from 1981 to 1984 based upon existing rates and credits.

Table 1.—Transfer Tax Revenues as a Percent of Total Federal Revenue, Selected Years—1925 to Present

[Dollar amounts in millions]

Year	Net transfer tax revenue [1]	Total Federal revenue [2]	Percent of revenues attributable to transfer taxes
1925	$86	$3,641	2.4
1930	39	4,058	1.0
1935	154	3,706	4.2
1940	250	6,879	3.6
1945	531	50,162	1.1
1950	484	40,940	1.2
1955	778	65,469	1.2
1961	1,619	94,389	1.7
1963	1,841	106.560	1.7
1966	2,414	130,856	1.8
1970	3,000	193,743	1.5
1981	8,035	614,735	1.3
1982	6,827	618,221	1.1
1983	5,933	600,598	1.0
1984 (est.)	6,011	670,665	.9

[1] Calendar year receipts (Note: calendar year receipts of the transfer taxes generally are received in the next subsequent fiscal year.)

[2] Fiscal year receipts.

Table 2.—Federal Transfer Tax Revenues, Fiscal Years 1983–88 (estimated for 1984–1988)

[In millions of dollars]

1983	1984	1985	1986	1987	1988
6,052	6,052	5,657	5,401	5,036	4,780

2. State revenues

As indicated above, present law allows a limited credit against Federal estate tax for death taxes paid to a State. Typically, most States impose an inheritance tax and, in addition, impose an estate tax, commonly called a "pick up" or "make up" tax equal to the difference between the maximum State death tax credit and any inheritance taxes imposed on property passing from the decedent. Table 3 sets forth the aggregate amount of the State death tax credit for selected years during the period 1925 to the present. This may be considered an additional burden of the Federal estate tax, although the revenue goes to the State governments, not the Federal Government.

Table 3.—Credit for State Inheritance Taxes Paid, Selected Years—1925 to Present

[In million of dollars]

Year	Amount
1925	11
1930	113
1935	44
1940	45
1945	65
1950	49
1955	86
1961	196
1963	208
1966	280
1970	333
1977	552
1981	896
1982	984
1983	1,043
1984 (est.)	1,106

3. Historical distribution of the Federal estate tax

Table 4 provides a comparison from 1925 until the present of (1) the number of estate tax returns filed; (2) the number of estates paying estate tax, expressed as an absolute number and as a percentage of all individuals dying in that year; (3) the aggregate dollar amount of gross estate of all estate tax returns filed for that year; (4) the aggregate dollar amount of taxable estate of all estates paying tax for that year; (5) the aggregate dollar amount of estate tax paid for that year; and (6) the average estate tax rate of estates paying tax during that year.

Table 4.—Selected Federal Estate Tax Data, Selected Years—1925 to Present

[Dollar amounts in millions]

		Taxable returns					
Year	Number of returns	Number of taxable returns	Percent of all decedents	Gross estate	Taxable estate	Net estate tax	Average tax rate (%)
1925	14,013	10,642	0.8	$2,958	$1,621	$86	5.3
1930	8,798	7,028	.5	4,109	2,377	39	1.6
1935	11,110	8,655	.6	2,435	1,317	154	11.7
1940	15,435	12,907	.9	2,633	1,479	250	16.9
1945	15,898	13,869	1.0	3,437	1,900	531	17.9
1950	25,858	17,411	1.2	4,918	1,917	484	25.2
1955	36,595	25,143	1.6	7,467	2,991	778	26.0
1961	64,538	45,439	2.7	14,622	6,014	1,619	26.9
1963	78,393	55,207	3.0	17,007	7,071	1,841	26.0
1966	97,339	67,404	3.6	21,936	9,160	2,414	26.4
1970	133,944	93,424	4.9	29,671	11,662	3,000	25.7
1977	200,747	139,115	7.3	48,202	20,904	4,979	23.8
1981	114,720	74,607	3.7	52,641	31,856	8,035	25.2
1982	85,386	55,530	2.8	55,273	33,449	6,827	20.4
1983	69,223	48,341	2.4	59,230	35,957	5,933	16.5
1984 (est.)	60,754	42,528	2.1	61,717	38,044	6,011	15.8

III. ISSUES ARISING UNDER SIMPLIFICATION PROPOSALS

A. Imposition of Tax

1. Taxation of direct skips

Unlike present law, both the Treasury and ALI Discussion Drafts would impose a generation-skipping transfer tax on transfers that are made directly to younger generations and that skip over intervening generations. (Under both Discussion Drafts, such transfers would be taxed only once, regardless of the number of generations between the donor and donee.) One of the principal arguments against the present generation-skipping transfer tax is that, because such direct skips are not taxed, the wealthiest individuals remain able to avoid transfer tax at one or more generations by "layering" their estates through direct skips. Those advancing this argument point out that persons of more moderate means must leave their property in generation-sharing arrangements to achieve a meaningful economic benefit for each generation.

Opponents of taxing direct skips argue that only one transfer of property occurs in these cases; therefore, arguably, only one transfer tax should be imposed. The gift and estate taxes fulfill this need, these persons argue. Additionally, opponents of imposing tax on direct skips also say that, unlike trusts for beneficiaries in multiple generations, taxes generally are not a primary motive for direct transfers (*e.g.*, gifts to grandchildren). Persons supporting taxation of direct skips counter this argument by saying that transfers in excess of the generous specific exemption or credit against tax provided under the Treasury and ALI Discussion Drafts, while not necessarily tax-motivated, generally are made with due consideration to tax consequences.

2. Taxation of trusts providing for generation-skipping transfers to more than one younger generation

A single trust may provide for transfers to more than one generation of generation-skipping beneficiaries. For one example, a trust may provide for income payments to the grantor's child for life, then for such payments to the grantor's grandchild for life, and finally for distribution of the trust property to a great-grandchild. Were such property transferred outright to each generation, the property would be subject to gift or estate tax a total of three times. Similarly, under present law, the property would have been subject to transfer tax (gift, estate, and generation-skipping transfer tax) a total of three times.

Under both the Treasury Department and the ALI Discussion Drafts, only two transfer tax events would occur in these cases. If tax neutrality is desirable, it may be argued that any revised generation-skipping transfer tax should result in three transfer tax events in this example. This feature of the two Discussion Drafts raises equity issues because persons with greater amounts of wealth arguably can create single trusts that skip multiple generations more economically than can persons of more moderate means.

B. Specific Exemption *vs.* Credit Against Tax

Both the Treasury Department and ALI Discussion Drafts would provide a mechanism for exempting from the tax certain transfers by each person. The Treasury Department Draft would provide an up-front specific exemption for transfers of up to $1 million. The ALI Draft would give a credit of $417,000 against the tentative tax.

Both the specific exemption and the credit approach have strong proponents. It is argued by some that a specific exemption furthers the objective of simplicity by excluding certain trusts entirely from the tax system. A credit, on the other hand, requires all trustees to be cognizant of the generation-skipping transfer tax since the credit is realized only when a transfer occurs. Others argue that a credit is superior to an exemption since it does not allow appreciation on property transferred to a trust to escape the generation-skipping transfer tax.

C. Transferability

The Treasury Department Discussion Draft, unlike the ALI Draft, would permit a person to transfer his or her unused exemption to a spouse or former spouse, both by lifetime gift and at death. Additionally, the transferee spouse could retransfer this exemption to his or her subsequent spouses. The transferability issue arises whether there is an exemption or credit. Proponents of transferability argue that this feature allows more flexibility to taxpayers in estate planning. Opponents of transferability say that it adds complexity and creates potential for abuse.

If it is determined that some transferability of the specific exemption or credit should be allowed, but restrictions are necessary to prevent abuse, several options are available. First, use of a transferred exemption amount could be limited to transfers made by a spouse during marriage (or widowhood). Alternatively, the use of exemption amounts transferred to a spouse could be restricted to transfers by the donee spouse for the benefit of the transferor's lineal descendants, or for application to QTIP property included in that spouse's estate. Finally, if spousal transfers were allowed, restrictions could be imposed to preclude retransfer of the exemption to subsequent spouses or to limit aggregation of exemptions.

D. Annual Exemption for Certain Distributions

The Treasury Department Discussion Draft would provide an exemption of up to $10,000 per year for distributions to certain trust beneficiaries. This exemption would be available only for beneficiaries two generations below that of the trust grantor and only if the distributing trust also has beneficiaries one generation below that of the grantor. This exemption would be in addition to the $1 million per grantor specific exemption and the exemption for transfers that are not taxable gifts also contained in the Treasury Draft. Arguably, this exemption would provide a needed *de minimis* rule for trust distributions.

Additionally, some persons have urged that this exemption is appropriate under the Treasury Department Draft because part of the benefit of a trust's specific exemption effectively may be "wasted" on distributions to nontaxable beneficiaries in the first generation below that of the grantor. For example, if two-thirds of a trust were exempt from tax, only two-thirds of all distributions to the transferor's grandchildren would be exempt, even if fewer than two-thirds of all distributions made by the trust were made to those beneficiaries. A portion of the trust's exemption might be viewed as being allocated in substance, therefore, to non-generation-skipping transfers to children of the transferor.

An issue arises as to whether any exemption in addition to those available to transferors in general is appropriate in light of the specific exemption of $1 million or credit of $417,000 as the Treasury Department and ALI Discussion Drafts respectively would provide. If such an additional exemption were approved, an alternative method of realizing its objective might be to allow trustees to allocate all exempt distributions to otherwise taxable beneficiaries. Under such a rule, for example, all distributions to grandchildren would be exempt from tax to the extent those distributions did not exceed the exempt portion of the trust multiplied by the total of distributions made to all beneficiaries of the trust (on an annual or cumulative basis).

E. Rate of Tax

Under present law, a single transfer tax rate schedule is applied to cumulative lifetime and deathtime transfers. A single unified credit exempts from the transfer tax, cumulative transfers of up to $325,000 (scheduled to increase by annual increments until it reaches $600,000 in 1987). The rate of tax imposed ranges from 18 percent on the first $10,000 in taxable transfers to 55 percent on transfers in excess of $3 million. The generation-skipping transfer tax is calculated with reference to the transfer tax history of the deemed transferor, using the same rates and unified credits, and so forth.

Under the Treasury Department Discussion Draft, taxable generation-skipping transfers would be subject to a flat rate of tax equal to 80 percent of the maximum transfer tax rate applicable at the time of the transfer (e.g., 44 percent in 1984). This tax generally would be imposed on a "tax-inclusive" basis, except in the case of direct skips, on which tax would be imposed on a "tax-exclusive" basis.

Under the Discussion Draft of the American Law Institute, taxable generation-skipping transfers would be subject to a flat rate of tax equal to the maximum transfer tax rate applicable at the time of the transfer (e.g., 55 percent in 1984). The taxes under the ALI Discussion Draft generally would be imposed on a "tax-exclusive basis, except in the case of taxable terminations, which would be taxed on a "tax-inclusive" basis.

Proponents of a unified progressive system argue that application of the progressive transfer tax rate schedule is consistent with the progressivity of the overall transfer tax system. Application of a flat rate to generation-skipping transfers would, depending on the rate chosen and the transferor's transfer tax history, create artificial incentives or disincentives to making generation-skipping transfers, while preservation of the unified progressive rate schedule would insure neutrality among alternative forms of disposition.

Proponents of a flat-rate tax argue that it is administratively easier to deal with such a tax. Noting that use of a unified system forces maintenance of a cumulative tax base, they argue that such recordkeeping, although appropriate in a transfer tax system imposing liability on a single transferor, is less appropriate and is impractical in the case of a generation-skipping tax imposed on different persons.

F. Credit for State Taxes

The Treasury Department Discussion Draft would permit a credit against the revised generation-skipping transfer tax for State generation-skipping transfer taxes if the taxable transfer occurred as a result of death. The present generation-skipping transfer tax and the estate tax provide credits for such State taxes. No such credit is available against the gift tax. These credits are in substance revenue sharing with the States. An issue arises as to whether this indirect form of revenue sharing should be continued in the case of a revised generation-skipping transfer tax or whether it is more appropriate to limit revenue sharing to that approved directly by the Congress as such.

IV. DESCRIPTION OF BILLS

A. Present Law

1. Overview

Under present law, a generation-skipping trust is defined as a trust which provides for the splitting of benefits between two or more generations that are younger than the generation of the grantor. A generation-skipping transfer tax, substantially equivalent to the estate tax which would have been imposed on direct transfers to each generation, is imposed on certain distributions from, and terminations of interests in or powers over, such trusts.

The tax is imposed when trust assets are distributed to a generation-skipping beneficiary or upon the termination of an intervening interest in the trust. No tax is imposed on outright transfers to generation-skipping beneficiaries.

No tax is imposed if the younger generation beneficiary has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor.

In addition, present law provides an exclusion for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

2. Imposition of tax

A generation-skipping transfer is defined as a transfer to a beneficiary least two generations younger than the transferor. Generation-skipping transfers are subject to tax if made under a trust or similar arrangement. No tax is imposed in the case of outright transfers to generation-skipping beneficiaries.

Taxable events

A generation-skipping transfer tax is imposed on the occurrence of either a *taxable termination* or a *taxable distribution*.

A *taxable termination* means the termination of an interest or power of a younger generation beneficiary who is a member of a generation which is older than that of any other younger generation beneficiary of the trust. Such a termination generally would occur by reason of death (in the case of a life interest) or by lapse of time (in the case where the grantor created an estate for years).

For example, if a trust provided income for life to the grantor's child, with remainder to the grantor's grandchild, there would be a taxable termination of the child's interest upon his or her death because this death would terminate the interest (in this case, a life income interest) of a younger generation beneficiary (the child) who was a member of a generation older than that of any other younger generation beneficiary (the grandchild) of the trust. For purposes of determining whether there has been a generation-skipping transfer, the determination as to whether there are younger generation beneficiaries is made immediately before the transfer takes place.

Special rules postpone the taxable termination (and thus the imposition of the tax) in cases involving future interests or powers, multiple beneficiaries, and discretionary trusts.

A *taxable distribution* occurs whenever there is a distribution from a generation-skipping trust, other than a distribution out of accounting income (Code sec. 643(b)) to a younger generation beneficiary of the trust, and there is at least one other younger generation beneficiary who is a member of an older generation than the distributee. For example, assume that a discretionary trust is established for the benefit of the grantor's child and grandchild. The trustee exercises its discretion by distributing accounting income to the child and also makes a distribution out of corpus to the grandchild. This would constitute a taxable distribution because there would be at least one younger generation beneficiary (the child) who was a member of a generation older than that of the grandchild.

Where there are distributions out of corpus as well as out of income, the distributions to members of the oldest generation (whether or not they are younger generation beneficiaries) are to be treated as having been made out of income (to the extent of the income), and the distributions to younger generations are to be treated as having been made out of any remaining income, and then out of corpus.

The terms *taxable termination* and *taxable distribution* do not include any events which are subject to gift or estate tax (for example, because the beneficiary whose interest in a trust has terminated had a general power of appointment with respect to the trust property). Where both a termination and a distribution result from the same occurrence (such as the death of a member of an intervening generation), the transfer is treated as a termination.

Generation assignment

A generation-skipping trust is a trust having two or more generations of "beneficiaries" who belong to generations which are "younger" than the generation of the grantor of the trust. For purposes of the generation-skipping transfer tax provisions, a "grantor" of the trust includes any person contributing or adding property to the trust.

Generally, generations are determined along family lines where possible. For example, the grantor, his or her spouse and brothers and sisters are one generation; their children (including adopted children) are the first younger generation; their grandchildren constitute the second younger generation, etc. Spouses of family members are assigned to the same generation as the family member to whom they are married.

Where generation-skipping transfers are made outside the family, generations are measured from the grantor. Individuals not more than 12 1/2 years younger than the grantor are treated as members of the grantor's generation; individuals more than 12 1/2 years younger than the grantor, but not more than 37 1/2 years younger, are considered members of the grantor's children's generation, and so forth.

3. Credit against tax

Present law provides specific exclusions from tax if the younger generation beneficiary has nothing more than (1) a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor. In addition, a special exclusion is provided for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

Because the tax is based upon the transfer tax history of the deemed transfer, a generation-skipping trust is entitled, in calculating the tax arising after the death of such deemed transferee, to any unused portion of that person's unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and a deduction for certain administrative expenses.

4. Computation of tax

Rate of tax

The present generation-skipping transfer tax is substantially equivalent to the tax which would have been imposed if the property actually had been transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust is created for the benefit of the grantor's child during the child's life, with remainder to a grandchild. Upon the death of the child, the generation-skipping transfer tax is computed by adding the child's portion of the trust assets to the child's estate and computing the tax at the child's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the child is treated under present law as the "deemed transferor" of the trust property. The deemed transferor's marginal estate tax rate is used for purposes of determining the tax imposed on the generation-skipping transfer. Under present law, the applicable rate on taxable transfers ranges from 18 percent on the first $10,000 in taxable transfers to 55 percent on transfers in excess of $3 million.

Tax base and payment of tax

In the case of a *taxable distribution*, the amount subject to tax is the value of the money and property distributed (determined as of the time of the distribution). The tax base includes the transfer taxes paid under these rules with respect to the distribution, regardless of whether these taxes are paid by the beneficiary out of the proceeds of the distribution, or the taxes are paid by the trustee out of trust monies which are paid over directly to the Government. In the case of a *taxable termination*, the tax base equals (1) the value of the trust property in which an interest has terminated and/or (2) the value of the property which was the subject of a power (where a power has terminated).

Neither the deemed transferor nor his or her estate is liable for the tax imposed under these provisions. Generally, the tax is paid out of the proceeds of the trust property. In the case of a taxable distribution, however, the distributee of the property is personally liable for the tax to the extent of the fair market value of the property which he or she receives (determined as of the date of the distribution). In the case of a taxable termination, the trustee is personally liable for the tax. However, the trustee is permitted to file a request with the Internal Revenue Service for information concerning the transfer tax rate bracket of the deemed transferor. Where the transfer is to a grandchild of the grantor of the trust, the trustee may also request information concerning the extent to which the $250,000 exclusion of the deemed transferor has not been fully utilized. The trustee is not liable for tax to the extent that any shortfall in the payment of the tax ultimately determined to be due results from the trustee's reliance on the information supplied by the Internal Revenue Service in response to either of these requests.

Credit for State taxes

Because the generation-skipping transfer tax is calculated with reference to the transfer tax history of the deemed transferor, the generation-skipping trust is entitled to any unused portion of the deemed transferor's credit for State death taxes.

No specific credit is provided with respect to the payment of State generation-skipping taxes.

5. Coordination with other provisions

Estate tax

To the extent consistent with the specific provisions concerning generation-skipping transfers, the rules of the Code relating to the gift tax apply in cases where the deemed transferor is alive at the time of the generation-skipping transfer, and the rules relating to the estate tax apply where the generation-skipping transfer occurs at or after the death of the deemed transferor.

The alternate valuation date is available where a taxable termination occurs as a result of the death of the deemed transferor. In this case, the election to use the alternate valuation date is to be made by the trustee of the generation-skipping trust (who is also the person liable for the tax under these circumstances) and it is not required that the executor of the deemed transferor's estate also elect that provision.

Income tax

Where certain rights to income are subject to the tax on generation-skipping transfers, the income tax treatment of so-called "income in respect of a decedent" may apply to this income. Thus, the recipient of this income is entitled to a deduction (in computing income tax) for the generation-skipping transfer tax in the same way as that recipient is allowed a deduction for estate tax imposed on these items (sec. 691(c)). Also, where a generation-skipping transfer which is subject to tax occurs as a result of the death of the deemed transferor, section 303 treatment, which permits certain tax-free redemptions of stock to pay estate tax, is available. The trust and the actual estate of the deemed transferor are treated separately for purposes of the section 303 qualification requirements.

B. Description of H.R. 6260

(Treasury Department Discussion Draft)

1. Overview

H.R. 6260, the Treasury Department Discussion Draft, would amend the existing generation-skipping transfer tax, which attempts to determine the additional gift or estate tax that would have been paid if property had been transferred directly from one generation to another, to impose a simplified tax determined at a flat rate.

Transfers of up to $1 million per grantor would be exempt from tax. Additional exemptions would be provided for certain transfers that are not subject to gift tax and for distributions of up to $10,000 per year to certain trust beneficiaries.

The generation-skipping transfer tax would be expanded to include direct generation-skipping transfers (e.g., a direct transfer from a grandparent to a grandchild) as well as transfers in which benefits are "shared" by beneficiaries in more than one younger generation. Also, the tax would be imposed on distributions of current trust income as well as trust corpus.

2. Imposition of tax

As under present law, H.R. 6260 would define a generation-skipping transfer as a transfer to a beneficiary at least two generations younger than the transferor. Thus, only transfers to grandchildren or younger generations would be subject to tax. Generation-skipping transfers would be subject to tax whether in trust, pursuant to an arrangement similar to a trust, or outright.

In general, H.R. 6260 would retain the present-law rules on generation assignment, except that lineal descendents of the grandparents of the transferor's spouse also would be assigned to generations on a basis like that for such descendents of the grandparents of the transferor.

Taxable events

A generation-skipping transfer tax would be imposed on the occurrence of any one of three events—a *taxable distribution*, a *taxable termination*, or a *direct skip*.

The first two events generally involve transfers that are taxable under present law. A *taxable distribution* would occur upon distribution of property to a generation-skipping beneficiary (e.g., a grandchild). A *taxable termination* would occur upon the expiration of an interest in a trust if, after that termination, all interests in the trust were held by generation-skipping beneficiaries. Persons holding interests in property generally would be defined to include only those persons having a current right to property (or income therefrom) or persons who were current permissible recipients of the property (or income therefrom). For example, a person having an income interest for life or a holder of a general power of appointment would be treated as having an interest in property.

A *direct skip* would occur upon an outright transfer for the benefit of a person at least two generations below the transferor or a transfer of property to a trust for one or more such beneficiaries. As stated in the Overview, an example of a direct skip would be a gift from a grandparent to his or her grandchild.

Effect of disclaimers

Under H.R. 6260, a disclaimer that resulted in property passing to a person at least two generations below that of the original transferor would result in imposition of the generation-skipping transfer tax. This is because the property is treated as passing from the original transferor to the ultimate recipient for purposes of the transfer taxes. For example, if a child of a decedent made a qualified disclaimer, and, under local law, the disclaimed property passed to the grandchildren of the decedent, a generation-skipping transfer tax would be imposed on the transfer (in addition to any estate tax to which the transfer was subject). Pursuant to H.R. 6260's general source of tax rule, the disclaimed property, rather than the decedent's estate generally, would be primarily liable for payment of the generation-skipping transfer tax.

Tax on income distributions

Unlike present law, the H.R. 6260 would subject generation-skipping distributions from a trust to tax whether the distributions carried out trust income or trust corpus. However, an income tax deduction would be given to the recipient for the generation-skipping transfer tax imposed on the distribution.

Tax on trusts providing for generation-skipping transfers to more than one younger generation

A single trust may provide for transfers to more than one generation of generation-skipping beneficiaries. For example, a trust may provide for income payments to the grantor's child for life, then for such payments to the grantor's grandchild for life, and finally for distribution of the trust property to the grantor's great-grandchild. Were such property left outright to each generation, the property would be subject to gift or estate tax a total of three times. Under present law, such a transfer in trust would be subject to transfer tax (gift, estate, and generation-skipping transfer tax) a total of three times. H.R. 6260 would subject the property to transfer tax only two times—gift or estate tax on the original transfer and generation-skipping transfer tax on the termination of the child's interest.

3. Exemptions from tax

$1 million exemption

H.R. 6260 would provide an exemption of up to $1 million for each person making generation-skipping transfers. In addition, an individual could apply the exemption to transfers made by his or her spouse (including future transfers) or transfer the exemption to the spouse. This "transferability" aspect of the exemption also would permit surviving spouses and other former spouses to receive unused amounts of a decedent's exemption, and to retransfer that amount to their subsequent spouses.

The $1 million exemption could be allocated to transfers at any time up to the due date of an individual's estate tax return. Allocations after an initial transfer generally would not, however, affect the taxation of generation-skipping transfers occurring before the allocation was made. Once a transfer, or portion of a transfer, was designated as exempt, all subsequent appreciation in value of the exempt property also would be exempt from generation-skipping transfer tax.

The operation of the specific exemption may be illustrated by the following example. Assume a grantor transferred $1 million in trust for the benefit of his or her children and grandchildren. If the grantor allocated $1 million of exemption to the trust, no part of the trust would ever be subject to generation-skipping transfer tax—even if the value of the trust property appreciated in subsequent years to $10 million or more. On the other hand, if the grantor allocated only $500,000 of exemption to the trust, one-half of all distributions to grandchildren would be subject to tax and one-half of the trust property would be subject to tax on termination of the children's interest. If, after creation of the trust, the grantor allocated an additional $250,000 of exemption to the trust, the exempt portion of trust would be redetermined, based upon the values of the trust property at that time. This new inclusion ratio would apply to future distributions and terminations, but generally would not change the tax treatment of any past events.

In light of the $1 million exemption, the $250,000 grandchild exclusion of present law would be eliminated. As explained above, however, the $1 million exemption would not be limited to transfers to grandchildren of the transferor.

Exemption for nontaxable gifts

The generation-skipping transfer tax would not apply to any lifetime transfer which was exempt from gift tax pursuant to either the $10,000 annual exclusion or the special exclusion for certain tuition and medical expense payments.

Special $10,000-per-year distribution exemption

A special $10,000-per-year exemption would be provided for certain otherwise taxable distributions from trusts. This exemption would be determined by aggregating all taxable distributions received by the individual and his or her spouse in a year. Additionally, only those distributions to persons at the level of the transferor's grandchild from trusts having current beneficiaries in a higher generation would qualify for this special exemption. For example, a grandniece of the grantor would qualify for this exemption, but only when another person such as the grandniece's mother also had an interest in the trust.

4. Computation of tax

Rate of tax

The rate of tax on generation-skipping transfers would be 80 percent of the highest gift and estate tax rates. Thus, the tax rate would be 44 percent until 1988, when it would decline to 40 percent.

Tax base and payment of tax

The tax base and method of paying the generation-skipping transfer tax would be as follows:

Taxable distributions.—The amount subject to tax would be the amount received by the transferee (i.e., the tax would be imposed on a "tax-inclusive" basis). The transferee would pay the tax on a taxable distribution. (If a trustee paid any amount of the tax, the trustee would be treated as making an additional taxable distribution of that amount.)

Taxable terminations.—The amount subject to tax would be the value of the property in which the interest had terminated (i.e., the tax would be imposed on a "tax-inclusive" basis). The trustee would pay the tax on a taxable termination.

Direct skips.—The amount subject to tax would be the value of the property received by the transferee (i.e., the tax would be imposed on a "tax-exclusive" basis). The person making the transfer would pay the tax on a direct skip.

Credit for State taxes

A credit against the amended Federal tax for generation-skipping transfer tax imposed by a State would be allowed with respect to taxable transfers occurring at death. The maximum credit would be a flat percentage of the Federal tax to be specified in the statute. A general State inheritance or estate tax for which credit was claimed in determining estate tax would not qualify for this credit, even if the State imposed the tax at a rate in excess of the maximum credit allowable to the estate under Code section 2011.

5. Coordination with other provisions

H.R. 6260 also includes several provisions coordinating the generation-skipping transfer tax with the gift and estate taxes. The Internal Revenue Code provisions governing administration of the gift and estate taxes also would apply to the amended generation-skipping transfer tax. Estate tax rules would apply to generation-skipping transfers occurring as a result of death, and gift tax rules would apply in other cases.

In addition to any basis adjustment received under the gift or estate tax basis provisions, the basis of property subject to the amended generation-skipping transfer tax generally would be increased by the amount of that tax attributable to the excess of the property's value over the transferor's basis. In the case of taxable terminations occurring as a result of death, a step-up in basis like that provided under the estate tax would be provided.

Property transferred in a direct skip occurring as a result of death would have the same value for purposes of the generation-skipping transfer tax as the property had for estate tax purposes.

Thus, if the transferor's estate elected the alternate valuation date or the current use valuation provision, the value under those provisions would be used in determining the generation-skipping transfer tax. In addition, even if an estate did not elect the alternate valuation date, an election could be made to value any property transferred in a taxable distribution or a taxable termination on the alternate valuation date if the distribution or termination occurred as a result of death and the requirements of that provision were satisfied.

The special rules under which estate tax attributable to interests in certain closely held businesses may be paid in installments also would apply to direct generation-skipping transfers occurring as a result of death.

The estate tax credit for tax paid in certain prior transfers would be adjusted to reflect the generation-skipping transfer tax in certain cases.

The provision permitting tax-free redemptions of stock to pay estate tax would be amended to permit those redemptions to pay generation-skipping transfer tax in the case of such transfers occurring as a result of death.

C. Description of H.R. 6261

(Discussion Draft of the American Law Institute)

1. Overview

H.R. 6261, the Discussion Draft of the American Law Institute, would replace the existing generation-skipping transfer tax with three taxes, each determined at a flat rate. The three taxes would be a tax on taxable distributions from generation-skipping trusts, a tax on taxable terminations of generation-skipping trusts, and a tax on outright generation skips.

In essence, each generation-skipping trust created by a transferor would be treated as a separate taxpayer for gift and estate tax purposes. Distributions to persons of generations lower than the children of the transferor would be subject to a gift tax. An estate tax generally would be imposed when all of the interests in a trust of the grandchildren (and higher generations) terminated if the trust continued after that time. A gift tax also would be imposed on the outright transfer from a transferor to his or her grandchildren or to persons in lower generations.

The tax rate would be the maximum Federal gift and estate tax rate (i.e., 55 percent until 1988 and 50 percent thereafter). In lieu of the unified credit and grandchild exclusion of present law, each transferor would be granted a generation-skipping transfer tax credit of $417,000.

In addition, trusts which are exclusively for the benefit of a single beneficiary would be treated as owned by that beneficiary for gift and estate tax purposes, unless the grantor of the trust elected otherwise.

2. Imposition of tax

Taxable events

H.R. 6261 would impose a tax on a *taxable distribution,* a *taxable termination,* and an *outright generation skip.* These taxes would apply whether the transfer was in trust, pursuant to an arrangement similar to a trust, or outright. Generation assignments would be made only in the case of family members. Assignment of generations among family members would be determined by reference to the grandparents of the transferor and his or her spouse.

Taxable distributions.—In general, a taxable distribution would occur when property was distributed from a trust (other than a trust treated as owned by a single beneficiary) unless the distribution was to a person who was assigned to a generation the same as or higher than the generation of the children of the transferor (referred to as the "excepted class"). In addition, a taxable distribution would include distributions made up to nine months after what otherwise would be a taxable termination.

Taxable terminations.—In general, a taxable termination would occur upon the expiration of an interest of a beneficiary if the the beneficiary was not in the excepted class and there was no beneficiary of the trust after that time who was a member of the excepted class. Thus, where consecutive life estates were left for the issue of the transferor, a taxable termination would occur at the death of the last grandchild of the transferor.

Outright skips.—In general, an outright skip would occur where there was a transfer directly to a person who is not a member of the excepted class (i.e., a transfer from grandparents to grandchild).

Trusts for nonfamily members.—In the case of a trust created for nonfamily members, the beneficiaries of the trust would not be assigned to generations. Instead, a taxable termination would be deemed to occur every 35 years.

Tax on income distributions

Unlike present law, H.R. 6261 would subject generation-skipping distributions from a trust to tax whether the distributions carried out trust income or trust corpus.

Tax on trusts providing for generation-skipping transfers to more than one younger generation

A single trust may provide for transfers to more than one generation of generation-skipping beneficiaries. For example, a trust may provide for income payments to the grantor's child for life, then for such payments to the grantor's grandchild for life, and finally for distribution of the trust property to the grantor's great-grandchild. Were such property left outright to each generation, the property would be subject to gift or estate tax a total of three times. Under present law, such a transfer in trust would be subject to transfer tax (gift, estate, and generation-skipping transfer tax) a total of three times. H.R. 6261 would subject the property to transfer tax two times—gift or estate tax on the original transfer and generation-skipping transfer tax on the termination of the grandchild's interest.

3. Credit against tax

Each transferor would be allowed a credit of $417,000 to apply against the generation-skipping tax on transfers he or she made (referred to as a "GST credit"). The credit would be equal to the difference between the amount of tax which would be imposed under the unified estate and gift tax rate schedule (reduced by the unified credit) and the amount that would be paid if the tax were at the highest rate (determined after all future changes in the estate tax rate schedules and unified credits are phased in fully).

In the case of generation-skipping transfers occurring during the lifetime of the transferor, the credit would be allocated to generation-skipping transfers in the order in which they occurred. In the case of generation-skipping transfers occurring after the death of the transferor, any unused GST credit would be allocated in accordance with the direction of the transferor, except that the trustees of generation-skipping trusts created by the transferor could agree to reallocate the credit.

4. Computation of tax

Rate of tax

The rate of tax on generation-skipping transfers would be the maximum unified Federal gift and estate tax rate. Thus, the tax rate would be 55 percent until 1988, when it would be reduced to 50 percent.

Tax base and payment of tax

In the case of taxable distributions, the tax would be computed like a gift tax (i.e., on a tax exclusive basis). However, there would be no annual exclusion, marital deduction, or gift splitting available. The tax would be imposed on the trustee of the generation-skipping trust. However, the trustee and distributee could elect to have the distributee pay the tax.

In the case of taxable terminations, the tax would be computed like an estate tax (i.e., on a tax inclusive basis). However, there would be no marital deduction. The tax would be imposed on the trustee of the generation-skipping trust.

In the case of outright skips, the tax would be computed as a gift tax (i.e., on a tax exclusive basis). The tax would be imposed on the transferor of the outright skip.

Owned trusts

Unless the grantor of the trust elected otherwise, trusts for the exclusive benefit of a single beneficiary would be treated as owned for estate and gift tax purposes by that beneficiary. If property were distributed from the trust to another person, a gift or estate tax would be imposed upon the deemed owner of the trust. However, the deemed owner would be entitled to recover any gift or estate tax arising from such distributions from the trust.

Multiple grantors

In the case where more than one person transferred property to a trust, the separate transfers generally would be treated as separate trusts.

Credit for State taxes

No State death tax credit would be allowed against the revised taxes on generation-skipping transfers.

5. Other amendments

In light of the rules dealing with generation-skipping trusts and owned trusts, the rules relating to the treatment of QTIP trusts (secs. 2044 and 2519) and the rules relating to powers of appointments (secs. 2041 and 2514) would be repealed. Moreover, since the ALI Draft is designed is to impose a transfer tax only once each generation, the credit on previously taxed property (sec. 2013) would be modified so that the 10-year phase-out would not apply where a decedent (the second decedent), who had received property from a another decedent (the first decedent), was in the the same or a higher generation than that of the first decedent.