S. HRG. 110–1019

OUTSIDE THE BOX ON ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

APRIL 3, 2008

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

55–312—PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
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OUTSIDE THE BOX ON ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING

THURSDAY, APRIL 3, 2008

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Lincoln, Salazar, Kyl, and Roberts.

Also present: Democratic staff: Bill Dauster, Cathy Koch, Tiffany Smith, Bridget Mallon, and Tom Louthan; Republican staff: Elizabeth Paris, Chris Condeluci, and George Boone.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

A Chinese proverb says, "Planning lies with men, success lies with heaven." That is certainly true with the estate tax. No matter how hard people plan, the estate tax a family will pay can be largely a matter of chance. It can pretty much be up to heaven.

Current estate tax law is complicated. It lacks certainty for American families. The law changes, and changes, and changes. We seriously need reform. This is the third hearing that the Finance Committee has held to tackle these issues. In November, witnesses testified about the difficulty that the changing law causes estate planning. Witnesses testified that, depending on the year, you could have a large estate tax liability or you could have no estate tax liability. That is because the law changes every year from 2008 to 2011.

Last month, we focused on alternatives to our current estate tax. Witnesses identified proposals to simplify our estate tax system. This hearing we will focus on some more possible reform proposals. We will discuss the liquidity problems of small and family-owned businesses. Current law allows qualifying small businesses to defer paying estate tax if they pay in installments, but the law is overly complex and subjective.

We will discuss the exemption for couples under current law. When a person dies, the exemption is either used or it is completely lost. So today we are discussing portability. Portability would allow a spouse to transfer any remaining exemption to the surviving spouse. That would give the couple the full exemption.

We will discuss reunifying the gift and estate taxes. Prior to 2001, tax changes for gift and estate taxes were unified and they had a single graduated rate schedule. The estate and gift taxes were also combined into a single unified credit. That meant that taxpayers could use their gift tax credit while they were alive, but if taxpayers did not use their entire unified credit amount while they were alive, their estates could use the remainder of the credit to eliminate or offset estate tax liability. Now, the amount that the transferors can transfer tax-free while alive is substantially less than the amount that they can transfer tax-free at death.

We will discuss charitable giving under transfer taxes. Estate tax law allows for an unlimited exclusion of charitable bequests. We will discuss how various reform proposals would affect charitable giving.

I hope that these hearings will spark a good policy debate. And I hope that the debate will lead to a bipartisan estate tax compromise, because whether you can leave something to your kids should not be entirely up to Heaven. The operation of our estate tax laws should not be entirely a matter of chance, and Congress needs to do a little better planning.*

I'd now like to introduce the panel. The first witness is Dennis Belcher, who is a partner with McGuire Woods in Virginia. Mr. Belcher is also chairman of the American Bar Association's Task Force on Federal Wealth Transfer Taxes.

The second witness is Shirley Kovar, who is an attorney with Branton and Wilson in San Diego, CA. Ms. Kovar is also a fellow of the American College of Trust and Estate Counsel and chairs the Transfer Tax Study Committee.

Next, Dr. Roby Sawyers, who is a professor of accounting at North Carolina State University. Mr. Sawyers is also the chair of the American Institute of Certified Public Accountants' Transfer Tax Reform Task Force.

Finally, we have Diana Aviv, who is president and chief executive officer of Independent Sector.

Thank you all for coming. As is our regular practice, your prepared statements will automatically be included in the record, so please use your 5 minutes to summarize. I will hold you pretty close to 5 minutes. If you go over a minute or two, we are reasonable here.

So, why don't you proceed, Mr. Belcher?

STATEMENT OF DENNIS BELCHER, PARTNER, McGUIRE WOODS, LLP, RICHMOND, VA

Mr. BELCHER. Thank you, Chairman Baucus, Ranking Member Grassley, and distinguished members of the committee. I am Dennis Belcher, and I have submitted earlier my written testimony, so what I will do today is to summarize my testimony.

But first I want to give you why I have developed my testimony. It is based on my experience of 30 years in the practice of law of representing clients, primarily closely held business owners. My testimony is also based on being chair of a task force that developed a report on the Federal wealth transfer tax system. I am president-elect of the American College of Trust and Estate Coun-

* For more information, *see also,* "Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform," Joint Committee on Taxation staff report, April 2, 2008 (JCX–23–08), *http://www.jct.gov/publications.html?func=startdown&id=1317.*

sel, and I am past chair of the American Bar Association's Real Property, Trust, and Estate Law Section.

But I am also a member of a family business. I grew up on a farm in the Shenandoah Valley of Virginia, and my family had a trucking company and a family farm. I am proud to say that, notwithstanding that my father died in 1985, because of the benefit of the installment payment provision that Congress allowed under section 6166, we still have that farm and we still have that family business.

I applaud this committee's efforts to try to bring a solution to the uncertainty that we have in the estate tax law. In my meetings with clients, it is extremely difficult to explain to them what they should be doing, as the chairman pointed out, with the numerous changes in the exemptions over the next 4 years. That makes it very expensive for these taxpayers.

You will hear today many recommendations for simplification that will take many taxpayers out of the estate tax planning business, and I applaud this committee's efforts to try to do that. The task force report, which we have submitted to the members of the tax writing committee—and we have had discussions with the staff—goes a great deal toward trying to take people out of the estate planning business.

Ms. Kovar will talk about portability, which will eliminate the need for many married individuals to have estate planning. Dr. Sawyers will talk about the reunification, which will also mean that taxpayers will not have to resort to expensive lawyers and accountants to make sure that their assets pass with a minimum amount of tax.

My testimony focuses mainly on the installment payment provision allowed by Congress under section 6166 of the Internal Revenue Code. That section allows a deferral for 4 years with interest only, and then the estate tax attributable to the closely held business is paid in 10 annual installments. Notwithstanding that the exemption will increase to $3.5 million next year, many closely held business owners will still be subject to estate tax.

Without the benefit of an installment payment provision, the successors to the business owner will have to liquidate the business or raise funds at probably the most inopportune time to do that, when the founder of the business has died, when the business may be in turmoil, or when there may be a downturn in the economy.

What the deferral payment provision allows is an individual's family to plan for the payment of the estate tax, either through the earnings from the business as we did in our family or, second, through a liquidation over a period of time where the family can be assured of maximizing the benefits that the founder worked so hard to accumulate.

You will see in my written testimony that businesses that have a family emphasis generally do very well when compared to their peers in the public sector. Why do they do that? Because they are able to take a long-term view. I represent families that are in some very difficult businesses now, such as transportation, with the rising fuel costs, and also in the media, with what is going on with newspapers. If these individuals had to report on a quarterly basis, they would make different business decisions than when they take a long-term view.

Taxpayers do need the benefit of the installment payment provision authorized under the Internal Revenue Code. That provision needs some modifications, as I set forth in my report. I again applaud this committee for their efforts in trying to resolve this situation, and I encourage the committee and its staff to speak with members of the task force report as they go forward.

Thank you, sir.

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

[The prepared statement of Mr. Belcher appears in the appendix.]

The CHAIRMAN. Ms. Kovar?

STATEMENT OF SHIRLEY L. KOVAR, ATTORNEY, BRANTON AND WILSON, APC, SAN DIEGO, CA

Ms. KOVAR. It is an honor to appear before this distinguished committee to testify regarding the portability of the estate tax exemption to a surviving spouse. I will address how portability would simplify estate planning for married couples without creating any new tax benefit.

Although I am here as an invited witness in my individual capacity, I am also authorized to speak on behalf of the American College of Trust and Estate Counsel, also known as ACTEC, with respect to the legislative proposal that appears as Exhibit A to my written testimony. That proposal was prepared by ACTEC's Transfer Tax Study Committee and was approved last month by ACTEC's board of regents.

Portability has already received significant attention in Congress, first by the House in H.R. 5970, and then as set before the Senate last year as part of the effort of a number of Senators to work out a compromise on the future of the estate tax.

In my remarks today I will first describe portability and then discuss the reasons that compel me and the members of the American College of Trust and Estate Counsel to recommend passage of estate tax legislation that includes portability.

First, what is portability? Simply put, portability is the transfer of a deceased spouse's unused estate tax exemption to the estate of the surviving spouse. Take as an example a married couple with a combined estate of $4 million upon the death of the surviving spouse. Assume the exemption is $2 million per person. I use $2 million because that is what the law currently provides in 2008. Also assume the husband dies first, as statistics show is usually the case, and he transfers his estate to his surviving wife. Under current law, the husband's $2 million exemption simply disappears when the surviving wife dies.

Presumably, some day I am going to be a surviving wife, based on statistics. Her estate contains the remaining assets of both spouses, but the estate of the survivor will only have her single $2 million exemption. Under current law, there are only two ways for a married couple to make use of both exemptions. One, the deceased spouse can transfer assets to someone other than the surviving spouse, but that is rarely a popular technique, particularly in smaller estates.

Two, the deceased spouse can, in a will or a will substitute, establish an irrevocable bypass or credit shelter trust which in effect divides ownership between the surviving spouse and the children of the marriage. That division results in complex trust administration at best, and litigation nightmares at worst.

In short, a credit shelter trust is not a technique that a married couple would use, except for the benefit of preserving the exemption of the deceased spouse. The first reason then that we favor portability is that it satisfies client desires to transfer the estate of a deceased spouse outright to the surviving spouse, while at the same time making use of the exemption of both the deceased spouse and the survivor.

In addition to carrying out client preferences, we recommend portability for three more very important reasons. These are: (1) simplify estate planning; (2) achieve greater consistency with existing tax policy; and (3) importantly, accomplish by statute the same tax result that a married couple may achieve now, but only with complicated planning and estate administration.

With regard to simplification, which is probably the most obvious feature of portability, it would vastly simplify current estate planning and administration. First, with portability, a married couple can side-step the complexities of a credit shelter trust plan which include a will or trust that contains a complicated formula to maximize use of the exemption, which only an estate planner or other professional can understand. Two, they can avoid the use of three separate taxpayers, namely the surviving spouse as an individual, the credit shelter trust, and an administrative trust to hold the combined estates until the bypass trust is funded. Third, it eliminates the division of assets between the surviving spouse and the credit shelter trust, which is made all the more difficult in an illiquid estate such as a small family business or family farms and ranches and, importantly, the frequent need for the spouse with a higher net worth to transfer assets to the other spouse during lifetime in order to ensure that each spouse has sufficient assets to use the exemption. With portability, the estate tax is applied on the combined estate at the death of the surviving spouse, so it is unnecessary for each spouse to hold assets equal to the exemption amount.

A second reason portability makes sense is that it is consistent with other ways the tax law recognizes a married couple as, in effect, a single economic unit. For example, in 1981, when the marital deduction for transfers between spouses was made unlimited, the Finance Committee stated that "the committee believes that a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes." Enacting portability then would fulfill the promise of combining the exemptions of a married couple that was implicit in the policy forming the basis of the unlimited marital deduction.

A third compelling reason to make portability a reality is that a married couple can already use both exemptions with the use of a credit shelter trust. The impact of portability then would simply accomplish by statute what now requires careful and sophisticated lifetime planning; number two, complex administration after the first spouse's death; and number three, denial of the non-tax goals of the married couple to provide security and flexibility to the surviving spouse.

In conclusion, in my view portability is the best estate planning idea for married couples, particularly those in traditional families, since the unlimited marital deduction. Portability is, in short, a great idea. I sincerely hope that, with the support of this committee, portability will be a great idea whose time has come.

The CHAIRMAN. Thank you, Ms. Kovar, very much. I appreciate that. It makes good sense.

[The prepared statement of Ms. Kovar appears in the appendix.]

The CHAIRMAN. Dr. Sawyers?

STATEMENT OF DR. ROBY B. SAWYERS, PROFESSOR, DEPARTMENT OF ACCOUNTING, NORTH CAROLINA STATE UNIVERSITY, RALEIGH, NC

Dr. SAWYERS. Thank you for the opportunity to testify today on issues related to simplification of the estate and gift tax, but particularly the reunification of the estate and gift tax exemption amounts.

In addition to being a professor, I am a practicing CPA. I am also a member of the American Institute of CPA's Tax Executive Committee, and I chaired the AICPA's Transfer Tax Reform Task Force and was a contributing member of the Joint Task Force on Federal Wealth Transfer Taxes. Much of my testimony today comes from the previous reports issued by both of those task forces.

In order to provide certainty to taxpayers, AICPA encourages Congress to make permanent changes to the estate tax prior to its scheduled repeal in 2010. A written statement for the record outlining the AICPA's priority list of suggested reforms was provided to this committee for consideration following last month's hearing on alternatives to the Federal estate tax system.

My testimony today focuses on three issues surrounding the decoupling of the estate and gift tax exemptions. First, taxpayers and tax practitioners face planning difficulties as a result of the decoupling that occurred back in 2004. Under the law prior to the Economic Growth and Tax Relief Reconciliation Act, the estate and gift tax exemptions were unified and could be used to offset both lifetime gifts and transfers at death.

The advantage of that policy was that it was well-understood by taxpayers, and it simplified estate and gift tax planning by simply reducing the number of tax and non-tax variables that a taxpayer had to consider when deciding whether or not to make a transfer during life or a transfer at death. However, under current law, while the estate and the generation-skipping transfer tax exemptions stand at $2 million and will increase to $3.5 million in 2009, the gift tax exemption remains at $1 million.

Second, as a result of the decoupling, taxpayers, including small business owners, may be discouraged from making orderly lifetime gifts of property, and in fact to engage in business succession planning at all. Historically, the gift tax has been less expensive than the estate tax, providing an incentive for taxpayers to make intrafamily transfers during life. That policy has several advantages, including a potential for increasing tax revenues to the government.

But the primary advantage is that it encourages lifetime distribution of family capital to younger generations. It encourages small business owners to plan for the orderly transfer of management and control of their businesses to younger generations, and it encourages, in fact, all taxpayers to make gifts of cash and other property to younger generations.

It is these younger taxpayers and younger generations who need the capital in order to buy new houses, in order to raise and educate their children, and in order to buy other goods and services in the marketplace. Reunification of the estate and gift tax exemption should result in a greater propensity to make both taxable and non-taxable gifts and provide a stimulus to the economy.

The third issue is a direct result of the uncertainty surrounding the future of the estate tax. Donors making both taxable and non-taxable gifts often reflect prudent tax planning in the face of a future estate tax, however the prospect of no estate tax in 2010 may make individuals reluctant to make taxable lifetime gifts that otherwise would be sensible for both tax and non-tax reasons, including business succession planning. It also puts CPAs and other professional advisors in an awkward position, as properly advising a client as to the benefits of making lifetime gifts requires an assumption as to whether or not there will be an estate tax in the future.

In summary, the AICPA suggests that the estate, generation-skipping transfer tax, and the gift tax exemption amounts be reunified. Reunification will accomplish three things: it will simplify planning for taxpayers and avoid all the cumbersome number-juggling that is now required in our planning; it will provide an incentive for small business owners to make business succession plans; and it will provide an incentive for all taxpayers to make intra-family transfers of wealth during life.

We hope that you and other members of Congress will consider these suggestions in the debate about estate tax reform. We look forward to working with Congress to achieve simplicity, efficiency, and effectiveness as you consider changes to the current estate and gift tax system.

Thank you for the opportunity to share these views.

The CHAIRMAN. Well, thank you, Doctor, very, very much. I appreciate that.

[The prepared statement of Dr. Sawyers appears in the appendix.]

The CHAIRMAN. Now we have Ms. Aviv.

STATEMENT OF DIANA AVIV, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INDEPENDENT SECTOR, WASHINGTON, DC

Ms. AVIV. Chairman Baucus, Ranking Member Grassley, and distinguished members of the committee, thank you for your invitation to talk about how the estate tax supports the services provided by charitable organizations and how we might work together to prevent abuses of our laws regarding the estate tax and charitable giving.

I serve as the CEO of Independent Sector, which is a national coalition of 600 members that collectively represents tens of thousands of public charities, private foundations, and corporate giving programs.

America's 1.5 million charities and foundations are substantially aided by people who give their time and resources to help individuals and communities. Americans are motivated to contribute for many reasons, but research shows that tax policy has a considerable impact on when, to whom, and how much they give.

The estate tax has been critical in motivating Americans to give back even more to the causes that they support. The Congressional Budget Office found that the estate tax leads affluent people to donate greater amounts than they otherwise would because such donations, whether made during life or as bequests, sharply reduce estate tax liability. The CBO estimated that, if the estate tax had not existed in 2000, contributions to charities would have been reduced by between $13 and $25 billion, which added up to more than the total donations made by all corporations in that year.

The President's budget estimates that eliminating the estate tax would result in the loss of nearly $522 billion in Federal revenues over the next 10 years, marking an end to countless programs that serve all Americans and help to strengthen communities.

In seeing the estate tax as a vehicle for ensuring that every citizen begins life with an equal opportunity to succeed, President Theodore Roosevelt endorsed the inheritance tax and stated, in 1906, "A man of great wealth owes a particular obligation to the state because he derives special advantages from the mere existence of government."

Like other Americans, the very wealthy benefit from government investments in areas such as defense, security, national parks, and infrastructure, and they rely on government's protection of individual property rights. America has a longstanding expectation that the people who prosper the most in this society have an obligation to help preserve it for future generations.

As with any tax system, the estate tax can be manipulated by unscrupulous individuals to provide inappropriate financial benefits to themselves and their families. Independent Sector has stood shoulder to shoulder with this committee to support the identification and punishment of those who abuse charitable resources for personal gain and to encourage charitable organizations to institute practices to prevent such abuses.

We have recently become aware of ways in which the estate planning device known as the charitable lead trust makes possible tax deductions to donors and their heirs without providing the promised returns to charity. Used properly, the charitable lead trust has helped to generate considerable contributions that have generated substantial benefits for individuals and communities. However, the current statutory formula and timing for calculating tax liabilities creates the potential for overstated charitable deductions and understated tax liabilities for beneficiaries.

There are three specific ways Congress can help deter abuses associated with estate planning and charitable organizations. First, Congress should ensure that the IRS has sufficient resources to maintain a strong oversight, enforcement, and education program to enhance compliance by all taxpayers.

Second, Congress should pass legislation permitting the IRS to require electronic filing of nonprofit annual information returns and of estate tax returns. Electronic filing would increase compliance by providing immediate feedback on incomplete and potentially inaccurate information. It would also permit Federal and State regulators to devote more resources to oversight, education, and enforcement instead of cumbersome manual processing of paper returns.

Third, Congress should make necessary adjustments to the statutory formula and timing for calculating tax liability for charitable lead trusts to help ensure that tax deductions are not taken for promised donations that never materialize and that there is a more reasonable calculation of the projected value of any remaining amount at the end of the trust period.

Reforms of the estate tax must not benefit the few at the expense of the many. A robust estate tax would ensure adequate Federal revenues and encourage charitable contributions to help nonprofits provide services vital to our communities. We urge you to protect individual legacies while safeguarding the promise of a better future for all.

Thank you.

[The prepared statement of Ms. Aviv appears in the appendix.]

The CHAIRMAN. Thank you, all of you, very much.

I am going to begin with Mr. Belcher. Do you have any significant changes you might recommend for further installment information that is provided for closely held companies?

Mr. BELCHER. Yes, sir, Mr. Chairman. I put that in my written testimony. The first thing that I point out is that Congress should modernize the installment payment provisions. What I mean by that is that the section was enacted in 1976 and business entities have changed in the last 30 years. For example, limited liability companies are not mentioned as a business form that would qualify for the benefits of the installment payment provisions. Many, many clients will use the limited liability company business form for conducting business, even very large businesses.

So clients come to us and they say, well, will a limited liability company comply with the provisions of the installment payment provisions or do I need to form a corporation? They would much rather use a limited liability company, but we have to tell them we're not sure whether a limited liability company would comply.

The CHAIRMAN. Would a limited liability company fall from the intent of the provision?

Mr. BELCHER. It is not specifically mentioned. But fortunately, in my experience, the Internal Revenue Service has been liberal in its use of that. But many times you will run into what we refer to as an outlander Internal Revenue Service agent that will use this as the ability to say you do not technically qualify. So I think, Mr. Chairman, that the modernization is very important.

I mentioned several other things about holding companies because, for example, some of my farm clients will put their real estate in one limited liability company, their cattle and equipment in another limited liability company, and then they will use them all in the same operation. But the question is, is it an active business? There are certain provisions that allow that to occur, but clients will have to consult with a fairly sophisticated and knowledgeable tax lawyer when they are trying to make transfers to their children.

The CHAIRMAN. Do you think the 4-year deferral and the 10-year installment periods are about right?

Mr. BELCHER. I think, in many instances, it is right. The reason I say that is that you have time during which to gather assets to pay the taxes. For example, think of this. When your estate consists primarily of a closely held business, how are you going to pay the principal on that tax? Are you going to pay it on income or are you going to sell assets? If you can pay it on income, it is going to take you a while to use after-tax income. So, I think that clearly the 4-year deferral is extremely helpful.

The CHAIRMAN. And the 10-year installment is about the right period of time?

Mr. BELCHER. Yes, sir.

The CHAIRMAN. All right.

Mr. BELCHER. That is correct.

The CHAIRMAN. Ms. Kovar, your portability suggestion. Basically what happens? A couple signs a document making the full exemption available to the surviving spouse? How does that work? What do they do?

Ms. KOVAR. Yes. As I indicated, upon the death of the deceased spouse—let us say it is the husband, because they do usually go first—there would be a $2-million exemption that that spouse would have, but typically at that level there is going to be a transfer of all of the assets to the surviving spouse.

The CHAIRMAN. Right.

Ms. KOVAR. And that $2 million exemption just disappears.

The CHAIRMAN. So what is the simple way to take advantage of it?

Ms. KOVAR. The simple way is portability, which is already in 5970, although the American College of Trust and Estate Counsel does have a few recommendations with regard to the change of 5970.

The CHAIRMAN. And portability is what? Is it a document? Is it a statement?

Ms. KOVAR. Portability is a statutory transfer of the unused estate tax exemption of the deceased spouse.

The CHAIRMAN. It is a statutory transfer.

Ms. KOVAR. Correct.

The CHAIRMAN. All right. From the deceased to the survivor.

Ms. KOVAR. Correct.

The CHAIRMAN. All right. Can you think of any reason why we should not just make that change?

Ms. KOVAR. Absolutely not. I think, as I indicated, we have lots of reasons to do it: simplification; it is going to conform to existing tax policy; and, most importantly, the wealthy can already do it by hiring a lawyer to make it happen, whereas if you have, for example, Dennis's family that has a family business, and maybe there is a family that was not so lucky to have Dennis, and as a result there is a transfer of the family business directly to the surviving spouse, there is no credit shelter trust, there is no planning that has gone on, and they are going to have to sell that business.

The CHAIRMAN. What strikes me is that all four of you basically are suggesting changes within the regime, the realm of the current system. That is, large, huge, major changes. That is, modify the deferral transfer period, make portability, reunify, figure out how to get these charitable lead trusts that are being abusive and so forth.

Do any of you think there should be a major change? I mean, you are basically saying that the $3.5-million exemption by 2009 is all right, I guess. I do not know if you are saying that or not. The 45-percent rate is all right. If you are saying that, I do not know. But what major changes would any of you recommend?

Mr. BELCHER. Mr. Chairman, when we were working on the task force we looked at alternative systems. I know that this committee had some hearings on alternative systems.

The CHAIRMAN. Right. Right.

Mr. BELCHER. And what struck me about alternative systems is that the first issue you look at is, when do you impose a tax, assuming you are trying to be revenue-neutral? Do you impose it at death or when a transfer occurs? Well, imposing it when a transfer occurs makes more sense than imposing it at death, but that means you are going to have to have carry-over basis. That is the box you are in.

What we could do, if we were starting with a whole new system, we would not have the system we have. We would probably use something like carry-over basis. But I think that would be so disruptive because many people would think——

The CHAIRMAN. Have carry-over basis as a transfer and no estate tax.

Mr. BELCHER. Yes. And the reason why I say that is, in my situation I give assets to my wife. She has carry-over basis. She pays an income tax. My wife has had a tax increase, even though she would not have a taxable estate.

So you say, well, what we will do is give $2 million, $3.5 million of free bases. Now you are right back in the soup of complexity about how you do the allocations.

The CHAIRMAN. So because of that box, that is a big enough barrier to prevent us from going down that road, do you think? Or to say it differently, work with and tinker with the current system?

Mr. BELCHER. I think that the carry-over basis, the modified carry-over basis system that was put in with the 2001 Tax Act has some significant problems and would require even more planning than what we have today, because you have a system that only 2 percent or 1 percent of the population is subject to, and they are used to it. It has been around so long.

The other issue that you always talk about and hear about is valuation and how difficult valuation is.

The CHAIRMAN. Right.

Mr. BELCHER. Well, you are going to have that same issue with whatever alternative system you have.

The CHAIRMAN. Right.

Ms. AVIV. If I can.

The CHAIRMAN. Yes.

Ms. AVIV. May I just add that, since I have noted in my oral testimony and in my written testimony that we think that the estate tax—it may not have been the intended benefit—has the unintended benefit of supporting in a significant way charitable contributions and is a profoundly important part of the charitable sector's income. We think that the proposal that you offered last month, the changes, the modifications, is the right way to go at this point in time. We would be deeply worried if there were further cuts either to lower the tax rate or to have a higher exemption level, that that would have adverse consequences on the charitable sector's ability to do its work.

The CHAIRMAN. All right. Ms. Kovar and Dr. Sawyers? Very briefly, because I am way over my time.

Dr. SAWYERS. Mr. Chairman, one other issue that the AICPA is very concerned about is reinstating the full State estate tax credit. As a result of getting rid of the State estate tax credit, a number of States have decoupled and instituted their own systems. That is complex for taxpayers and advisors as well, so we think it is important to reinstate that credit or have some other mechanism like a surtax that could then be shared with the states in an equitable way to avoid dealing with potentially 50 different State systems.

The CHAIRMAN. Yes. Well, it is unfortunate, I think, the decoupling there, and also separating gift and estate, which basically are revenue raisers. Congress wanted the money. As so often happens, the decision is made on a budget basis, not on a policy basis. Basically you are all saying we ought to go back and look at the policy, which makes a lot of sense.

Ms. KOVAR. I would just say one final thing, very short.

The CHAIRMAN. Yes. Yes.

Ms. KOVAR. Which is, this may be a small step for Congress, but it is going to be an enormous leap for surviving spouses.

The CHAIRMAN. I hear you. [Laughter.] And you intend to survive. [Laughter.] Thank you.

Senator Salazar?

Senator SALAZAR. Thank you very much, Chairman Baucus. You had promised that we would have hearings on the estate tax, and you have carried through with that promise. This is now the third time that we have had a hearing on how we might move forward with respect to permanent estate tax reform, and I appreciate your leadership very much on this issue.

I am pleased that we are devoting time and energy to this matter because, in the case of Montana, Colorado, Kansas, and Iowa, we have issues that have been of concern to me, especially with the ranching and farming community where it is very easy to be asset-rich and very cash-poor. It does not take a lot of land in the State of Montana, or even in the State of Colorado, to be able to be in a position where the estate tax can, in fact, force you to have to sell your ranch or your farm.

So, I have been pleased to join with Senator Roberts in a proposal that would provide some relief to family farmers and ranchers, so long as they continue to stay on their family farm and on their family ranch. So, I appreciate the work of this committee, and I appreciate your ideas here this morning.

From my point of view on the estate tax, we have to, number one, provide some certainty for the future, because no one knows whether they are going to die in 2009, 2011, or 2015, so I think those of you who are affected by it or those of you who are involved in helping clients plan for the future and their estates have a difficult time when you do not know what the rules are going to be.

Second of all, I think we should do everything we can to preserve going concerns, including family farms, ranches, and businesses, instead of forcing them, by our tax laws, to basically break up a going concern.

Third, I also think we need to be responsible to the fiscal realities that we deal with here in Congress every day. The fact is, we have gone into a mode, especially the last 10 years, it seems to me, where we have created a mountain of debt that continues to grow and grow. I do not want us to move forward with estate tax reform that is going to add inordinately to that mountain of debt.

So let me ask a question of any of you. That is, if we were to deal with segments of the estate population, is that something that would make sense? If we were to—for example, the proposal that Senator Roberts and I have deals specifically with only farmers and ranchers, and the condition there being that the estate can continue to be used as an ongoing family farm and ranch. Is that the kind of targeted reform that might make some sense, short of a broader kind of reform that we might undertake?

Why don't we start with you, Mr. Belcher, and just move across.

Mr. BELCHER. Yes, sir. Our task force report did not address targeted relief. We felt that was a policy issue and it was up to this committee and other committees to look at that. Personally, I think targeted relief is good, but it adds complexity to it. The proposal that you have is very similar to the old business exclusion that creates complexity. I work with many clients that have to go through special use valuation under section 2032(a).

The worry I have is that the targeted relief needs to be significant enough to make a difference. In other words, if you look at the Joint Committee proposal where they go through how targeted relief under special use valuations does not solve problems, it is because, as the exemption moves up, the smaller relief is less significant.

What will happen is that clients will have to look at those provisions carefully, look at the material participation and make sure that they are complying with that, and it needs to be significant enough so it can be worth their while to do it. But I would applaud the committee to look at targeted relief.

Senator SALAZAR. Do Ms. Kovar or any of the other witnesses have a comment on that?

Ms. KOVAR. Just that, with regard to portability, I think it will help farmers and ranchers in the same way that it will any other small business or any smaller estate, so I do not think there ought to be any distinction made between farmers and ranchers with regard to portability.

Senator SALAZAR. Is your spouse here today?

Ms. KOVAR. No, he is not. [Laughter.] And after 37 years, maybe he will not be! [Laughter.]

Senator SALAZAR. I am very interested in your assumption of this longevity of women versus men and what it does to Senator Roberts and all of the rest of us.

Ms. KOVAR. That is statistics.

Senator SALAZAR. The facts are the facts.

Let me ask a second question to all of you. If we were to move forward with a tax rate for estates into the future and to index that tax rate, do you have a recommendation on what that tax rate should be for an estate?

Dr. SAWYERS. Not a specific recommendation, though I think I would ask Congress, if the intent of the estate tax or one of the reasons for the tax is to serve as a backstop to the income tax, that perhaps it would make sense to tie the top estate and gift tax rate to the top income tax rate.

Ms. AVIV. Again, as I said in my earlier comments to Chairman Baucus, I thought that his proposal of 45 percent was the right level. The reason for our thinking on that relates to the commitment of individuals to give money to charities, and being able to do that at levels that would continue to support the work of the charitable community.

Senator SALAZAR. Do you think there would be a difference between the 45-percent rate versus a 35-percent rate?

Ms. AVIV. We do. We say that based upon what we have seen in the last number of years. Our experience with tax incentives for charitable giving or the opportunity for people to, in lieu of paying taxes, give to charities, is that people always give, but the rate, the level, and the amounts that they give and the time that they give, it is substantially affected by these rates. So, yes.

Senator SALAZAR. Thank you very much.

My time has expired, and I know Senator Roberts has been waiting.

Senator Roberts?

Senator ROBERTS. Well, thank you, Mr. Chairman.

Senator SALAZAR. I will note, Senator Roberts, that you have moved up in seniority very fast. I am still at the very end of the table, and we came here at the same time less than a year ago. You are already almost to the front.

Senator ROBERTS. Yes. I am just happy to be ranking. [Laughter.] I know the chairman has left on a temporary basis to go check on his estate tax. [Laughter.] I thought, under the circumstances, you being chairman, you could ask unanimous consent that the committee report the Salazar-Roberts Estate Tax Repeal as passed, the third meeting be waived, and that the bill receive priority consideration on the floor of the Senate this week and be deemed as passed by the Senate. [Laughter.] If you would say "without objection," I think we are way ahead of the game. [Laughter.]

Senator SALAZAR. I do not have the gavel. [Laughter.]

Senator ROBERTS. Man, just grab it. [Laughter.] You have to take advantage of these things. According to the witness, we are not going to be here very long. [Laughter.] You do not have to applaud at that, for goodness sake. [Laughter.]

Senator SALAZAR. I am afraid it would endanger our farm bill. We need to get our farm bill across the finish line.

Senator ROBERTS. Well, I will tell you what. We could write one pretty doggone quick, I know that. But at any rate, I think we had better go back to regular order. There is an old Chinese proverb, as the chairman has indicated: be careful what you ask for. That has nothing to do with a Chinese proverb, but I thought I would toss it in. [Laughter.]

I have a question for Mr. Belcher. Thank you for all the work that you have done, and thank you for your personal example with your dad. I am very happy that you have the family farm still within your control. I am glad that anybody has a family farm these days under their control.

But I would like to focus on the issues you raised about the installment payment provision. As I understand it, a business that has elected to pay its estate tax liability in installments has up to 5 years to begin doing so, with the possibility of a 4-year extension for "reasonable cause." It is that definition, that explanation of a reasonable cause, that I am interested in. Could you explain what qualifies as a reasonable cause for such an extension?

Also, is there any provision we should consider that would recognize that, even though a very small business owner or farmer is working hard to make either the interest or installment payments in a timely manner and has been granted a time extension, the government still has the option to take the business or the farm if the owner falls on hard financial times and cannot keep up with payments? Is there any remedy here?

Now, in Colorado, Kansas, Montana, other States, we have had drought for 3, 4 years. We had a blizzard, then we had a tornado. I do not know what is next. I do not know what we did to Mother Nature, but Mother Nature has really done a lot to us. Maybe a plague of locusts is next, I do not know. But that worries me, so if you could maybe give us your expertise in regards to what qualifies as a reasonable cause, more especially that the government can still come back in and take the business from the farm.

Mr. BELCHER. Thank you, Senator Roberts. First, I see "reasonable cause" in the installment payment provisions used rarely. Now, why do I see that? It is because you have the 4-year interest only. This gives the family the time to figure out what they want to do. Will they be able to pay the installments out of operating income or will they have to sell an asset? If so, they have that 4-year period to do it.

So Congress, by giving families the installment payment provision with a 4-year deferral of just payment only of interest, has given the family the opportunity to plan. I mean, many of our clients, unlike Ms. Kovar, believe that they are not going to die and so they put off planning until the last minute.

Senator ROBERTS. I am planning on 2010, by the way. [Laughter.]

Mr. BELCHER. That will make your children happy.

Senator ROBERTS. Yes.

Mr. BELCHER. In those instances where we use reasonable cause, it has been my experience that the Internal Revenue Service has been fairly liberal in granting it. That is where you do not meet the installment payment provisions and you are dealing with real estate that was not used in a farm and you have to pay the tax right away, and you are in an economy right now where it is difficult to sell real estate and realize the actual value of the property. The Internal Revenue Service has been fairly liberal in granting the 1-year extension. You cannot count on it. We tell clients that they had better assume that it is not going to be granted, because if it is not granted the tax is giving it away.

Now, protecting the tax payment. The Internal Revenue Service can apply a lien to the property, so if the farmer/rancher/business owner cannot pay the tax because the children cannot run the business the way the father did, or they just made some bad decisions, or they had some bad luck, the Internal Revenue Service has a lien and can exercise on that lien.

I pointed out in my testimony that there are some issues with the way that lien has been applied. I recognize that the Internal Revenue Service needs to have the protection to make sure the installment payment of tax is paid. But what happens is, I have an interest and stock in a business. If I die, the stock is includable in my estate. My executor elects the installment payment provision.

Then the IRS comes in and my estate can either put up a bond, which you are not going to get a bond for a 15-year period, so you will have to put up property. You would think you would put up the stock because that is what is taxable in my estate. Many Internal Revenue Service agents accept that. Some are saying, no, I do not want the stock, I want the assets in the company. I want hard assets. I want the real estate. By doing that, that inhibits the ability of the business to raise operating capital.

Senator ROBERTS. Why is there not a consistent method of handling this? If you have someone at the IRS saying I want something tangible, and you have others that are working with people, I do not understand why IRS does not have a consistent policy here.

Mr. BELCHER. The Service had a consistent policy of not getting a lien until about 4 years ago, and then there was a report from the Comptroller of the Internal Revenue Service that recognized there were a lot of unpaid installment payments and that there were no liens. So, immediately the Service came up and said, well, we are going to collect that and we are going to impose a lien, and you can either have a bond, which you cannot get a bond for a 14-year period. Insurance companies just will not issue them. I mean, if you have the collateral to do that, you can pay the tax.

Senator ROBERTS. So that is not an option.

Mr. BELCHER. And so it is the lien. What happens is, there is very limited guidance issued by the Internal Revenue Service on what type of lien, how it should be administered. What I recommend is that the lien would be on the asset that is taxable in the individual's estate.

Senator ROBERTS. Well, that makes sense.

My time is up. Senator Baucus is expected momentarily, so we will have a little sing-along. [Laughter.]

Ms. Aviv, first of all, thank you for sharing your insight into charitable giving. I do not know of anybody who is opposed to charitable giving. I am encouraged by the numbers that you cite in terms of the amount people do contribute to their communities, as well as the amounts they are given.

But the thing I do not understand is, if the estate tax were to be repealed or reformed to impose a lesser burden on families and small business owners, why would Americans not continue to donate to the charities they have spent their lives supporting and promoting? I do not get that. If you drop the guillotine in regards to estate tax, it seems to me that, if you would reform it or repeal it, you would have more money to go to the charities. Simply because people do not have a concrete number in terms of donated dollars to reach in order to eliminate their estate tax liability, would Americans not continue to have a very deep interest in supporting their long-preferred charity, or church, or organization?

Ms. AVIV. Senator, our experience and the experience in looking at the data on this very issue seems to show that Americans are always generous and that they have always given, but the level at which they give, the amount they give, is affected by the tax incentives that are available to them.

We thought, for example, with the proposal that you supported and you introduced last year on the IRA charitable roll-over that had not been available to people before to use, that with the availability of that incentive, there were tens of millions of additional dollars that were raised and given to all kinds of communities across the country and for all kinds of issues that were needed. The kind of people who used the IRA roll-over were different than the kinds of people who have used the opportunity to use their estate to donate to charity.

In the case of the estate tax, to avoid that liability, it has been largely very wealthy donors who have used that opportunity to give to charities. In the case of the IRA charitable roll-over, to our surprise we learned that folks who qualify for that of all income levels used it to give to charities. So what we find in our experience is that different kinds of incentives induce different people in the population to give at much greater levels than was otherwise the case.

Then I would like to say that what the Congressional Budget Office's study showed us in 2000 was that, if the estate tax had been eliminated at that time, that charitable organizations, they estimate, would have lost somewhere between $13 and $25 billion, which is a huge chunk of income to the charitable community.

Senator ROBERTS. Did Teddy Roosevelt, when he charged up San Juan Hill, tell his men, "Men, let's take the hill and don't worry if you pay the ultimate sacrifice, I've made an arrangement that everything that you have earned in regards to service to our country will be going to government programs and to charity as opposed to your widow?" I am being very facetious here. [Laughter.] I think he inherited an awful lot of money before he charged up San Juan Hill.

Ms. AVIV. My interpretation, Senator, of his view was, for those who had been lucky enough to benefit from immense wealth, that they have a responsibility to give back.

Senator ROBERTS. I think that should be on an individual basis. I do not think my dad thought about that in regards to Iwo Jima, or for that matter any situation I may have had in the Marine Corps. But I am getting way off the subject here.

By the way, we passed the Salazar-Roberts bill, Mr. Chairman. [Laughter.]

The CHAIRMAN. Did you also pass the farm bill? We need that.

Senator ROBERTS. Sir, that is up to you and up to the esteemed chairman of the Agriculture Committee. I am just here to give you advice and whatever else that I can offer.

Thanks to all the witnesses. Thank you very much. You have all really provided us with some very detailed information that we need as we go forward on this very important issue.

Mr. Chairman, thank you so much for your leadership on this. We came awfully close a year or two ago. It was an 8:8 vote, as I recall.

The CHAIRMAN. Right.

Senator ROBERTS. And that was a shame. These people could have been doing other things this morning, in fact, if that had not happened.

But thank you.

The CHAIRMAN. Needless to say, I think they could still be doing a lot of things.

Senator ROBERTS. Well, they are in the full-time business of apprising us of how to do that.

Thank you, sir.

The CHAIRMAN. Thank you, Senator Roberts.

I would like to know, Ms. Aviv, if you have pondered a little bit about the degree to which any changes in Federal estate tax law might help nudge more charitable giving to rural areas as opposed to urban areas. That is not quite directly the focus of this hearing, but it is a concern of mine. Essentially, these foundation grants in my State average about $20 per capita. In the top 10 States, the average is $147 per capita. Charitable giving is skewed toward urban areas. Just give us your thoughts on how to balance that out a little bit.

Ms. AVIV. This has been an issue close to your heart, and I know you have done a lot of work and have met with a lot of good foundations to encourage them to do that. I have met with some of your colleagues who work in your office to talk about these issues. It seems to me that it is quite difficult, in my experience, to tell foundations how to give their funds. I am trying to tell them all the time and they do not listen to me as well as I hope they would. I think that there are large numbers of very wealthy people who have benefitted from the recent windfall on Wall Street who are not yet giving, and there need to be ways for us to incentivize them to give.

I think it is much easier to go to those who are of immense wealth who have yet to give to make the case, and our organization would be happy to work with you to find a way to encourage those folks who ought to be stepping up and giving back some, to be thinking in a broader way not only about where they live, but in communities that need them greatly, such as the rural communities that you mentioned.

The CHAIRMAN. I have thought, actually, it is like a lot of things in life: seeing is believing. If we can get people out from behind their desks and their office buildings and going out into the country and seeing what is going on, it makes a big difference.

Ms. AVIV. When I look at what the Lilly endowment is in Indiana, by creating many, many community foundations in local communities and then getting those local community foundations to raise local dollars, by creating that kind of program that allows for that whole State an opportunity for local people to give in the area, I think that that is one of the ways to look at that sort of solution.

The CHAIRMAN. Many people say Federal estate and gift tax law—and he is here, the man who has said that many times—forces estates to sell a lot of their property to pay the tax. You just cannot manage it in a reasonable way to keep the operation, keep the business in the family. With aggressive tax planning, aggressive estate planning, they may have to pay a few dollars to an attorney, but you save much, much more by preventing the sale, forced sale, of property in order to pay the Federal estate tax.

So the question is, in your experience, all four of you, how often do you see a business, a family-held business, sold or a significant portion of it sold in order to pay off Federal estate taxes? My question is going to lead more into, like, the rates and the exemptions up to $3.5 million per person in 2009, let us assume that stayed permanent. It is indexed with a step up. Under those circumstances, with unification—I do not know if that is terribly relevant. But how many, in your judgment, places would have to be sold? How many businesses would have to sell a large portion?

Dr. SAWYERS. I think the numbers are relatively small, but it does happen. I think the difficulty is figuring out sometimes whether those small businesses and farms are sold in order to pay for the estate tax or whether for other reasons, or a combination of those two. Certainly there is evidence that it happens, but I think it is relatively rare.

The CHAIRMAN. Mr. Belcher?

Mr. BELCHER. Senator, that is a very good question. Most of my clientele are closely held business owners. I have had families sit in the office and say, well, we want to keep the marketable securities and we will sell the business. It is the age-old family that said, we are tired of picking apples, let us cut the apple tree down and sell it for firewood. But I have seen some sold because of the estate tax.

But think of the allocation of capital. I mean, just in my stepfather's situation, we have a trucking business and we are paying estate tax instead of buying trucks. We are paying interest on estate tax instead of buying trucks. You are exactly right that a well-planned estate can plan for that burden, but is that the proper allocation of capital?

I am dealing with a situation now where—and this feeds right into Ms. Kovar's point that the husband dies first—this individual died of pancreatic cancer 2 weeks ago. He was 55 years old. He did not do any planning. He was a self-made entrepreneur. His estate is $5 million, and it is illiquid. He has debt against real estate that he had just bought to use in the business. His son is 31 years old, and his son is trying to hold onto the business.

Now, in that estate with $5 million, there is going to be about a $1.5-million burden put on that estate. Think of what that is going to do for that struggling business. If it were not for the estate tax or if it were not for the installment payment provision, that family would have to sell. But Dr. Sawyers is right, it is not an everyday occurrence, but it also involves the allocation of capital.

The CHAIRMAN. So you would extend out the installment period a longer period of time, or a deferral for more years or whatnot? There are other problems?

Mr. BELCHER. Yes, sir. I think that is exactly right. If you are using revenue to solve problems, other issues—I mean, when a client comes to me and they say, what other options do I have instead of the installment payment provisions, I say, well, you can go to a bank and most of them will give you 5 to 7 years, and they are going to lock up all of your collateral and they will give you all of these covenants, or you can use certainty under section 6160, under the installment payment provision, provided that you qualify.

The CHAIRMAN. What about life insurance?

Mr. BELCHER. Life insurance works for those people who plan, but for the individual who does not plan, it does not work. You are exactly right. If a client comes to me and says, I am going to have a very successful business and I am just getting ready to get started, I can structure it so he will not be subject to estate tax. But is that fair for the person who comes to me later and says, wow, I wish I would have talked to you 10 years ago? So you put to that person the choice of buying life insurance, and is that the right allocation of capital? We are forcing people do things. Also, in some instances people are uninsurable.

The CHAIRMAN. Right. Well, we are trying to make some sense of all of this. I do not think a full-out appeal is in the cards in this Congress, but at least some way to relieve the burden. That is the goal here. Thank you very much.

Senator Kyl?

Senator KYL. Thank you, Mr. Chairman. I appreciate your calling the hearing. You may know, those of us on the Judiciary Committee, which includes Senator Grassley and Senator Hatch, were called to the Judiciary Committee to make a quorum this morning for some very important business, and as a result we could not be here, and I regret that.

I thank all the people on the panel. I have reviewed summaries of your testimony, and I am looking forward to reading your testimony in full.

Mr. Chairman, I appreciate you holding the hearing.

Let me get back to the conversation that I just heard. And I apologize that I did not hear what the rest of you all said. But it is something that I have had some, both personal experience with, and then also in past years we have had testimony. Part of it deals with this question of the proper allocation of capital.

In other words, the basic question of whether it serves good public purpose to risk the possibility that businesses either have to sell off important assets or the entire business to pay an estate tax, or whether, as a matter of public policy, it is better for that money to be put back into the business or kept in the business in some way. I am personally familiar with cases in which the entire business had to be sold, and other cases where property had to be sold off.

In either case, it seems to me that this question of proper allocation of resources is the way to go, that liquidity is not just a matter of whether you have bags of cash to hand to Uncle Sam, but rather how you have to put limits on your business, or expansion of your business, or hock your business, or restrain your business in some way in order to pay Uncle Sam.

That goes back to the basic question of whether the public policy in favor of a tax which hits businesses like that is outweighed by the need for Federal revenue, with the tax collecting something a little over 1 percent of Federal revenue, or whether there are better ways to do it.

Senator Baucus and I have struggled over the years to try to find a sweet spot here to compromise both principles, the fact that the government could generate revenue, but that we do not impinge upon the businesses, in terms of marginal impact, that are most at risk. This argues for a higher amount of exemption or unified credit, and hopefully after that a lower rate than we currently have.

I think there has been a general recognition in Congress that both of those are worthwhile goals. There are also some technical changes that the committee has proposed to be dealt with, and I gather were discussed in this hearing. Those are useful to examine too because they do help to define whether, at the margin, you are making it possible for people to continue to operate.

One question I would like to ask you is, several years ago Alicia Munnell did some work and gave us an estimate that about as much money is spent each year on estate planning, insurance acquisition, lawyers, accountants, and others, all toward the object of avoiding paying some of the tax, or all of it, or planning around it, as the Federal Government ends up collecting in the tax.

That, too, is an expense that a tax like this puts on the system. Some taxes are pretty efficient: you make money, you pay, and that is it. Others, there are so many ways that you could try to deal with it, and the tax is deemed to be so unfair and has such a big impact, that people are motivated to spend a lot to try to avoid it. One of the things we are trying to get at here is whether this is such a tax, at least with respect to the larger percentage of filers that have to either file and end up paying, or file and perhaps not end up paying. I am not talking about the ones at the higher level, because they clearly are going to have to pay something.

What is your experience—just starting at this end of the table, and I would like to hear from all of you. I realize all of you somewhat benefit, or most of you benefit somewhat from this situation, but clearly you are in a position to know how much people have to pay for this. So could you give me your ideas or your evaluation of how much is spent compared to what is eventually taken in?

Mr. BELCHER. Senator Kyl, I saw that study when it came out, and it surprised me because, just from my talking with other tax professionals around the country, it did not reflect that. But once you add in insurance costs, which is an investment—I mean, I have clients who have no need for liquidity to pay estate tax, but they will buy insurance for a lot of different reasons, primarily because it is a good investment, tax benefits, certain things of that nature.

So I think if you look, I believe that there is not that much spent on planning to avoid the tax. I will agree with you that it is an inefficient way of collecting tax. I mean, any time you have to do evaluation, you have to submit a very lengthy report, and you have to have an audit to make sure that everything is correct and you have a complicated system, it is inefficient.

But one thing that I applaud this committee for is taking the moderately wealthy out of the estate planning business. I mean, it makes no sense for a client who has a house and a retirement account to go see a lawyer who is knowledgeable and experienced in estate tax planning—which means expensive—to plan their affairs. I think that raising the exemption, and Ms. Kovar's point on portability, will take a lot of the moderately wealthy out of the estate planning business.

Senator KYL. Thank you.

Ms. KOVAR. Just to reemphasize what Mr. Belcher just said, the easiest way to reduce the amount of time that estate planning lawyers, including myself, spend writing credit shelter trusts for clients in the $2- to $4-million range, is portability. At $2 to $4 million, for example, a client can come in, I can explain that, well, the credit shelter trust is going to protect appreciation, but if we can gauge that by the time of the death of the surviving spouse that the estate is not going to exceed $4 million—and I use $4 million because that is the exemption right now for two people—then you do not have to have a credit shelter trust. They are not going to be using that exemption on the first death to give it to children and grandchildren because surviving spouses—yes, like me—need the entire estate.

On the other hand, if you are talking about estates above the $4-million or above double the exemption, then there is going to still have to be planning. But when you realize the number—and I do not know the number in that $2- to $4-million range, or double the exemption, whatever that is—it is a huge step, I think, in reducing the amount of attorney time talking about tax issues. I would much rather spend the time with my client talking about their special needs child, or there is drug abuse in the family, how are we going to deal with that, there is disability, there is asset protection. It goes on and on and we do not spend enough time on those non-tax goals.

Senator KYL. Thank you. That is another angle on it that is very important too. Thank you.

Dr. SAWYERS. Thank you. With respect to the amount of planning, I think it is interesting to look at the number of taxable returns and the size of the gross estates for those individuals who actually paid estate tax. In 2006, there were some 23,000 taxable returns filed. There were only about 4,500 of those estates that had gross estates exceeding $5 million. So, you can certainly reduce planning and complexity for a large number of folks who are currently affected by the estate tax by increasing that exemption amount a bit, or doing things like portability.

It is also interesting to note that the 4,500 folks who had gross estates over $5 million paid about two-thirds of the $25 billion of estate tax that was paid in 2006. So, two-thirds of the revenue comes from the top 4,500 estate tax returns that were filed in 2006.

The CHAIRMAN. I am going to have to leave now, but Senator Kyl and Senator Lincoln will stay. Senator Lincoln will take over chairing this committee. I regret, I have to manage a bill on the floor of the Senate. I want to thank you very, very much for your testimony. I have learned a lot, and I think this committee has learned a lot. Thank you very, very much.

Senator Lincoln? Senator Kyl, were you finished? Why don't you finish up, Senator Kyl?

Senator KYL. Well, my time is up. But if we can just have the last panel member comment.

Ms. AVIV. Thank you, Senator Kyl.

Senator KYL. I think we have time, and the two of us can stay for a little bit longer. Thank you, Mr. Chairman.

Ms. AVIV. Thank you. The focus of my testimony has been on the estate tax and charitable communities, and charitable giving in particular. Our experience from that aspect, particularly when one looks at the very large nonprofit organizations that have the ability to access and meet with major donors who are thinking about their estates, that in those cases the planning of the estates is not related to avoiding of taxes—it may be, but that is not the only reason—from our perspective, that planning is to help them decide and for them to think about to which causes they want to give, how much they want to give to family members, and all of the rest. They find that kind of planning extremely useful. Also, the nonprofit community is a beneficiary of that kind of planning, so of course they welcome it.

Senator KYL. Blanche, do you want to go ahead?

Senator LINCOLN. Well, I, first of all, want to thank the chairman and the ranking member, Senator Grassley, for holding this hearing today and allowing us to focus on a few issues that will be very important, I think, in the weeks ahead as we craft a permanent solution to the estate tax. I think it is so important. I think many of our hopes are that we will wrap up our hearings and move forward to a mark-up, because we do hear an awful lot at home. I apologize for being late. I was just at a hearing about the price of gas, which I also hear a lot about at home.

But this is probably one of the second most important issues, along with health care, because people know that we face a cliff in 2010 and 2011. For our family-owned businesses and farms, in preparation for that, the unknown is the most frightening for almost any of us as human beings. So, I hope that we will use these hearings and move forward in coming up with a mark-up.

The portability of the exemption between spouses is certainly a long overdue concept and one that I think will be most helpful to our smaller estates that might not realize current law requires complex planning to ensure the estate is appropriately organized between the spouses, and that is going to be important for States like Arkansas.

We should definitely include a portability provision in an estate tax reform package, and I appreciate many of the comments that you all have had. I know, Dr. Sawyers, you just mentioned portability in your comments there.

Similarly, the reunification of the estate and gift tax is good policy. We all know that, I think; certainly the cost of it has been somewhat of an issue. But we should also look for ways to modernize section 6166, which allows some of our closely held businesses to pay their estate tax liability in annual installments. The last panel we had, we talked about prepayment in some instances.

Does that make it better for either the IRS, for some of our colleagues, or anybody else in terms of how we look at trying to structure estate tax and make it more viable and predictable for family businesses? Again, a special thanks to the chairman. I do hope that the committee will move quickly. We appreciate it so much. I know Senator Kyl and I have had great passion on this issue for quite some time and we do want to see some results. We feel like our constituencies are at that jumping off point where they really do feel like they need to have some certainty as to what they can expect.

Just a couple of questions for you all. Mr. Belcher, in your testimony you did briefly mention a laundry list of provisions in the code that were implemented in an effort to benefit closely held business owners, section 303, 2032(a), 2057, and 6166, as I mentioned.

As you noted, most of those provisions have stringent requirements for individuals, which I think makes them somewhat cumbersome for our smaller estates to plan for and to take advantage of, and that becomes difficult. They end up spending a tremendous amount of money in seeking out the legal assistance that they need to make those plans.

But in years past, I have looked at ways to expand on those provisions to provide more relief for our family-owned businesses and farms. Most recently, I filed an amendment during the consideration of the farm bill that would have set the 2032(a) cap at the same level as the general estate tax exemption. I still think that is a pretty good idea, and I will certainly look for opportunities to expand the 2032(a) as our reform discussions continue.

But, unfortunately, in section 2057 I have found that family businesses across my State particularly feel it was so complicated and difficult to use, that they would prefer we focus instead on implementing a reasonable exemption level and a tax rate and leave the niche provisions that have limited applicability out of the discussion as much as possible.

Maybe you could kind of give me your opinion about this, I guess particularly in regard to 2057. Do you think the repeal of the Qualified Family-Owned Business Interest (QFOBI) that happened in 2001 was the right thing to do, or should we revisit that decision?

Mr. BELCHER. Well, Senator Lincoln, thank you for the question. From a personal standpoint, I wish section 2057 had not been repealed.

Senator LINCOLN. You wish it had not?

Mr. BELCHER. Had not, because I learned so much about it. [Laughter.] And it became as useless as a buggy whip. But from dealing with my clients and in working with that, the complexity would overcome them, tying their hands because the benefit was so limited. Earlier, Senator Salazar asked a question about targeted relief. My comment was, if you are going to put in targeted relief, make it worthwhile so that, when they go through the hoops, when a client or taxpayer goes through the hoops, it is worth doing. But I think you are exactly right to focus on the exemptions and the rates rather than the complexity of the QFOBI under section 2057.

Senator LINCOLN. Well, following up on that, from what Senator Salazar had talked about and your response, what I found in my conversations, with the Joint Committee on Taxation particularly, that has modeled the different variations for me to try to come up with, how do we do this in a way that makes sense is, if you make the targeted relief too significant, then so many of the estates that would not otherwise use it will. They will structure themselves so that they qualify for that generous targeted relief. If it is not enough, it is not worth it. If it is too much, everybody does it. Then all of a sudden, it ends up costing tons.

Mr. BELCHER. I think that is right. Well, I think that is a possibility. But, for example, I do not see people restructuring their affairs to materially participate in a farm and create the effort that it does.

Senator LINCOLN. Because farming is too hard.

Mr. BELCHER. Well, it is. My father told me when I was growing up, he said, "Dennis, if you've got a friend, give him a farm. If you've got an enemy, give him two farms." [Laughter.]

Senator LINCOLN. That is right.

Mr. BELCHER. So I think that there is the possibility of targeted relief being abused. I mean, I was convinced, for example, that, if QFOBI relief goes up significantly, that you are going to find Wall Street pushing a product that would turn every securities portfolio into an active business.

So, I think that certain targeted relief, you have to be very careful about. But under 2032(a), special use valuation, if you have a member of the family who is out there materially participating, I have not seen any abuse. I do not have clients who say, well, I am going to cash in my portfolio and buy a farm just so I can save estate tax.

Senator LINCOLN. Yes. Well, materially contributing, I think is what you used. It has been unbelievable, the conversations we have had over this farm bill as to who is contributing to the farm operation. Somebody who is keeping the books, who is booking the commodities, who is doing everything except getting their hands dirty is all of a sudden finding themselves, like my 80-year-old mother, on a tractor in order to be able to qualify as somebody who is actively participating. So, those are good definitions for us to try to look ahead for as well.

One question I would just pose to all of you. That is, maybe because I am an optimist, I also tend to be more energized, in many instances, just because I feel like we should be getting things done in a more timely way. I think time is of the essence, particularly for the practitioners who are here on our panel. You are all very well aware of 2010 and what that cliff means. It takes us back to 2001. I have been saying for more than 3 years now that time is of the essence, and I am hearing it at home.

I do not know how many other members are hearing from constituents who are afraid of the unknown and do not know what we are going to do, and would much rather have something that they could at least predict. It is one of the reasons Senator Kyl and I have certainly, in the committee, really encouraged the committee to move forward on that. We need to get some kind of permanent reform in place. Our family-owned farms and businesses have to plan for the future. They are one of the biggest groups that produces jobs in States like mine, family-owned small businesses.

Would you agree that the sooner we get permanent law into place the better off our families are going to be? Do you think that if we just kind of keep talking about, what is the best—I have always told people, I did not come here to create a work of art, I came here to create a work in progress. Yet, this is a place where people want to create art, and it takes us forever. Any comments on the timing?

Dr. SAWYERS. Certainty is certainly critical. We as practitioners, as well as taxpayers, would benefit greatly from being able to know with certainty whether there will be an estate tax or not. I hope that any changes that are made, though, would be positive and follow the lines of some of the things that we have mentioned today dealing with portability, reunification, and essentially increases in the exemption amount which we think would really benefit small businesses and farms and make it more likely that small business owners would undertake business succession planning during life. We want there to be an incentive for small business owners to plan their affairs during life rather than to, as Dennis mentioned earlier, unfortunately, come to them when they are faced with an illness and not having done any planning.

Ms. AVIV. Senator, from the point of view of the charitable community, I think that the point you make is absolutely critical. We have large organizations who work with donors who say, let us wait and see what happens and are not prepared to plan their estates at this point in time because they do not know.

With charities facing hard times right now, with donations coming in at a much slower rate, in smaller increments, the idea that there is an opportunity here where, with certainty, people would know what the possibilities are and what the options are and could plan accordingly, would make an immense difference. So, we support moving on this in an expeditious way, but also in a wise way.

Senator LINCOLN. Your comment earlier was that it does not really distract from people giving, what it distracts them from is from their planning and making decisions. I think that is an important thing.

Ms. AVIV. And also the level at which they give. Our experience is that people will always give, but, if there are incentives and opportunities that incentivize giving, they will give that much more. So, we are for policies that will support greater incentive for giving, which is why we are so appreciative of your supporting the IRA roll-over.

Senator LINCOLN. Yes.

Ms. KOVAR. I would just say, the sooner the better. 2008 would be terrific. But if it cannot be done, then 2009 is better than 2010.

Senator LINCOLN. Yes.

Mr. BELCHER. If you think you have been hearing complaints from your constituents this year, wait until next year when they get letters from their lawyers saying that the estate plan they have done is out of date, they need to do a totally new estate plan for 2010, and then come back in 2011 and do another one.

Senator LINCOLN. Yes.

Mr. BELCHER. I mean, what a waste of effort.

Senator LINCOLN. Well, and what a waste of resources in the sense that, to have three different estate plans in three different years when they could be funneling those resources into job creation. I look around my State, and these small businesses, they are our number-one employer. We are working hard on health care.

Senator Snowe and I have been working on providing small businesses and the self-employed access to better health care at a lower cost. I mean, they have unbelievable costs to them already. This is not something we need to lay on the back burner. So, I appreciate that.

Senator Kyl?

Senator KYL. Well, thank you, Senator Lincoln. Could I just piggy-back on that and thank you for all the work you have done in this area? Small businesses create the bulk of the jobs in our country. Obviously they are in a tough competitive position with corporations that do not have the same problem. So when you have a small business and a death and you face the death tax, the corporation does not have anything like that. We really want to promote small businesses, the creation of small businesses and their perpetuation. Obviously we have to do something about this, and the sooner the better.

Let me just close with three questions based upon a premise here. I think, Dr. Sawyers, you articulated—no, Mr. Belcher, I guess, talked—well, all of you have. But the bottom line is to take as many people who really should not have to worry about this out of the estate planning business in the first place.

Dr. Sawyers, you did comment on that. When we talked about the moderately wealthy not having to pay the expense and worry about this, I think that is our goal here. Maybe roughly stated, to sort of end the estate planning requirement for the bottom two-thirds or so of filers, stated in a very, very rough way based upon your statistics.

A very good friend of mine back in Phoenix, AZ who does some of this work said it is really a shame. There are several very bad planning ideas that professional planners talk people into because of the uncertainty that attends this whole thing, most of which are either not necessary or not good ideas, but they all cost money. One of them he talked about was the perpetual trust. As we consider this, I hope that we can both eliminate the need for most of these folks to have to worry about it, but also address the fact that they are still going to have folks coming after them trying to sell them products, and that there are some other things we can do at the margins and on some of the technical estate planning issues, and we are going to need the advice from at least three of you on this. That might be useful, too.

Let me just ask you about three specific things. If we are going to try to take most of these folks that should not have to worry about paying the money out of that game, there are a couple of things we could do, it seems to me. One thing to do is to create a $5-million exemption or unified credit rather than $3.5 million. Another would be to certainly index whatever the unified credit is, index it for inflation. That seems to me to be an absolute no-brainer, and we have always had, I think, unanimous agreement in the Senate on that.

Then another idea, because homes are now going up in value so much, I mean, obviously that is one of the things we are facing right now. We are talking about taking the FHA lending limits up because the value of homes is now so much higher than it used to be. Maybe taking homes out of the equation, just exempting homes from the value of the estate like we do with a homestead exemption, would be another way so a lot of folks whose primary wealth is in their home just would not have to worry about it.

What do you all think of those three ideas to try to create a larger exemption so that you just take folks out of the game of having to worry about it, indexing the credit for inflation, or the unified credit, I should say, and just providing, in effect, a principal residence exception? Just go on down the line.

Mr. BELCHER. Thank you. Senator, in looking at those three ideas, I think the first two are well worthy of implementation. I have a little issue with the third, which is exempting principal homes. One thing that I worry about with my clients, when you were talking about your friend in Phoenix saying clients are doing things they should not do, not only do we need to take people out of the business, we need to keep them from making artificial decisions because of the estate tax law.

Senator KYL. Right.

Mr. BELCHER. With the graying of America, you will get many individuals who will be moving into assisted living or some other type of facility. You would hate to sit there and say, well, you have a very expensive house, you are much better off not to move into that facility, or keep that facility just because of the estate tax. So, I worry that what we do would create artificial behavior.

Senator KYL. Excuse me. Of course, one way to deal with that is to provide the exception, if you move into assisted living, then the proceeds from the sale are not counted, too.

Mr. BELCHER. Yes. But I think you would have to do something——

Senator KYL. I get your point.

Mr. BELCHER [continuing]. To prevent the artificial behavior.

Senator KYL. Yes. Yes. Good. Thank you.

Ms. KOVAR. Yes, Senator. With regard to your first question, the larger exemption, a real easy way to do that is to have portability, because what portability does is double the exemption in the survivor's estate, with all of the other comments that I made with regard to why we should have portability. That is an easy way and a fair way to increase the exemption.

Second, with regard to indexing for inflation, I would only say that when we do that it ought to be for the estate tax, the gift tax, and the GST or generation-skipping tax. Right now, the GST is the orphan because the estate tax and the gift tax in the existing bill provide for portability. That is not true for the GST. Even though some people say, well, is that not just for the super wealthy, actually I think it is counter-intuitive that the GST helps only the wealthy.

The reason for that is that the wealthy are going to use the GST exemption on the first death—not on the second death but on the first death—to be able to move assets down from the surviving spouse, who is already provided for in the very wealthy families. That means a credit shelter trust. So, these are not going to be the people who are going to use it.

Instead, you have the model that I have been using, the $2- to $4-million exemption. What happens there is, these folks cannot afford to use the GST exemption on the first death. We need portability to get it to the second death. On the second death, there are a lot of non-tax reasons for which the surviving spouse may want to use more than only her single exemption to benefit her children and grandchildren.

For example, when I talked before about drug abuse, they want to skip that child, make the grandchildren the beneficiaries. Maybe they do not approve of that child's lifestyle and as a result they are going to skip that generation, or for other reasons. As a result, I think indexing is great, but only if we do it for all three.

I agree with Mr. Belcher with regard to the principal residence exception. It would treat people, I think, unfairly depending on what State you live in. I have lived in California for the last 34 years, and yes, it would be terrific if we could completely exempt principal residences from taxation.

But would it really be fair for my mother, who lives in Oklahoma and where I am from, where housing is not nearly as expensive? So I think it would be working counter to the comment that many people have made with regard to small businesses, farms, and ranches, where perhaps, at least in many cases, the value would not be as much as another State's.

Senator KYL. And one way you could deal with that is simply have a cap on the value.

Ms. KOVAR. Correct.

Senator KYL. Yes. Thank you.

Dr. Sawyers?

Dr. SAWYERS. I would agree with the previous responses, and just note that targeted relief, regardless of whether it is for a personal residence or small business, can be problematic and unfair. We can always come up with examples of illiquid estates that perhaps should also have relief from the estate tax at death. I think a better way to provide relief for illiquid estates is through things like increasing the exemption amount, portability, providing for the same exemption amount for estate and gift tax purposes.

Ms. AVIV. Senator, on indexing for inflation, we certainly think that that is right. It almost goes without saying that that is absolutely necessary. We have not thought about this in detail. Obviously the notion of trying to protect what needs to be protected on the one hand, and then on the other hand making sure that there is a fairness across the board. There are people in major cities who cannot afford to buy homes. For them, there may be some equity issues raised.

So, we would certainly want to think it through to make sure that, in the course of doing this, the goal of protecting what needs to be protected is achieved across the board, regardless of how Americans live their lives given the circumstances of their birth.

In regards to the larger exemptions, we worry, which is one of the reasons why we have been supportive of being very careful when proceeding with the larger exemptions. We worry that the way in which this will cut into charitable donations will be so deep as to undermine the ability of this sector to serve the people of our society in the way that they need to.

So, as you mentioned earlier, there is a balance of competing principles, and we probably would want to come back to that balance of competing principles and make sure that they do not favor the one at the expense of the other.

Senator KYL. Let me just say, and then I will close, that I appreciate it. All of you have had some important things to say, and I really do appreciate your ideas. I think they really help to provide some momentum for us as well.

I just want to comment on your last point. I have never liked charitable giving to be based upon the force of the government: we are either going to take your money or you can give it to charity, which do you want to do? I just do not like that as a concept. The other thing is, I think—I know—it works both ways. I have told this story to friends before—Blanche has heard me talk about it—about some very good friends of my wife and mine who were huge charitable givers in our community. They had a small business that produced a good income, a couple hundred employees.

They finally built it up to the point where they were among the biggest givers in the community. He had a Boys and Girls Club named after him just before he passed away. They were always there for the community. Well, the tax required that they sell their printing business. There was no way they could get liquid. Everything that they had, they put back into the expensive equipment that you need in the printing business to stay competitive, and so they had to sell the business.

Of course, they sold it to a big corporation which, after a few years, left the community. It never gave a dime to the community. So, it does work both ways. You get some successful small businesses, they are going to be contributors to the community. They do not do it because of estate planning, they do it just because they want to. Then you force the sale of a business, and it is all gone. So, I think that is a fact that we have to take into account, too.

But, again, thank you. I really appreciate the wisdom of this panel. Thank you, Senator Lincoln.

Senator LINCOLN. Thank you, Senator Kyl. Just, I, too, appreciate your input into this. Without a doubt, Dr. Sawyers, your last comments, bringing about the issue of liquidity and how we deal with that with increased exemptions and rates that are reasonable, and certainly portability for family businesses, because from our standpoint, coming from an agricultural State, land values are incredible.

I have to tell you, you do not make a lot of money farming these days. But with the land values it is not because you are making so much money that the land values have gone up, it is because there are more people and less land. It is more in demand for a multitude of different things. So, that is an issue for us. Certainly in small businesses, I know, Mr. Belcher, I have these multitudes of family businesses where they put their heart and souls, but they have also put every ounce of investment that they have into the infrastructure.

They are the ones whose name is in the backdrop of the Little League park, they are the ones who are paying for the band uniforms at the school, they are the ones who are keeping their local community foundation going with the endowments that make a difference. When they have to sell because every ounce of those dollars was put into investment in that company, growing that company, growing those jobs and they are not liquid and they have to sell it to a bigger corporation, Senator Kyl is right, then it is not them that is back there supporting that community, necessarily. Sometimes they do, but more often than not they do not.

So we really appreciate your input. We look forward to further conversation, but more importantly, we look forward to moving forward and getting some certainty for our constituency. Thank you all for joining us. We will look forward to visiting with you more.

The committee is adjourned. Thank you very much.

[Whereupon, at 11:51 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Testimony of Diana Aviv
President and CEO
Independent Sector
April 3, 2008

Chairman Baucus, Ranking Member Grassley, and Members of the Committee:

Thank you for this opportunity to appear before you today. It's an honor to provide a perspective from our nation's nonprofit community, and to discuss the implications of changes to the estate and gift tax system for the services nonprofits provide to enrich lives and strengthen communities across the nation and around the world.

I am Diana Aviv, president and CEO of Independent Sector, a national, nonpartisan charitable organization with approximately 600 members, including public charities, private foundations, and corporate giving programs, collectively representing tens of thousands of charitable groups in every state across the nation. Our coalition leads, strengthens, and mobilizes the charitable community to fulfill our vision of a just and inclusive society and a healthy democracy of active citizens, effective institutions, and vibrant communities. IS members represent a broad cross-section of our nation's nonprofit community, which exists to improve society, frequently in partnership with government, in diverse areas such as health care, education, human services, the arts, and community development.

My testimony today will focus on two themes: the impact of the estate tax on charities, and areas of potential abuse that the Committee should evaluate. America's charities and foundations are created and sustained by people who want to give their time and resources to solve problems and enrich their communities. Americans are motivated to give because of their compassion for those in need, their desire to advance a particular cause, or sometimes, simply because they have been asked. Whatever the motivation for giving, research has shown that tax policy has a considerable impact on when, to whom, and how much Americans give, particularly if they are in higher economic brackets.

Estate tax policy strongly encourages Americans to give back to their communities both during their lifetimes and through their estates. The estate tax also provides significant revenues to support government-funded programs that are vital to sustaining healthy communities and the well-being of Americans of all ages. Many of these programs are delivered through, or in partnership with, charitable organizations and would not be possible without the combination of the public and private support that our tax system facilitates. As Congress considers the best ways to structure the estate tax system going forward, we urge you to ensure that it continues to encourage Americans to give back to their communities through charitable contributions and that it protects the ability of both federal and state government to provide vital services.

As with any tax system, the estate tax can be manipulated by unscrupulous individuals to provide inappropriate financial benefits to themselves and their family members. Independent Sector has stood with this Committee in your work to identify and punish those who abuse charitable resources for their personal gain and to encourage charitable organizations to institute effective practices to prevent such abuses. We believe this same vigilance should be applied to the oversight and enforcement of the tax laws as they apply to estates and to vehicles for lifetime giving that allow taxpayers to avoid their appropriate tax obligations.

The Estate Tax and Charitable Giving

America's nonprofit community now encompasses more than 1.5 million organizations, large and small, that engage people in securing basic needs, creating opportunities, offering hope, fostering creative expression, and nurturing our spirits. These organizations produce results because of the commitment and talent of the people who have dedicated their lives to helping others. While funding sources for individual organizations varies substantially, the majority of support for the work of the community as a whole comes from consumers of services and voluntary contributions: 38 percent from dues, fees, and other charges for goods and services, 17 percent from individual contributions, and an additional 3 percent from private foundations and corporate giving programs. Government grants and contracts provide 31 percent of the community's revenues, and other sources, such as income from assets, supply the remaining 11 percent.

Congress and state legislatures have long recognized the special importance of the work of charitable nonprofits and have encouraged the American people to support this work by allowing taxpayers to deduct charitable contributions when calculating their income taxes, subject to specific allowances and rules. Congress has provided even greater motivation for Americans to give back to their communities through their estates by permitting unlimited deductions for charitable contributions when calculating estate taxes. Americans can choose to leave their entire estates to charity thus eliminating all estate tax liability.

These incentives have had a significant influence on the how – and how much – Americans give to support charitable causes. The Congressional Budget Office found that the estate tax leads affluent people to donate far more than they otherwise would, because such donations—whether made during life or as bequests at death—sharply reduce estate tax liability.[1] The CBO found that about one-sixth of the estates filing estate tax returns in 2000 left a charitable bequest which together totaled $16 billion. Charitable bequests were heavily concentrated in the largest estates with over 70 percent of the total bequests coming from estates valued at more than $3.5 million.

The CBO further estimated that if the estate tax had not existed in 2000, donations to charities would have been reduced by $13 billion to $25 billion, which is more than the total amount of corporate donations in that year. For example, if a potential donor's assets would be subject to a 45% estate tax rate, then a charitable bequest of $1 million would reduce the tax liability of the estate by $450,000. The unlimited deduction for charitable giving provides a valuable incentive for the wealthiest of our citizens to give back to the communities in which they have lived and earned success.

If Congress were to repeal the estate tax or significantly reduce estate tax marginal rates, the significant decline in charitable donations from wealthy Americans forecast by the Congressional Budget Office study would have damaging effects on the nonprofit community and on society as a whole. Donations from individuals, including bequests, make up 84% of all contributions, constituting one-sixth of the total support for charitable nonprofits. Moreover, about two-thirds of all contributions by individuals in 2000 were made by people with a net worth high enough to

[1] Congressional Budget Office, *The Estate Tax and Charitable Giving*, July 2004.

potentially face the estate tax. If nonprofit groups lost a substantial part of these donations, many of them would have to scale back their activities significantly.

Impact of the Estate Tax on Government Revenues

While tax policy provides critical incentives to encourage charitable giving, the most fundamental reason for the estate tax, or any tax, is to provide government with the resources it needs to meet important public priorities. Economists and forecasters across the political spectrum, as well as respected international bodies like the International Monetary Fund, agree that the nation faces devastating long-term fiscal problems as the baby boomers age and need increased health care. Deficits are on course to reach economically unsustainable magnitudes unless strong action is taken. Permanently repealing or significantly reducing the estate tax would dig the deficit hole even deeper, jeopardizing the viability of numerous programs and services that are relied upon by millions of Americans every day.

Repeal of the estate tax would result in a loss of roughly $522 billion over five years[2] and $1 trillion in lost federal tax revenues over a ten-year period.[3] The magnitude of this loss of revenue should be viewed in the context of budget realities. President Bush's proposed FY 2009 budget called for cuts to entitlement spending totaling $208 billion over five years and eliminating or reducing 151 programs to reach a savings of only $18 billion. A projected loss in federal revenue of $1 trillion over a 10-year period would mark the end of countless discretionary programs that serve all Americans, not just the neediest, as well as severely damage the capacity of the federal government to provide healthcare and other benefits to a growing number of retiring baby boomers. We would undoubtedly see deep cuts in federally funded programs vital to the people served by the nonprofit community, including education, the arts, health care, and especially aid for poor and vulnerable people, as well as elimination of community development grants, first responder funding, and entrepreneurship grants.

Elimination of the estate tax would also harm state budgets, many of which have their own estate tax linked to the federal.[4] Current estimates by the Center on Budget Policy Priorities indicate that at least 28 states face immediate fiscal crises and 17 of those have made or are considering budget cuts that threaten vital services in order to achieve balance.[5] Further loss in revenue would cripple restructuring efforts and may extend the threat of budget collapse to the remaining states, including those that have just barely recovered from fiscal crisis earlier this decade. Eventually, the budget squeeze will be felt the hardest at the local level for community programs that find critical government support dried up, diminishing their capacity to structure services tailored specifically to meet the diverse needs of their constituencies.

All of these challenges impact the charitable community in many ways. Organizations that rely on grants and contracts from federal, state, and local governments to provide services have been affected by cuts and changes in funding priorities. In recent years, we have witnessed a decrease in

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[2] CBPP – "The Dubious Priorities of the President's Budget" – Robert Greenstein, James Horney, Richard Kogan – February 7, 2008

[3] CBPP – "The Estate Tax – Myths and Realities" – October 11, 2007

[4] "A Compromise on the Estate Tax" – *The Chronicle on Philanthropy* – Diana Aviv and Robert Greenstein – November 11, 2004

[5] "Facing Deficits, Many States Are Imposing Cuts that Hurt Vulnerable Americans" – *CBPP* – Iris Lav and Elizabeth Hudgins – March 13, 2008

the absolute dollar amounts (not just inflation-adjusted dollars) in the federal budget for non-defense domestic discretionary programs vital to the sector. Indeed, spending on non-defense discretionary services outside of homeland security has declined both as a share of the total federal budget and of the nation's economy. There have also been changes in the dollars allocated for and funding formulas for mandatory programs that affect services for needy individuals and families, raising the demand for services provided by charitable organizations.

To summarize, the estate tax provides a stream of funding that is essential to the work of charities in enhancing life and to the work of government and its priorities. We urge the Committee to consider these factors as it addresses the future of the estate tax.

Abuses Involving Charities

Independent Sector opposes all schemes that provide inappropriate financial benefits to donors and their families as a result of their arrangements with or donations to charity as part of estate planning or lifetime giving. The nonprofit community has a sound record for self-evaluation and of taking action to promote tax compliance. IS has strongly supported the efforts of this Committee and those of Chairman Baucus and Ranking Member Grassley to investigate and expose sham transactions involving unscrupulous individuals and charities. We have fully endorsed the use of the severest remedies under law to penalize all willing participants to abusive transactions involving the contribution of non-cash property to charity. Whether the wrongdoers are tax shelter promoters, appraisers, donors who overstate their deductions or receive inappropriate benefits, or officials at tax-exempt organizations who knowingly participate in fraudulent schemes, it is our position that they must be punished for the sake of the nonprofit community as a whole.[6] Here today, we reaffirm our support for your commitment to addressing potential tax law abuses in the nonprofit community, particularly those related to the transfer of estate-related assets.

At the encouragement of this Committee four years ago, Independent Sector convened the Panel on the Nonprofit Sector to perform what constituted the most comprehensive review of the governance, regulations, and operations of the charitable community in more than three decades. The Panel, composed of 24 nonprofit and philanthropic leaders, ultimately prepared a series of recommendations for Congress to improve the oversight and governance of charitable organizations and for individual nonprofit organizations to ensure high standards of ethics and accountability. In June 2005, the Panel presented its Final Report to Congress and in April 2006, it released a Supplemental Report.[7]

Together these reports contain a strong, carefully integrated package of over 130 recommendations for actions that lawmakers, the IRS, and the sector itself could take to improve the accountability and tax-law compliance of charitable organizations. The Panel identified areas of misconduct that were not covered by existing law. The Panel also recommended methods for strengthening existing law enforcement systems to facilitate a more streamlined use of resources.

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[6] See, e.g., Letter to Chairman Baucus and Ranking Member Grassley regarding Sham Transactions Based on Inflated Property Values, June 21, 2007, Independent Sector | Newsroom - IS Endorses Senate and Treasury Efforts to Eliminate Sham

[7] A third Panel report dealing with self regulation, *Principles for Good Governance and Ethical Practices: A Guide for Charities and Foundations*, was released in October 2007.

In the year following the release of the two reports, Independent Sector and many other nonprofit organizations consulted with Senators and Members of Congress, encouraging them to enact legislation implementing the Panel's recommendations. The result was the package of legislative reforms passed by Congress as part of the Pension Protection Act of 2006 and signed into law in August 2006. Those reforms included increased fines and penalties for violations of prohibitions on excessive private benefits, clearer rules for appraisals required to substantiate tax deductions for charitable contributions, and new rules to ensure that assets held in donor-advised funds and supporting organizations are used to benefit the intended charitable purposes. These reforms represent the most comprehensive change to the laws governing charitable organizations since the 1969 Tax Act and have significantly strengthened the legal framework that enables our charitable community to be a vital resource for our nation.

The reforms in the Pension Protection Act, while necessary and important, cannot eradicate all instances of abuse involving charitable donations. Recently, the IRS released its 2008 list of the 12 most egregious tax schemes and scams. The so-called "Dirty Dozen" includes among its numbers a section on abuse of charitable organizations and deductions. Identified misuse includes tax shelters, attempts by donors to maintain control over donated assets, income from donated property, and overvaluation of contributed property.[8] Independent Sector and its members share the concerns of the IRS that improper schemes continue and are working to educate the nonprofit community on strong self-governance principles and tax-law compliance.

Potential for Estate Tax Abuse

All of us recognize that illegal conduct involving donations to charities hurts all donors, the charities themselves, and the people they serve. This Committee has previously publicized fraudulent schemes involving deductions for property donations to 501(c)(3) organizations, with violations including improper return benefit to the donor, improper retention of a partial interest in donated property, inflated valuation, and possible permissible private benefit on the part of 501(c)(3) organizations that participated in the transactions. We recognize that in principle as well as practice, variations of these infractions have the potential for proliferating in relation to the estate tax.

Estate planning is a beneficial and essential tool for aiding American citizens in protecting and properly transferring their assets following their deaths. Wealthy Americans frequently retain competent professionals to plan and manage their estates, regardless of tax-law consequences, because their affairs can be extremely complicated.

We recognize that there are opportunities in the law that can be exploited to time gifts and remainders to benefit estate transferees in ways that were not contemplated by Congress and should be reconsidered. To the extent that schemes are being designed to provide inappropriate benefits to heirs through gifts to charitable organizations, these practices should be uncovered and stopped. Our attention has recently been directed to the complex estate planning device known as the "charitable lead trust" (CLT) as an area of potential abuse. These estate-planning tools are very popular in the nonprofit community because they can generate considerable charitable giving to a wide array of organizations and serve to benefit the people and communities where they operate. A CLT allows individuals to put a sum of money into a trust which will donate an annual stream of

[8] IRS Dirty Dozen List, IR-2008-41, March 13, 2008.

revenue to a charity for a ascertainable period of time (e.g., life of the donor, number of years) and pass any left over assets, known as the remainder, to named beneficiaries. The plans are advertised to potential donors as a "powerful tool," as a device that results "in little or no taxes," and more.

The inducement is that a CLT permits an individual to pass on substantially appreciated assets without paying additional gift or estate taxes.[9] The reason is the method by which the Internal Revenue Code calculates the benefits and liabilities under CLTs. An individual's tax liability is assessed at the time of the transfer of assets into the trust. Rather than permitting a charitable tax deduction for each year that it is received by the charity, the law requires that the present value of the entire donation be calculated up front. Any amount left over after subtracting this present-value calculation is considered the "remainder" for the beneficiaries and taxed at the date of transfer at the appropriate gift tax rate.

Consider, for example, an individual who deposits $1 million in a 20-year charitable lead trust, and stipulates that the charity is to receive $70,000 in income annually, with the remainder going to his sons and daughters. Using the statutory interest rate of 120% of the Federal Midterm Rate, the Treasury tables project the value of the donation as $777,500 and the remainder as $222,500, which is then taxed accordingly. In this example, the trust principle actually grows to about $2.5 million because actual investment performance far outpaces the statutory rate (which was 3.6% for March 2008). Since the statutory interest rate is so low and the projected value of the remainder has already been taxed, the heirs receive over $2 million free of estate or gift taxes.

In certain circumstances, the donor can take a charitable deduction from income taxes when the assets are transferred into the trust. Charities may never receive the full amount of that donation if the funds in the trust are poorly managed and the rate of return falls below the statutory discount rate. When this happens, the funds run out before the promised donations are ever received, but the donor will have already received the full benefit of the deduction.

Proposed Reforms

There are a number of ways in which the nonprofit community and the government may work closely to deter any ongoing and future abuses associated with estate planning and charitable organizations, including adequate funding for Internal Revenue Service enforcement programs, improved reporting mechanisms and requirements, and reform of donation vehicles.

1. IRS Funding

First, Congress should ensure that the IRS has sufficient resources to maintain a strong oversight and investigation program to enforce compliance by all taxpayers. We also believe that stronger oversight and education of charitable organizations are central to enhancing compliance with the law and ultimately increasing the ability of charities to improve lives. Research indicates that a healthy Internal Revenue Service enforcement budget could help to narrow the nation's tax gap and ultimately reduce the federal deficit. We applaud the continued dedication of Congress to support increased funding for IRS services.

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[9] Generation-skipping taxes may still apply.

2. Enhanced Compliance through Electronic Filing of Tax Returns
The Internal Revenue Service has a daunting job in rooting out fraudulent conduct, a problem made more difficult because of the lack of electronic filing of many tax returns and the need to perform "paper searches" in order to find the truth. Electronic filing of the annual information returns filed by nonprofit organizations and of estate tax returns would permit both federal and state regulators to devote a greater portion of their limited resources to oversight, education, and enforcement instead of cumbersome, costly manual processing of paper returns.

Electronic filing is also likely to increase compliance with reporting requirements by providing immediate feedback on incomplete and potentially inaccurate information before returns are filed. Electronic filing software provides organizations with immediate checks on incomplete and potentially inaccurate information before they file returns, and e-filing also allows the IRS to reject and provide immediate feedback to organizations about incomplete returns and those with obvious inaccuracies.

The annual information return (Form 990) filed by nonprofit organizations serves as the primary document providing information about an organization's finances, governance, operations, and programs for federal regulators, the public, and many state charity officials. This past December, the IRS released its redesigned Form 990 which many tax-exempt organizations must file annually and make available to the public. The revised Form 990 incorporates numerous changes recommended by the Panel on the Nonprofit Sector. Independent Sector believes the revised form will facilitate accurate, complete, and consistent reporting by exempt organizations, will be easier for most entities to complete, and improve public understanding of how organizations operate. We consider the new Form 990 a major step forward in accomplishing the nonprofit community's goals of accountability and transparency.

Currently, the IRS does not have the statutory authority to require electronic filing of the Form 990 by organizations that submit fewer than 250 returns (including W-2s and other forms). The Internal Revenue Code should be amended to allow the IRS to require electronic filing by all organizations that file at least five tax forms per year.

Similarly, Congress should amend the tax code to permit the IRS to require electronic filing of IRS Form 706, the form that an executor of a decedent's estate is required to file to determine estate tax liability. Under the current filing regime, the IRS must compare paper returns of estates and charities to investigate whether wrongdoing has occurred. Electronic filing of the 706 returns would allow the IRS to identify quickly missing or incomplete information and apply electronic diagnostics to flag potential discrepancies. As with the Form 990, Independent Sector supports examination and reform of the Form 706 to require electronic filing as a method for increasing accuracy and permitting more direct oversight.

3. Charitable Lead Trusts
As stated previously, charitable lead trusts are a valuable and popular tool for estate planning that allows individuals to give back to their communities while providing for their families after death. For charities throughout the country, the resources from CLTs have allowed them to pursue their missions of improving lives and transforming communities. The fundamental concept of the estate-planning tool is sound.

The current statutory formula and timing for calculating tax liability, however, appear to create the potential for overstated charitable deductions or understated tax liability for beneficiaries. We believe the Committee should review the current law to determine whether the statutory rate should be revised as it applies to CLTs. In the alternative, the Committee could consider changing the date at which tax liability is determined. Rather than estimating income and gift/estate tax liabilities at the time of transfer to the charitable lead trust, the tax consequences of the donations could be determined when they are actually received. This would mean that the charitable deduction would be available for each year in which a payment is made to the charity, and the tax liability for the remainder would be determined when the beneficiaries actually receive it at the end of the trust period. In each instance, the calculations would be based on fact rather than estimations. In the case of underperforming trust assets, this approach would also serve to ensure that charitable deductions are not taken for promised donations that never materialize.

Conclusion

Independent Sector is committed to encouraging the nonprofit community to meet the highest standards of ethical practice, and we stand ready to work with policymakers and the IRS to educate charities and foundations about various tax schemes and help prevent their spread. While the threat of fraud will remain even after estate tax abuses are properly addressed, an overwhelming majority of nonprofit organizations will continue to live by the letter and the spirit of the tax law. Maintaining that standard depends on a combination of active self-regulation and effective enforcement of the tax law, and our community recognizes that we must demonstrate to stakeholders that we operate ethically and accountably, since only then will we receive the public support that enables us to serve communities everywhere.

United States Senate Committee on Finance Hearing
Outside the Box on Estate Tax Reform:
Reviewing Ideas to Simplify Planning
April 3, 2008

Questions Submitted for the Record

Questions for Ms. Aviv:

Senator Baucus

1) *What provision in the tax Code currently causes the biggest problem for taxpayers in estate planning? Apart from the rate and exemption, in your opinion, if Congress could only make one additional change, what should it be and why?*

The present uncertainty of the future of the estate tax poses the biggest problem to taxpayers in estate planning in the United States. The primary change needed from Congress is to enact a permanent solution to preserve a fair and responsible estate tax that provides necessary revenue to the federal government, adequately protects small businesses and farm lands, and provides an incentive for charitable giving.

At this time we believe that your amendment to the budget resolution calling for an exemption of $3.5 million for individuals ($7 million for couples) and a rate of 45% meets that criteria. We further believe that Congress must evaluate the costs of any changes to the estate tax to ensure that our federal government is able to meet its responsibilities to our nation and the world.

2) *Recognizing that in 2006 Congress passed a number of reforms aimed at improving the accountability and tax law compliance of charitable organizations, what additional steps can be taken to prevent the potential for estate tax abuse related to charities?*

The most important step that Congress can take to enhance tax law compliance is to ensure that the IRS has adequate resources to strengthen its oversight, enforcement, and education activities for both individual taxpayers and charitable organizations. It would also be helpful for Congress to enact the necessary statutory changes to grant the IRS the authority to require virtually all nonprofit organizations (those filing more than 5 returns each year) to electronically file their Form 990 informational returns. Increased electronic filing will lead to greater compliance, transparency, and accountability of nonprofits to the government, donors, and the public.

3) *What potential changes can be made to the rules surrounding charitable lead trusts to cut down on the potential for abuse? If changes were made to the date on which tax liability is determined for charitable lead trusts, could this result in any potential planning issues for donors and their beneficiaries?*

Charitable lead trusts (CLTs) enable donors to contribute to the work of charities and help them pursue their missions of improving lives and transforming communities, while also providing for their family members. We believe that the fundamental concept of this estate-planning tool is sound. Nonetheless, we recognize that the current formula for calculating the valuation and tax liability of CLTs may result in more substantial under-taxed returns to heirs than was intended by

Congress. As I suggested in my testimony before the Senate Finance Committee, Congress may wish to reconsider that formula while preserving this important estate-planning tool.

I suggested two possible approaches to addressing the issue of substantial under-taxed remainders: 1) changing the interest rate for calculating the value of CLTs to better reflect current economic realities, or 2) calculating the value of CLT assets on the date they are actually transferred rather than the current practice of projecting values years before transfers occur. Either approach would require careful consideration to ensure that changes do not result in decreased resources for government and the charitable community to fulfill our mutual responsibilities to the American people, or further complicate the estate-planning process. Furthermore, if Congress were to proceed with any changes to the tax code regarding CLTs, it should ensure that existing trusts would not be affected.

Changing the interest rate to reflect current economic realities must take into account future fluctuations in the economy. Congress has revised the interest rate for calculating the present value of CLT asset transfers and similar programs on five separate occasions. To date, neither flat nor fluctuating interest rates have addressed Congress' dual concerns for promoting charitable giving and securing adequate tax revenues. It may be appropriate to consider a mixture of a fluctuating rate that is limited within a corridor with a fixed floor and ceiling so that extreme lows or highs are prevented.

Changing the date for the valuation of CLT asset transfers may help to ensure that tax deductions are not taken for promised donations that never materialize, but this could also discourage donors from utilizing this valuable estate-planning tool, given the risks of unknown future tax liabilities.

Independent Sector is ready to work with the Committee and all interested parties to examine this valuable estate-planning vehicle and alternative methods for computing the value of charitable and non-charitable asset transfers.

4) *Ms. Aviv, I am concerned about orphan trusts. Some charitable bequests become "orphaned": they get moved from a local bank to a big national or multinational bank and lose their donor's commitment to their community. It concerns me too when these orphan trusts have their charitable giving rates go down as a result.*

    a) *How can we make sure that the tax benefit given to charitable bequests results in charitable work that reflects the donor's commitment to his or her community, especially for small rural towns and other places that really need the resources?*

Donors have a responsibility to ensure that their trust instruments provide clear direction as to how trust funds should be managed and used, and we believe that more education of both donors and donor advisors would be helpful to address unintended omissions or errors in trust instruments. The article you included with your question points to two other key issues that affect whether or not "orphan trusts" are providing adequate returns to the charitable purposes intended by the donor: 1) the size of fees charged by bank administrators, and 2) the limited resources which have led to inadequate oversight by both state and federal regulators. Indeed, the article makes clear that when the New York attorney general's office investigated five orphaned foundations, the trust administrators made some positive changes.

The Internal Revenue Service has responsibility for investigating and enforcing prohibitions on excessive compensation to "disqualified persons" of private foundations and public charities. In its

April 2006 supplemental report to Congress, the Panel on the Nonprofit Sector recommended that Congress direct the Secretary of the Treasury to amend the self-dealing regulations applicable to private foundations and the intermediate sanctions regulations applicable to public charities[1] to clarify that when evaluating the reasonableness of a trustee's compensation, the fact that the compensation is specified in a trust instrument or otherwise authorized by a state or local legislative body, agency, or court is not determinative of whether such compensation is excessive. While the responsibilities of banks and other institutional trustees that act as both fiduciaries and administrators of trusts are substantially greater than those of individual trustees, there are nonetheless many mechanisms for evaluating whether the fees charged by an institutional administrator are comparable to those paid to other administrators with comparable responsibilities for overseeing comparably-positioned trusts.

In addition, Congress should take any steps within its power to ensure that both the IRS and state charity regulators have sufficient funds to provide appropriate oversight, enforcement, and education of donors and trust administrators regarding existing laws. We do not recommend any further changes in law at this time, but we are committed to continued examination of this important issue and will share with you any recommendations that might address the problems you have noted without producing unintended consequences that would create other, more costly problems.

b) How can Congress encourage generous levels of giving from charitable bequests and foundations to support the charities that are so vital across the country?

Chairman Baucus, thank you for your continuing support for charitable organizations and for your recognition of the vital contribution of charities to the country. In our opinion, the best way that Congress can encourage generous levels of giving through charitable bequests is to resolve the present uncertainty in estate tax law. I share the concerns expressed by witnesses at several hearings before the Senate Finance Committee that the changing tax rate and exemption levels have created confusion, and increased estate planning costs. Enactment of a stable and responsible estate tax rate and exemption level will remove the current disincentive and uncertainty.

In addition, Congress could greatly benefit the work of the charitable community by restoring and making permanent several charitable giving incentives, including the IRA charitable rollover. That provision, which expired at the end of last year, permitted older Americans who had accumulated more assets in their IRAs than they needed for retirement to make distributions to charities without suffering adverse tax consequences. Permanently restoring the IRA rollover would also give smaller organizations the time they need to educate themselves and donors about the benefits of the giving incentive, and thereby improve their ability to serve their communities.

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[1] IRC section 4958 regulations already provide that the authorization or approval of a compensation package by a state or local legislative or agency body or court is not determinative of the reasonableness of compensation. Identical standards should apply under both the public charity intermediate sanctions rules and the private foundation self-dealing rules.

5) Ms. Aviv, I'm very concerned about this gap in foundation assets in and giving to rural states.

a) If the estate tax were reformed, what impact might we see on foundation giving in rural states?

Maintaining a permanent and robust estate tax that allows wealthy Americans to give back to their communities through tax dollars or charitable gifts is essential to ensuring that our nation has the ability to address the needs of both urban and rural communities. In lieu of paying estate taxes that would be used for broad public purposes, individuals who were raised in or derived their fortunes from endeavors in rural areas can choose to structure charitable gifts through their estates in ways that will benefit those communities.

b) This problem demands a solution. What are your recommendations to move foundations' commitment to rural states forward?

Senator Baucus, we applaud your efforts to raise awareness of the needs of rural communities and to encourage foundations to consider rural communities in their grantmaking strategies. We are also encouraged by the Rural Collaborative Investment Program in the conference report for the Farm Bill, which would assist community foundations in rural states in their donor education and outreach efforts and which would help generate increased philanthropic resources to serve those communities.

There are many strategies that are or could be employed to encourage wealthy individuals to give back to the communities that have supported their efforts through direct gifts or the giving of foundations they create. It will be important to use these strategies in reaching out to and encouraging the many individuals who have benefited from the 2001 tax cuts to share the wealth they have accumulated with the communities where they were raised and where they have worked and derived their fortunes.

Independent Sector is currently examining how best to increase both private and public resources to address the needs of vulnerable populations in both rural and urban areas, and we look forward to working with you in that regard.

Senator Grassley

1) We have been working together on exempt organization issues for almost four years now. The work of your organization as well as the Panel on the Nonprofit Sector has informed this committee well so I ask you to consider a few more issues.

I continue to remain concerned that dollars intended for charitable purposes actually reach charitable beneficiaries. You have testified that the estate tax motivates many taxpayers to donate large amounts to charitable organizations upon their deaths. I think it is safe to presume that the majority of such gifts end up in college endowment funds or family foundations. Money not being spent for charity is just another abuse of the estate tax deduction in my opinion. As we consider reform of the estate tax, what kind of incentives can we provide to ensure that dollars taken as a deduction against estate taxes actually go to feed the hungry and shelter the homeless rather than line the pockets of heirs who draw salaries from the foundations created at their parent's death?

Senator Grassley, we have appreciated your leadership in working with the nonprofit community and the Panel on the Nonprofit Sector to address concerns that affect our ability to serve communities and improve lives throughout our nation. We share your commitment to ensuring that dollars taken as deductions against taxes are devoted to charitable purposes and not to the private benefit of donors or their heirs. Nonetheless, the question you pose raises many issues.

First, according to *Giving USA 2007*, an annual report compiled by the Center on Philanthropy at Indiana University, roughly half of charitable contributions through bequests is given to organizations in the "philanthropy and voluntarism" category, a category that includes private and community foundations as well as federated giving programs, volunteer centers, and management assistance programs for nonprofit organizations. The other half of giving through bequests is spread among a wide variety of religious, educational, human service, arts, and other organizations. In all of these categories, some of the money is spent immediately to address current needs and programs, and some is put into endowments or operating reserves to address future needs.

Many systems that establish principles for effective governance and management of charitable nonprofits encourage organizations to create cash reserves for future needs, including weathering the kind of economic downturn our nation is currently experiencing. Nonprofits may also set aside funds to purchase office buildings or equipment that will enable them to reduce their long-term operating costs and expand services, a circumstance that applies to my own organization, Independent Sector. The nonprofit community continues to work to find the right balance between meeting current needs and ensuring that resources are available to meet future needs

The changes in charitable regulations which you championed through the Pension Protection Act of 2006, many of which were recommended by the Panel on the Nonprofit Sector, introduced additional safeguards against the use of charitable resources held by foundations and public charities for the private benefit of donors and their family members. Foundation board members who hire members of the donor's family are currently subject to strict self-dealing rules and penalties if the compensation is in excess of amounts that would be paid to others serving in similar organizations and positions with similar skill sets and responsibilities. Through our current and ongoing educational efforts, we encourage the boards of foundations and public charities to ensure that all staff leaders are well qualified for their positions, that their performance is evaluated on a regular basis, and that their compensation is reasonable for their qualifications, responsibilities, and performance.

2) *In your testimony you suggest that the IRS should attempt to set up a system of electronic filing for the Form 706. Administrative issues aside, do you believe that if the IRS established this process to police the donors full donations through the electronic 706 that charities would be voluntarily compliant in filing forms electronically or by paper that validated the amounts which they had received from different donors?*

Independent Sector fully supports and urges Congress to enact legislation that would grant authority to the IRS to require virtually all nonprofit organizations (those filing more than 5 returns each year) to electronically file their Form 990 informational returns. On Schedule B of those returns, charities must list contributions of cash or property, and the names of their donors, if the value of the contribution is $5,000 or 2% of the organization's contributions, whichever is greater. In addition, charities must sign Form 8283 for taxpayers claiming a tax deduction for non-cash contributions (other than publicly-traded stock) valued at $5,000 or more, and we also support electronic filings of those Forms.

Given the potential difference in the value of property on the date of the donor's death, the basis for estate tax calculations, and the value of the property when it is received by the charitable organization, we are uncertain what additional reporting requirements might help in identifying inappropriate deductions from estate taxes and whether the possible cost of abuses that might be uncovered through those procedures would be sufficient to justify the additional costs of compliance by charities and enforcement by the IRS. We would be happy to explore this issue further with you and your staff.

3) *I worry about those trusts and foundations who don't have anyone minding the store. As reported in The New York Times last September, many of these "orphaned" charities get taken over by large banks or trustees that have no interest in fulfilling the wishes of the benefactors. Some think that is an issue that should be resolved by state law enforcement officials. However, since money given to charity at the time of death is exempt from federal estate tax, I would appreciate your thoughts on what we can do now to address this problem. Would requiring a complete payout to the intended charitable beneficiaries within a certain number of years after the donor's death make sense?*

Senator Baucus has raised similar concerns regarding the New York Times article on "orphaned" foundations and charitable trusts, which we have responded to earlier in this document. We believe that the article highlighted the importance of ensuring that donors and their advisors have adequate education to ensure that their trust instruments provide clear direction as to how trust funds should be managed and to address unintended omissions or errors in trust instruments. Appropriate state and federal oversight is also critical to ensuring that bank and other institutional administrators do not charge excessive fees and do fulfill the charitable intentions expressed in the trust instrument.

Some donors may choose to set a specific time period for the complete payout of the principal and any investment earnings to specific charitable organizations or to fulfill specific charitable intentions. For those donors who prefer to set up a fund to address longer-term or unanticipated future needs, it may be possible to establish requirements for the composition of trust instruments or to permit involvement of community foundations or some other advisory body to review whether funds are distributed according to the donors' intentions.

We believe this issue deserves further study and will be happy to share with you any findings or recommendations based on discussions and research with our member organizations.

Senator Snowe:

Ms. Aviv, I would like to thank you for your tireless efforts to promote the Public Good IRA Rollover Act (S. 819) that I introduced with Senator Byron Dorgan last year. Our bill would make permanent a provision that expired at the end of 2007 that allows individuals aged 70½ and older to donate up to $100,000 from their Individual Retirement Accounts to charities without having to count the distributions as taxable income, as well as eliminate the $100,000 cap. Our legislation would also allow a tax-free rollover for a life-income plan for individuals age 59½ or over.

1) *Focusing on the planned-giving component of this legislation through which an individual could donate to a charity and receive life income that is taxable, could you please comment on how this provision would promote charitable*

donations while simultaneously reducing individuals' present-law estate tax liabilities and addressing Congress' concern that individuals do not outlive their retirement savings?

Senator Snowe, I want to thank you for your question and for your work with Senator Dorgan in support of extending and expanding the IRA charitable rollover giving incentive. Your IRA charitable rollover legislation, S.819, addresses Congress' concern that individuals not outlive their savings. As you know, the defined contribution system, and its reliance on individual retirement accounts, puts all of the risk on the individual to make sure he or she has enough money on which to live until death. The Dorgan-Snowe bill encourages individuals to donate money to charities and receive annuity payments that they will never outlive. By promoting annuities through charities, Congress can shift risk away from individuals and ensure a steady income stream for the rest of their lives. At the same time, Congress can encourage charitable giving which can help expand and enhance services to individuals and communities throughout the country.

2) *Ms. Aviv, could you also please spend a moment commenting on the need to extend the charitable IRA rollover provision that expired at the end of 2007?*

   a) *What has been the effect on giving from allowing this incentive to lapse?*

The expiration of the giving incentive has created uncertainty and hesitancy among potential donors. We understand that investment advisors are telling clients that the law has lapsed so they should not give to charities from IRAs. Last month, the Wall Street Journal quoted Victoria B. Bjorklund, a partner at the law firm Simpson Thacher & Bartlett LLP, as saying, "So, it makes sense to wait and see whether Congress renews this provision before you make any such IRA transfers in 2008." This "wait and see" approach caused by the delay in restoring the giving incentive means that resources continue to sit in retirement accounts and are not being put to work in communities addressing current and future needs.

   b) *Do you have any metrics of how much giving this proposal encouraged in the brief period it was effective?*

Anecdotal reports from community foundations, social services charities, universities, and other organizations indicate that the IRA charitable rollover was a very popular incentive that generated support for charitable works throughout the country. The resulting gifts from individual retirement accounts – ranging from as little as $10 to the legal maximum of $100,000 – helped organizations build cancer centers, develop programs for counseling at-risk youth, support housing for homeless families, conserve wilderness areas, and provide art therapy for people with developmental disabilities. In Maine, for instance, PenBay HealthCare in Rockland received $26,000 in donations from IRAs and the Catholic Foundation of Maine received $35,000.

There are no comprehensive statistics on charitable giving in response to the IRA giving incentive. The Internal Revenue Service does not collect them. The National Committee on Planned Giving (NCPG) surveyed its members and found approximately 900 organizations received almost $140 million in IRA rollover distributions in the 16 months that the incentive was available. That organization found that more than two-thirds of the donations came in the amount of $5,000.

UNITED STATES SENATE

Committee on Finance

OUTSIDE THE BOX ON ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING

April 3, 2008

Testimony of
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I thank you for inviting me to testify about simplifying planning to address the payment of federal estate taxes. I am testifying on my own behalf and do not speak for any other person, organization, or entity. My testimony is based on my 30 years' experience in private practice representing individual clients, particularly closely held business owners, and assisting my clients in planning to deal with the burden of federal gift, estate and generation-skipping taxes. (I will refer to these taxes collectively as "transfer taxes.")

I applaud this Committee's efforts to resolve this year the uncertainty concerning the transfer tax laws. Taxpayers can deal more effectively with the federal transfer tax burden on their property when taxpayers know what the law will be in the foreseeable future. I have heard many complaints from clients about being unable to plan for the federal transfer tax burden given the uncertainty under the existing transfer tax laws.

I will testify about two matters (1) the *Report on Reform of Federal Wealth Transfer Taxes*, which addresses numerous aspects of federal transfer taxes, and (2) an issue of importance to closely held business owners, the installment payment of estate taxes attributable to a closely held business under Internal Revenue Code section[1] 6166.[2]

REPORT ON REFORM OF FEDERAL WEALTH TRANSFER TAXES

I was the Chair of the Task Force on Federal Wealth Transfer Taxes which produced the *Report on Reform of Federal Wealth Transfer Taxes*. The Task Force was formed by seven organizations representing professionals who advise clients on federal

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[1] Each reference to "section" is a reference to a section of the Internal Revenue Code of 1986, as amended.
[2] I will use the term "installment payment provision" to refer to section 6166.

wealth transfer taxes.[3] The Task Force members were some of the most knowledgeable professionals in the United States who advise clients in transfer tax planning. The organizations participating in the Task Force were:

- The American College of Trust and Estate Counsel,
- The American Bar Association Section of Real Property, Trust and Estate Law,
- The American Bar Association Section of Taxation,
- The American Institute of Certified Public Accountants,
- The American Bankers Association, and
- The American College of Tax Counsel.

The purpose of the Task Force was to produce a report that would provide expert analysis of the changes enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act) regarding federal wealth transfer taxes. The Task Force did not consider policy questions having to do with the economic effects of a wealth transfer tax system as compared to other systems of taxation or whether redistribution of wealth was an appropriate goal of the transfer tax system. The Task Force's central concern was to assess on the basis of simplicity, compliance, and consistency of enforcement, the temporary repeal of the estate and generation-skipping transfer taxes, the phaseout period, the continuation of the gift tax after repeal, the modified carryover basis rule, and alternatives to federal wealth transfer tax repeal.

The Task Force prepared the Report to provide diverse views and perspectives on a wide range of issues concerning the current federal wealth transfer tax system and the

[3] The American College of Trust and Estate Counsel Foundation, the American Tax Policy Institute and the American Bar Association Section of Real Property, Trust and Estate Law provided grants to enable the Task Force to publish their Report on Reform of Federal Wealth Transfer Taxes.

changes the 2001 Tax Act made to that system. The Report suggested options that Congress may consider but did not make any specific recommendations for regulatory or legislative action. The Task Force members and sponsoring organizations support the analysis of the alternative solutions to the issues identified but did not endorse any specific solution.

I believe the two most significant changes suggested in the Report are:

- Reunification of the gift and estate tax systems, and
- Portability of the unified credit and the GST exemption.

The Task Force distributed a copy of the Report to each member of the Congressional tax writing committees and their staff. The Report can be found at http://www.abanet.org/tax/pubpolicy/2004/04fwtt.pdf.

I hope that the Committee and its staff will call upon the Task Force as you consider changes to the federal wealth transfer tax system.

PAYING THE FEDERAL ESTATE TAX IN INSTALLMENTS ON CLOSELY HELD BUSINESS INTERESTS

Significance of Closely Held Businesses

Family owned businesses are a major part of the United States economy, making up 80 to 90 percent of all businesses in North America and contributing significantly (in excess of $5 trillion) to the United States Gross Domestic Product.[4] In a study of the companies making up the S & P 500, one study[5] found that one-third of

[4] J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review, September 2003.
[5] Anderson, Ronald C., Mansi, Sattar A. and Reeb, David M., "Founding Family Ownership and the Agency Cost of Debt" (hereinafter "Anderson, Mansi, Reeb Study"). Available at SSRN: http://ssrn.com/abstract=303864

these companies have deep family connections.[6] These families are heavily invested in the family business, and, on average, 69 percent of the family's total wealth is invested in the family enterprise. Because of the large, concentrated investment, family businesses operate in unique and efficient ways, including looking to the long term future of the business and the reputation of the family. The study also found that family businesses generally out-perform non-family businesses, posting a 6.65 percent greater return on assets than non-family businesses.[7]

The death of a closely held business owner often foretells the death of the business. Only 30 percent of all privately owned businesses survive past the first generation.[8] Although it is the goal of many business owners to transfer ownership of the business to future generations, only 12 percent of private businesses survive into the third generation, and a mere three percent are still in existence at the fourth generation and beyond.[9] There are many reasons for the lack of survival of closely held business for future generations including lack of succession planning, business failure, and inability to meet liquidity needs (some of which is caused by the federal transfer tax laws).

The Statistics of Income Division of the Internal Revenue Service produces data files from samples of tax and information returns filed with the Internal Revenue Service. The Statistics of Income Division publishes information on the number of returns filed, the amount of tax collected, and other tax return information. The Statistics of Income Division released recently a report entitled "Estate Tax Returns Filed in 2006: Gross

[6] The study defined a "deep family connection" to be the family responsible for starting the company was still heavily invested in the company, and has, on average, 18 percent of company equity.
[7] Anderson, Mansi, Reeb Study.
[8] Raymond Institute/MassMutual, American Family Business Survey, 2003.
[9] Raymond Institute/MassMutual, American Family Business Survey, 2003.

Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate."[10]

The Statistics of Income Report showed that approximately 49,000 estate tax returns were filed in 2006 and approximately 15 percent (7,567) of the tax returns listed as an asset stock in one or more closely held businesses.[11] The Statistics of Income Report also showed that those estates classified as the largest gross estates (greater than $20 million) held a higher percentage of stock in a closely held business than smaller estates. Approximately 50 percent of those estates greater than $20 million listed stock in a closely held business as an asset. In addition, the Statistics of Income Report showed that closely held stock was approximately five percent of the gross estate for all estates, but closely held stock constituted approximately 14 percent of the gross estate of estates greater than $20 million. It appears that for estate tax returns filed in 2006, the larger the estate, the more likely the estate will own a higher percentage of closely held stock. From a review of statistics for years before 2006, there is a similar pattern of ownership of closely held stock in prior years. Accordingly, notwithstanding that the assets that can pass free of federal estate tax is scheduled to increase to $3,500,000 in 2009, there will still be a significant number of closely held business owners who will be subject to federal estate tax and whose estates will need relief in the form of the installment payment provision.

Because of the illiquid nature of a closely held business, federal transfer taxes present a serious obstacle to a closely held business surviving the death of the business

[10] The Report can be found at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html.
[11] It does not appear that farm assets, including farm land, limited partnerships or limited liability companies are classified as closely held business interests for purposes of these statistics. If these assets were included, there would be a significantly larger percentage of estates holding closely held businesses.

owner. The shortfall of sufficient liquid assets to pay the federal transfer taxes incurred as a result of the business owner's death may necessitate a forced sale or liquidation of the business, thereby preventing the continuation of the business.

For many closely held business owners, the business represents the most valuable, and usually the most illiquid, asset in the business owner's estate. During the business owner's lifetime, the business is generally the primary vehicle of economic and emotional support for the business owner's family. As the primary asset of the business owner's estate, the business will be the source of funds to pay federal and state transfer taxes, debts, and administration expenses, as well as to pay for the support of the business owner's surviving spouse and other dependents. With careful planning to ensure the availability of the installment payment provision, the family may be able to retain the business and not sell the business to meet liquidity needs. If the family is forced to sell the business, the sale may occur at an inopportune time, either because of external forces, such as a down turn in the economy, or internal forces, such as a lack of business succession planning, internal strife, and emotional distress.

There are several provisions of the Internal Revenue Code offering benefits to the estate of a closely held business owner, including sections 303, 2032A, 2057, and 6166. Section 303 provides an income tax benefit by allowing the transfer of assets from a closely held business for an amount equal to the federal and state estate taxes and costs of administration. Section 2032A provides an estate tax benefit by valuing real property (generally farm real property) for federal estate tax purposes at the use value of the real property instead of the fair market value of the property. Until section 2057 terminated in 2003, section 2057 provided an estate tax benefit by excluding $675,000 in value from certain family businesses. Section 6166, the installment payment provision, provides an estate tax benefit by allowing the installment payment of the federal estate taxes attributable to a closely held business interest over a 14-year period at a bargain interest rate.[12]

If certain stringent requirements are met, each of the above provisions can offer relief to the estate of a closely held business owner. Unfortunately there are issues that make planning to meet the qualification for this relief uncertain. The purpose of my testimony is to discuss the issues that I believe Congress should address associated with the installment payment of estate taxes attributable to a closely held business.

History of Installment Payment of Estate Taxes Attributable to Closely Held Business Interests

In 1958, Congress provided the first installment payment provision for the estate tax attributable to closely held businesses by enacting section 6166. In the 1958 version, section 6166 provided payment in installments over nine years for the estate tax attributable to closely held business interests if the business interests constituted more than 35 percent of the decedent's adjusted gross estate or 50 percent of the decedent's taxable estate. The 1958 version of section 6166 did not provide any bargain interest rate.

In 1976, Congress expanded the installment payment relief by designating the 1958 version of section 6166 as new section 6166A and enacting a replacement section 6166. The new section 6166 expanded the installment payments by providing for a four-

[12] For estates of individuals dying in 2008, the interest rate on the unpaid tax is two percent on the tax attributable to the first $1,280,000 of value of closely held business interests (or two percent interest rate on $576,000 of estate taxes) and 45 percent of the interest rate applicable to underpayment of tax (3.15 percent with an underpayment rate of seven percent). Section 6166 does not reduce the estate taxes payable and the savings under section 6166 relate solely to the deferral of the payment of estate taxes and the bargain interest rate.

year period of interest only payments followed by ten equal payments of the federal estate tax (a fourteen-year deferral period) if the business interests constituted more than 65 percent of the decedent's adjusted gross estate. In addition, the 1976 version of section 6166 provided for a bargain interest rate of four percent for a portion of the federal estate tax.

In 1981, Congress, as a part of the Economic Recovery Tax Act of 1981, repealed section 6166A and reduced the percentage test of qualifying for installment payments under section 6166. Under the 1981 version of section 6166, Congress changed the closely held business interest percentage test from 65 percent to 35 percent and retained the fourteen-year payout period. The Tax Reform Act of 1984 added a provision dealing with the treatment of stock of any holding company that represents direct or indirect ownership and a provision dealing with passive assets held by business entities.

The last significant change to the installment payment provision occurred in 1997 when Congress reduced the interest rates charged on the unpaid tax and increased the amount of unpaid tax eligible for the reduced interest rate. In exchange for the lower interest rates, Congress eliminated the federal estate and income tax deduction of the interest paid on the tax deferred under the installment payment provision. In 2001 Congress amended the installment payment provision to provide special rules for closely held business interests in qualifying lending and finance businesses and also amended the holding company rules.

Although installment payments of federal estate tax attributable to a closely held business can be a helpful alternative to a closely held business owner's estate, closely held business owners have encountered difficulties concerning the application, operation and interpretation of the installment payment provision. I have observed the following significant issues with the installment payment provision:

- **Closely Held Business Owners Need the Ability to Pay Estate Taxes in Installments.** Closely held business owners need the ability to pay the estate taxes attributable to their business interests in installments. Closely held businesses are illiquid and cannot be converted to cash. Without the ability to pay federal estate taxes in installments, some closely held businesses will fail.
- **Congress Should Modernize the Installment Payment Provision.** The installment payment provision has not kept pace with modern business practices. The installment payment provision addresses the corporate and partnership forms of doing business but does not address new forms of doing business such as limited liability companies, limited liability partnerships, or business trusts. A closely held business owner must select carefully the type of business entity for the business enterprise to preserve the ability for the business owner's estate to pay the estate tax in installments under the installment payment provision. Congress should modernize the installment payment provision to reflect the new forms of business entities and treat limited liability companies, partnerships, and business trusts the same as corporations.
- **Congress Should Cure the Inadequate Treatment of Holding Companies under the Installment Payment Provision.** Under modern business practices, closely held business owners will frequently use a holding company and subsidiary structure (referred to as "tiered entities") to conduct various business

activities. The installment payment provision does not deal adequately with holding companies and tiered entities. Because of the complex and confusing holding company rules under the installment payment provision,[13] a closely held business owner needs to consult a knowledgeable (i.e. expensive) tax advisor when using a holding company structure so as to preserve the benefits of the installment payment provision.

- **Congress Should Improve the Definition of Passive Assets under the Installment Payment Provision.** Because the benefits of the installment payment provision are intended to be limited to active businesses, the installment payment provision precludes the installment payment of the federal estate taxes attributable to assets not used in the business (called "passive assets").[14] The present definition of passive assets under the installment payment provision,[15] however, needs modification to accommodate the way closely held business owners are conducting businesses. Otherwise, a business owner is forced to artificially structure the owner's business entities to comply with the rigid requirements of the installment payment provision.
- **Congress Should Allow Business Owners to Obtain Advance Rulings from the Internal Revenue Service on Whether the Business Owner's Estate Will Meet the Requirements of the Installment Payment Provision.** Unlike many tax planning situations where a taxpayer can request an advance ruling from the Internal Revenue Service on the tax effect of a proposed business structure, a closely held business owner cannot request the Internal Revenue Service to rule

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[13] Section 6166(b)(8).
[14] Section 6166(b)(9).
[15] Section 6166(b)(9)(B).

on whether the business owner's assets will qualify for installment payment of the estate tax. Congress should authorize and direct the Internal Revenue Service to issue advance rulings so a business owner can determine whether the deferral under the installment payment provision is available under the business owner's current business structure.

- **Congress Should Improve the Burdensome Lien Procedures under the Installment Payment Provision.** The Internal Revenue Service has implemented lien procedures to maximize the collectibility of the federal estate tax deferred under the installment payment provision. These lien procedures have been implemented unevenly by Internal Revenue Service agents in the field and can create an undue and unnecessary impediment to the closely held business owner's successors. Congress should change the lien procedures so as to minimize the administrative impediments for a closely held business owner's estate.

I will discuss briefly each of these issues.[16]

Closely Held Business Owners Need the Ability to Pay Estate Taxes in Installments

Estate taxes are due nine months after a business owner's death. The executor of a closely held business owner's estate generally needs liquidity to pay estate taxes, debts, beneficiary needs, and costs of administration. In some instances, the closely held business owner has sufficient liquidity because of planning through the use of life insurance and other techniques. In those instances where the business owner's estate

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[16] For a detailed discussion of these issues and other deficiencies with the installment payment provision, see Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, page 73 - 121 (Spring 2006).

does not have sufficient liquidity (the business owner may have been uninsurable or the business may have grown faster than the business owner could plan), the business owner's executor generally faces a difficult time in raising funds to meet liquidity needs, particularly funds to pay estate taxes (estate tax payments provide no new benefit to the business and only maintain the status quo). Accordingly, the executors of some closely held business owners' estates are faced with the need to raise significant funds at the most inopportune time, when the closely held business is in transition because of the death of an owner.

Modernization of the Installment Payment Provision

Before a closely held business owner's estate can receive the benefits of the installment payment provision, the estate must meet several requirements. One requirement is that the estate must have an interest in a "closely held business." [17] The Internal Revenue Code defines a closely held business under the installment payment provision[18] as a proprietorship, a partnership, and a corporation and does not mention a limited liability company, a limited liability partnership, or a business trust.

Business owners have changed the way they do business since the installment payment provision was enacted in 1976. When the installment payment provision was first enacted, most business owners conducted their businesses either in the form of a corporation or partnership. Since the enactment of the installment payment provision, new business forms, such as limited liability companies, limited liability partnerships, and business trusts, have been used by business owners to conduct their business

[17] Section 6166(a)(1).
[18] Section 6166(b)(1)(B) and (C).

operations. Unfortunately, the definition of a closely held business for purposes of the installment payment provision has not kept up with the times.

Although I have not encountered personally an instance where the Internal Revenue Service has denied the benefits of the installment payment provision where the closely held business was a limited liability company, the definition of the installment payment provision should be brought up to date to make sure that the benefits of the installment payment provision are available to a business owner's estate regardless of the business form.

In addition to the inadequate definition of a closely held business interest, the installment payment provision does not treat all business forms uniformly. For example, stock in a corporation will qualify as a closely held business interest if 20 percent of more of the *voting stock* is owned by the estate[19] while a partnership interest will qualify if 20 percent or more of the *total capital interest* is owned by the estate.[20] A better rule would be to allow qualification if a business owner's estate included either a 20 percent voting interest or a 20 percent capital interest. There are other examples under the installment payment provision of inconsistent treatment of business forms.[21]

Recommendation: *Amend the definition of "closely held business" under the installment payment provision to make it clear that all forms of businesses qualify for the benefits of the installment payment provision. Provide for the consistent application of the requirements under the installment payment provision regardless of business form.*

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[19] Section 6166(b)(1)(B)(i).
[20] Section 6166(b)(1)(C)(i).
[21] Sections 6166(b)(8) and (9). See Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, page 84 (Spring 2006).

Holding Companies and the Installment Payment Provision

Many closely held business owners now conduct their business operations in multiple entities owned by a holding company. The installment payment provision has not adapted to these changes which creates significant uncertainty for the business owner in determining whether the installment payment provision will be available upon the business owner's death.

Many business owners place assets used in an active business in separate entities with the entities being owned by a holding company. For example, an individual may create a limited liability holding company called "Brookdale Farms Holding Company." The individual may transfer: (1) the farm real property to a separate limited liability company called "Brookdale Farm Real Estate Company," (2) cattle and other livestock to a third limited liability company called "Brookdale Farm Livestock Company," and (3) the operating equipment to a fourth limited liability company called "Brookdale Farm Operating Company." Brookdale Farms Holding Company would own all of the interests in the three separate limited liability companies. If the individual wants to take advantage of the installment payment provision, the individual must be careful in making gifts and how the individual conducts the business activities. Otherwise, the installment payment provision may not be available.

Business owners use a holding company structure for many reasons, including estate planning (giving interests in the farm real property limited liability to one child and giving interests in the operating business to another child) and the limitation of tort liability. Because the Internal Revenue Service took the position that a corporation with its sole asset stock of another corporation is not a closely held business,[22] Congress amended the installment payment provision to allow the portion of stock of a holding company that directly or indirectly owns stock in a closely held active trade or business to be considered stock in the business company for purposes of the installment payment provision.[23] Before the holding company stock may qualify for installment payment, however, the holding company stock must meet several requirements and the executor must make an election.

The holding company structure presents numerous issues. What is the level of activity required by a subsidiary in order to qualify as a closely held business under the installment payment provision? Are intra-company loans (a loan from Brookdale Farms Operating Company to Brookdale Farms Real Estate Company) considered passive assets and not entitled to installment payment? Because the installment provision uses the term "company" in describing personal holding entities, is the application of the installment provision limited to corporate entities?

Recommendation: *Amend the definition of "holding company" under the installment payment provision to combine all interests owned by the closely held business owner for all purposes of the installment payment provision.*

Definition of Passive Assets

The installment payment provision limits the installment payment of estate taxes attributable to business interests that conduct an active trade and business. Passive assets held by an interest in an entity conducting a trade or business are excluded in determining whether the estate qualifies for the benefits of the installment payment

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[22] Technical Advice Memoranda 8219007 and 8134012; Private Letter Rulings 8448006 and 8130175; and R.E. Moore (DC) 87-2 USTC ¶ 13,741.

[23] Section 6166(b)(8) and (9).

provision and the amount of estate tax that can be paid in installments. A passive asset is defined as "any asset other than an asset used in carrying on a trade or business."[24] Although the limitation is a proper goal, the passive asset rules are unclear.[25]

The provisions of the installment payment provision do not provide when the amount of passive assets are to be deducted in determining the value of the closely held business interests. The Senate Committee Report relating to the provisions of the installment payment provision dealing with passive assets stated:

> The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision.[26]

Because Treasury has not issued these regulations, closely held business owners have no or little guidance as to the definition of passive assets.

Recommendation: *Amend the definition of "passive assets" under the installment payment provision to make it clear what is a passive asset and how the amount of passive assets is to be deducted in determining the value of a closely held business interest.*

Ability to Obtain Advance Ruling

In many tax planning situations, a taxpayer can request an advance ruling from the Internal Revenue Service on the tax effect of a proposed business structure. Under current law, however, a closely held business owner cannot request the Internal Revenue Service to rule on whether the business owner's assets will qualify for installment payment of the estate tax while the business owner is alive and able to make

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[24] Section 6166(b)(9)(B).
[25] See Practical Drafting, 1757 – 1776 (R. Covey, ed., July 1989).
[26] S. Rep. No. 98-169, 98th Cong., 2d Sess., at 715 (1984).

appropriate changes. This creates significant uncertainty for some business owners. Congress should authorize and direct the Internal Revenue Service to establish procedures for the issuance of advance rulings so a business owner can determine whether the deferral under the installment payment provision is available under the business owner's current business structure.

Recommendation: *Allow taxpayers to request advance rulings from the Internal Revenue Service on issues relating to the installment payment provision.*

Lien Procedures

In March 2000, the Treasury Inspector General for Tax Administration issued a Final Audit Report - The Internal Revenue Service Can Improve the Estate Tax Collection Process. In the Report, the Inspector General found that the United States Treasury was owed $1.4 billion of estate taxes unpaid attributable to closely business interests under the installment payment provision and of this amount $1.3 billion was not secured by liens. The Report recommended that the Internal Revenue Service secure liens for the amount of the unpaid tax at the time of the approval of the installment payment election. The Internal Revenue Service has been implementing this recommendation.

Section 5.5.6.1 of the Internal Revenue Manual covers the installment payment provision dealing with bonds and liens to secure the unpaid federal estate tax. According to the Manual, the Internal Revenue Service has these options to secure payment of the estate tax deferred under the installment payment provision:

- Require the estate to furnish a performance bond with a face value up to double the amount of tax being deferred, or

- Allow the estate to substitute the filing of a special lien (Form 668J) pledging the estate's right, title, and interest to specific property to the government.

Although the Federal Register lists approximately 100 acceptable bonding companies, one individual with the Internal Revenue Service stated that she was not aware of any bond ever having been written for an estate that elected the installment payment provision. Because a bond is impractical (no bonding company will issue a bond for a 14-year period without marketable collateral equal to the amount of the bond), the Internal Revenue Service requires a lien to secure the amount of the unpaid estate tax. Although this is a reasonable position in theory, the issue arises as to what is the proper collateral for the unpaid estate tax.

A general estate tax lien[27] arises upon the decedent's death and attaches to all assets in the decedent's estate and lasts ten years which cannot be extended. When an estate elects to pay the estate tax in installments, the Internal Revenue Service is secured by the general estate tax lien for only the first nine years and three months of the installment payment period unless the Internal Revenue Service obtains a special lien for the estate tax paid in installments.[28]

The Internal Revenue Service agents in the field determine what collateral is necessary to secure the unpaid tax. Many agents are acting responsibly and are accepting as collateral the property owned by the decedent that qualifies for the installment treatment. This is usually stock in a closely held corporation or a partnership interest in a limited partnership, and is generally not disruptive to most

[27] Section 6324(a).
[28] The Internal Revenue Service may obtain a special lien under section 6324A for the estate tax deferred under section 6166.

business operations. Without definitive statutory guidance, however, some Internal Revenue Service agents are not accepting the closely held business interests as collateral for the deferred federal estate tax and are requiring an executor to put up other assets, such as real estate or marketable securities owned by the estate or owned by members of the decedent's family, to secure the lien. Because a lien on these assets may prevent the decedent's family from borrowing funds necessary to operate the business, this is very disruptive to the business of the closely held business owner.

Recommendation: *Amend section 6324(a) to extend the general estate tax lien for estates electing to pay the federal estate tax in installments under section 6166 for the duration of the installment payment period plus a reasonable period of time (such as one year) to provide the Internal Revenue Service sufficient time to collect if there is a default in payment by the estate. Provide that the Internal Revenue Service can only require as collateral assets that were owned by the decedent unless the executor elects to provide other collateral.*

Conclusion

I hope that the Committee and its staff will call upon the Task Force who prepared the *Report on Reform of Federal Wealth Transfer* Taxes as you consider changes to the federal wealth transfer tax system. In addition, the estates of private business owners need the ability to pay in installments the federal estate taxes attributable to a closely held business interest. I encourage the Committee and its staff to address the following significant issues with the installment payment provision:

- Modernize the installment payment provision,
- Cure the inadequate treatment of holding companies,

- Improve the definition of passive assets,
- Improve the burdensome lien procedures, and
- Allow advance rulings.

I thank you for allowing me to express my views on this important subject.

Appendix

Biography

Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, pages 73 – 121 (Spring 2006)

INTERNAL REVENUE CODE SECTION 6166: COMMENTS TO TAX COUNSEL FOR THE SENATE FINANCE COMMITTEE

Task Force of the American Bar Association's Real Property, Probate and Trust Law Section*

Editors' Synopsis: This Article contains the written comments made to the Tax Counsel for the United States Senate Finance Committee by a Task Force composed of members of the Business Planning Group of the American Bar Association's Real Property, Probate and Trust Section suggesting how section 6166 of the Internal Revenue Code could be improved. The comments conclude that the language and administration of section 6166 are antiquated and no longer achieve the fundamental purpose of the statute, which is to provide estates holding substantial closely held business interests an opportunity to pay estate taxes on an installment basis. The Article illustrates several specific ways section 6166 could be updated to better conform to the realities of modern-day business structures.

* The Task Force members are all members of the American Bar Association's Real Property, Probate & Trust Law Section. Steven B. Gorin, of Thompson Coburn LLP, St. Louis, Missouri, chairs the Real Property, Probate & Trust Business Planning Group of committees and chaired the Task Force. He is a member of the American College of Trust and Estate Counsel's ("ACTEC") Business Planning Committee and a past chair of the Business Law Section of the Bar Association of Metropolitan St. Louis. E. Burke Hinds, of Messerli & Kramer P.A., Minneapolis, Minnesota, is an Adjunct Professor for the University of Minnesota's Masters in Taxation program and helped with edits for publication in the *Real Property, Probate & Trust Journal*. He is a member of ACTEC's Business Planning Committee and a past chair of the Minneapolis Estate Planning Council and the Estate and Financial Planning Committee of the Minnesota Society of CPAs. Benjamin H. Pruett, of Bessemer Trust, Washington, D.C., was with King & Spalding LLP, Atlanta, Georgia, when he worked on the Task Force. He is a member of ACTEC's Business Planning Committee, chair of the Fiduciary Legislation Committee of the State Bar of Georgia, and chair of the Estate Planning & Probate Section of the Atlanta Bar Association. Don Kozusko, of Kozusko Harris Vetter Wareh LLP, Washington, D.C. and New York, practices in the field of tax, estate planning and business planning. He is a member of ACTEC and the Society of Trust and Estate Practitioners. Michael Patiky Miller, of Weinberg, Ziff & Miller, Palo Alto, California, is certified as a Specialist in Taxation Law, California Board of Legal Specialization. He is a past chair of the California Taxation Advisory Commission.

PREFACE

Internal Revenue Code section 6166 allows an estate holding a qualified interest in a closely held business to defer the payment of estate tax so that the estate need not hold a "fire sale" to pay estate taxes on the business interest. When the American Jobs Creation Act of 2004[1] expanded the number of shareholders permitted for S corporations, Elizabeth Crewson Paris, a tax counsel for the Senate Finance Committee, mentioned that she was considering amendments to section 6166 to conform to the increased number of shareholders. When the chair of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association ("RPPT") mentioned concerns with the way the Internal Revenue Service was administering this provision, Ms. Paris invited comments from the Bar on how useful section 6166 is and how it might be changed to make it more useful, consistent with its original purpose.

Consistent with this request, Steven B. Gorin of St. Louis, Missouri, and Stephen Ernest Martin prepared a survey that RPPT publicized to its members. A link to this survey was also emailed to a number of fellows of the American College of Trust and Estate Counsel. Made available to the public at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html, the survey accumulated the comments of 157 people.

All who responded to the survey were invited to participate in writing comments. Steven B. Gorin exercised principal responsibility, and the other authors are noted in the author's biographical footnote at the beginning of this Article. In addition, Louis A. Mezzullo and Linda B. Hirschson of the RPPT's Committee on Coordination of Government Submissions reviewed the comments.

The following is a version of the comments that were sent to Ms. Paris on July 11, 2005, edited to conform to this *Journal's* formatting. The comments, as submitted, together with Mr. Gorin's transmittal letter, are available for viewing online at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html.

[1] Pub. L. No. 108-357 (2004).

I. COMMENTARY HISTORY

The following comments and recommendations represent the individual views of those members of the Real Property, Probate and Trust Law Section of the American Bar Association who prepared them and do not necessarily represent the position of the American Bar Association or the Real Property, Probate and Trust Law Section.

The comments were prepared by members of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association. Principal responsibility was exercised by Steven B. Gorin of Thompson Coburn LLP, St. Louis, Missouri, Chair of the Group. Also participating in the preparation of the comments were Benjamin H. Pruett of King & Spalding LLP, Atlanta, Georgia; E. Burke Hinds, Messerli & Kramer PA, Minneapolis, Minnesota; Michael Patiky Miller of Weinberg, Ziff & Miller, Palo Alto, California; and Don Kozusko of Kozusko, Harris Vetter Wareh LLP, Washington, DC. The comments were reviewed by Louis A. Mezzullo and Linda B. Hirschson of the Probate and Trust Division's Committee on Coordination of Government Submissions.

Although many members of the Business Planning Group of the Real Property, Probate and Trust Law Section of the American Bar Association who participated in preparing these comments and recommendations have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

These comments were influenced by the results of a survey to which 157 people responded. The survey was prepared by Steven B. Gorin and by Stephen Ernest Martin of Martin & Eskelson, P.L.L.C., Idaho Falls, Idaho. The survey was publicized to members of the Real Property, Probate and Trust Law Section and the American College of Trust and Estate Counsel and was available to the public at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html. All who responded to the survey, including an investment advisor who found the survey searching the Internet regarding § 6166, were invited to participate in the process. Only those listed above chose to participate actively.

II. INTRODUCTION

Section 6166 was added to the Internal Revenue Code in 1958 to allow estates to pay estate taxes attributable to substantial closely held businesses in installments. Prior to that time, the Internal Revenue Service ("IRS") had the discretion to permit installment payments, but such discretion was rarely given. Consequently, it was necessary for Congress to provide the estate with the right to defer estate tax payments if the requirements of § 6166 were met. Congress expressed the purpose for the change as follows:

> This provision is primarily designed to make it possible to ***keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax.*** Where the decedent had a substantial portion of his estate invested in the ***business enterprise***, under existing law, this may confront the heirs with the necessity of either ***breaking up the business or of selling it to some larger business enterprise***, in order to obtain funds to pay the Federal estate tax. . . . Therefore, although not removing any Federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid for out of the earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the Federal estate tax ***without upsetting the operation of the business. Your committee believes that this provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system.***[2]

A. Affirmative Policies Underlying Our Recommendations

Section 6166 has been amended several times to broaden availability to owners of closely held businesses, often in response to the administrative policies of the IRS that have restricted that availability.[3] Our recommendations are based upon the fundamental tax policy expressed in the legislative history—Congress intends that estates holding substantial closely held business interests have the right to elect to pay estate taxes in installments. Guided by this fundamental tax policy, our recommenda-

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[2] H.R. REP. NO. 85-2198, at 713 (1958) (emphasis added).

[3] *See infra* Appendix A. All references to sections are to the Internal Revenue Code of 1986, as amended, or to the Internal revenue Code of 1954 for references prior to 1986.

tions are designed to address the needs identified in the survey responses we obtained from members of the Real Property, Probate and Trust Law Section and the American College of Trust and Estate Counsel (published at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html). Accordingly, our recommendations grow out of the experiences of tax advisors in trying to assist closely held business owners to secure the tax deferral benefit that Congress intended to provide. Our recommendations reflect the following key conclusions, which represent our best efforts to apply the tax policy behind § 6166 to the current business environment:

1. Avoid "Fire Sales" on Illiquid Assets.

The primary Congressional policy underlying § 6166 is to recognize that closely held business interests and assets are inherently illiquid. It is often, quite difficult and, in many cases, impossible, for an estate to obtain the cash necessary to pay the related estate tax short of disposing of assets or the entire business at deeply discounted "fire-sale" prices. Accordingly, business assets that have no public market should qualify for deferred payment of estate taxes if all other requirements are met.

2. Business Interest Should Be Substantial Part of the Estate.

The fundamental requirement that the value of the closely held business interest exceed 35% of the decedent's adjusted gross estate is reasonable and should be retained.

3. Closely Held Business Definition.

The definition of what constitutes a "closely held business interest" should continue to be based upon alternate criteria of the number of owners of the business or the significance of the decedent's interest in the business. The criteria themselves should be updated to reflect current business practices and to be consistent with other parts of the Code. The estate also should be able to attribute ownership to the estate from other family members for this purpose without being penalized by shorter payment terms or a higher interest rate, if the value of the holdings included in the decedent's estate exceeds 35% of the adjusted gross estate.

4. Form of Business Should Be Irrelevant.

The rules for qualification for § 6166 should be applied consistently regardless of the type or number of legal entities or the structure of those entities. The statute should apply in the same basic way without regard to whether the business is conducted as a sole proprietorship, partnership, corporation, LLC, business trust, or other legal entity, or as a combination of multiple legal entities, including multiple tiers of subsidiary entities.

5. Only Business Assets Qualify.

Only the assets held for the reasonable needs of the business should qualify for installment payments of estate taxes. Other assets should not qualify for installment payments, but the determination of which assets are truly "business" assets should be based upon standards that Congress identified in prior legislative history, and not on rigid rules that can frustrate the statute's purpose with inequitable or unintended results.

6. Reasonable But Flexible Security Provided for Future Payments.

Once an estate has qualified to pay estate taxes in installments, the rules should ensure that the government's need to secure payment of future installments does not override the business' need for flexibility to obtain financing for continuing business operations and expansion. The requirements for compliance with § 6166 should not become so onerous as to render its benefits unavailable for practical purposes.

7. Simplicity.

Qualification under § 6166 exemplifies the Internal Revenue Code's complexity. This complexity increases not only the IRS' administrative costs but also taxpayers' compliance costs. Our recommendations seek to simplify the statute, add certainty, and reduce administrative costs.

B. Structural and Administrative Reasons for Change

Section 6166, in its current form, is a product of legislation enacted nearly 50 years ago, together with intermittent efforts to rectify unintended limitations on its availability. Since the last major substantive amendment was in 1984,[4] the statute is outdated because of changes to the types of business entities and structures that were not contemplated when last amended. The resulting inconsistency, uncertainty, inflexibility, and confusion require, in our view, an integrated restructuring of the statute. The language and administration of § 6166 no longer achieve the fundamental purpose intended by Congress in 1958, and the piecemeal efforts to amend the statute over the years have not kept pace with business developments:

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[4] Section 6166 has been amended several times since then. However, none of those changes affected the statute's fundamental structure.

1. Need to Adapt to New Forms of Doing Business.

The current statute is antiquated in failing to accommodate modern day business realities and address business structures commonly used today.

For example, many closely held business entities are now limited liability companies (LLCs). In response, the Treasury promulgated regulations in 1997 that made partnership taxation the norm for multi-member LLCs. However, § 6166 has not been updated to take into account the proliferation of LLCs, and 98% of the respondents to our survey stated that partnerships (including LLCs taxed as partnerships) should generally be treated the same way under § 6166 as corporations. Yet the qualification rules for § 6166 unnecessarily differ depending upon whether the business is taxed as a sole proprietorship, a corporation or a partnership.

Businesses are increasingly likely to operate and finance their activities through more complex structures than in the past. These complex structures are compounded by the further complexity of § 6166. The result is that a business organized as multiple legal entities is treated differently under § 6166 than the same business would be treated if organized as a single entity. This inequity would be corrected if the statute were amended to apply (1) a functional standard to determine whether an asset is held for the business's reasonable needs, so an entity holding business assets is not misconstrued as being a passive asset, and (2) family attribution to determine whether a business is closely held without reducing § 6166 relief. Congress recently amended the rules for determining whether a business is a small business eligible to make an S election when it enacted the American Jobs Creation Act of 2004. Considering that S corporations are growing in popularity faster than any other type of business entity,[5] the § 6166 ownership rules should be consistent with the closely held business qualification for S status. Respondents to our survey agreed, supporting definitions that apply family attribution without adverse consequences in determining the number of owners of a business (65%) and an increase in the maximum number of owners to 100 (56%).

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[5] According to http://www.irs.ustreas.gov/pub/irs-soi/04proj.pdf (last visited March 21, 2006) S corporation tax return filings have increased from 736,900 in 1985 to a projected 3,718,300 in 2005. Partnership tax return filings have increased from 1,755,300 in 1985 to a projected 2,684,100 in 2005. C corporation tax return filings have decreased from 2,632,000 in 1985 to a projected 2,318,100 in 2005.

2. *Lack of Guidance for Planning.*

Planning to meet the current complex rules under the statute is made still more difficult by the lack of guidance on which taxpayers can rely over the necessarily long periods of time involved in planning for and paying estate tax liabilities due to the death of a business owner.

Court decisions provide little guidance since Tax Court jurisdiction for declaratory judgments under § 6166 has existed only since 1984.

Treasury has issued very little in the way of regulations or other guidance on § 6166, including regulations that Congress specifically mandated when key amendments were made in 1984. When Congress enacted §§ 6166(b)(8) and (9), it directed the Treasury to promulgate regulations "defining the circumstances under which partnership and corporate assets are to be treated as passive investments"[6] and, thus, which portion of the business would not be eligible for estate tax deferral. Congress specifically directed that the regulations provide "rules similar to [those] governing the accumulated earnings tax" under § 537[7] to distinguish assets held for the reasonable needs of the business and those that are not. No such regulations have ever been issued by the Treasury, but the regulations under § 537 remain consistent with Congress's intentions with respect to § 6166(b)(9) and should be followed in articulating rules for § 6166.

The IRS currently declines to issue advance rulings to living taxpayers seeking guidance on unclear provisions of § 6166, thus making it extremely difficult for taxpayers to effectively plan for their estates to qualify. It has not publicly adopted a no-ruling policy, but as a practical matter, it has turned down recent requests. This refusal to issue advance rulings contrasts sharply with the IRS's willingness to issue hundreds of private letter rulings on the application of estate and generation-skipping transfer tax to living taxpayers.[8]

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[6] S. REP. NO. 98-369, at 715 (1984).

[7] *Id.*

[8] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 96-44-053 (1996). The IRS recently issued Rev. Proc. 2005-33, outlining the steps executors must take to exhaust administrative remedies before seeking a Tax Court declaratory judgment under Code Sec. 7479 with respect to a Code Sec. 6166 election. Within the 2004–2005 Priority Guidance Plan promulgated by the Office of Tax Policy (the IRS's "Business Plan"), the IRS included projects to update "Rev. Ruls. 75-365, 366 and 367 regarding interests in real estate held by a decedent" as item 12 on the "Tax Administration" list. http://www.irs.gov/pub/irs-utl/2005-2006_guidance_priority_list.pdf (last visited February 28, 2006.) However, guidance has not been issued yet.

3. Flexibility Needed for Making Elections.

If the value of the qualifying business interests does not exceed 35% of the decedent's gross estate, the estate cannot make a § 6166 election. This conclusion may change after the estate tax return is filed as a result of newly discovered information or audit changes that increase the business value or decrease the value of other assets. Currently, § 6166(d) does not allow an election to be made beyond the extended due date of the estate tax return. Survey respondents overwhelmingly (93%) supported extending § 6166 elections beyond the original return date.

4. Practical Barriers Caused by Security Requirements.

Even if an estate qualifies under § 6166, it may be unable to operate the business effectively while deferring the estate tax if the security required by the government is too expensive or makes normal business financing difficult or impossible to obtain.

At various times in the past, the security requirements imposed by the IRS to permit estates to pay the estate tax in installments have varied extensively across the country, restricting the opportunity for business owners to plan ahead. In response to a report by the Treasury Inspector General for Tax Administration,[9] the IRS has begun to apply more uniform standards, but, unfortunately, in the direction of routinely imposing rigid security requirements. Anecdotal evidence indicates that some IRS collections offices are more reasonable than others. Although only 12% of respondents to our survey have heard of cases in which the IRS's lien and bonding authority was asserted when alternative methods would have adequately protected the IRS's legitimate interest in securing its tax collections, 90% of respondents to our survey stated that the IRS's authority to impose pubic tax liens or bonds should be modified to authorize the IRS to impose them only when alternative methods do not adequately protect the IRS's legitimate interest in securing its tax collections.

The estate or the decedent's family might not be able to pledge assets that are acceptable to the IRS, such as marketable securities or real estate. Furthermore, a strict requirement for public tax lien filings or commercially issued bonding can also be very troublesome. The stigma of a public tax lien can be disastrous to a business; and bonding requirements can be onerous, considering the expense and length of time for which a bond would be required. If the IRS is unwilling to accept a security interest in

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[9] I.R.S. Tech. Adv. Mem. 2000-30-059 (March 29, 2000).

shares or other equity interests in closely held businesses, the statute's purpose is frustrated.

When an estate tax is imposed due to the death of a business owner, the government should not be a preferred creditor whose need for tax collections overrides the need to continue to operate the business, particularly when doing so is contrary to the stated purpose of § 6166.

III. GENERAL RECOMMENDATIONS

Based on these conclusions, our recommendations for Code § 6166 are as follows:

A. As under current law, the value of the closely held business enterprise included in the decedent's gross estate must exceed 35% of the decedent's adjusted gross estate.
B. A business enterprise (without regard to the form of legal entity) is closely held if:
   (1) The estate is one of up to 100 owners (determined in the same manner as S corporations) or is part of a family that holds at least 20% of the vote or 20% of the right to distributions.
   (2) The estate can aggregate interests it owns, directly or indirectly, into one "business enterprise" to which the 35% test applies.
C. Estate tax deferral can be made with respect to only those assets that the business enterprise holds for reasonable business purposes. Whether assets are held for reasonable business purposes would be determined after aggregating the interests included in the decedent's gross estate.
D. The election should be available on amended or late returns.
E. The government's security should be limited only to making sure that the government's interest is protected when the business enterprise is transferred and that business assets are not diverted from reasonable business purposes. Broader tax liens or bonding requirements should be used only when taxpayers abuse the benefit of estate tax deferral.

IV. DETAILED RECOMMENDATIONS AND ANALYSIS

Our recommended changes are intended to clarify the application of the existing statute, simplify the qualification rules, create fairness among similarly situated taxpayers and improve administrative efficiency by reducing disputed interpretations between taxpayers and the IRS. Specific details of our recommendations are summarized as follows:

A. Consistent Treatment for All Entity Types and Ownership Structures.

We generally recommend that § 6166 be amended to apply consistently, regardless of the type of entity in which the business is operated—corporation, partnership, limited liability company, business trust or in any other legal form. This theme of consistent treatment regardless of legal form is inherent in many of the specific recommendations detailed below.

Section 6166 currently distinguishes between closely held businesses operated as ***partnerships*** and closely held businesses operated as ***corporations***, even though there is no apparent policy reason for doing so. Where there are specific provisions for one form of business entity, the question necessarily arises as to whether or not a similar rule applies with respect to other types of entities, such as limited liability companies and business trusts. For example, consider the following:

- Section 6166(b)(1)(B)(ii) provides that if a *partnership* has more than 45 partners, it will qualify as a closely held business only if 20% or more of the total **capital interest** in the partnership is included in the decedent's gross estate, but § 6166(b)(1)(C)(ii) provides that if a *corporation* has more than 45 shareholders, then it will only qualify as a closely held business if 20% or more of the **voting stock** of the corporation is included in the decedent's gross estate.
- Section 6166(b)(7) provides that in some circumstances, in order to meet the 20% tests of § 6166(b)(1)(B)(ii) and (C)(ii), the estate may elect to treat a business interest attributed from family members or others to the decedent under § 6166(b)(2) as if such interest were included in the decedent's gross estate. This election is only available with respect to partnership interests and non-readily tradable stock. *Partnership* interests are eligible for this election, whether or not they are readily tradable, but *corporate* stock must be non-readily tradable.
- Section 6166(b)(8), which provides that the estate may elect to treat a business as a "holding company" in some circumstances, appears to apply only to *corporations* that hold stock in other corporations, without explaining whether such an election is available if either the parent or the subsidiary is a *partnership* or some other type of entity, or whether the benefits of such an election are available in all other cases without regard to the election.

- Section 6166(b)(9), which provides that installment payments are not available with respect to that portion of the estate tax attributable to passive assets held in a business, specifically defines *corporate stock* held by another corporation as a passive asset, subject to certain exceptions (one of which is § 6166(b)(8) discussed above), but is silent as to how interests in, or held by, non-corporate entities are treated.

While it is true that historically most small businesses were operated as corporations rather than partnerships, the business and tax climate has changed significantly in the last twenty years—such that limited liability companies (LLCs) treated as partnerships for many tax purposes are becoming the business entity of choice for many closely held businesses. Moreover, business trusts are becoming more prevalent with each passing year, and it is entirely possible that the passage of time might see the emergence of other types of business entities that are unknown today.

If the purpose of § 6166 is to avoid the necessity of either breaking up a closely held business or selling it to a larger enterprise, then the legal form in which the business is organized—whether as a corporation, partnership, LLC, business trust, or other entity—should not adversely affect the ability of those receiving a bequest of an interest in such a business to qualify for payment of estate tax in installments. As the statute is structured currently, however, the form of business entity can profoundly affect such qualification. Much of the discussion that follows also points out the ambiguities in § 6166 that arise due to the different (or at least apparently different) treatment accorded corporations and partnerships.

B. Consistent Definition of a Closely Held Entity.

We recommend that:

(1) The existing definition of "closely held business" be applied equally regardless of the type of entity and be renamed a "Closely Held Entity" to avoid confusion.
(2) An interest in a business entity that is included in the decedent's estate should qualify as a interest in a "Closely Held Entity" if it satisfies either of two tests, one of which is based upon the number of owners of the entity (referred to as the "Number of Owners Test"), and the other of which is based upon the percentage interest (and the character of that interest) in the entity that is included in the decedent's gross estate (referred to as the "20% Test").

(3) Family Attribution should apply to the "Number of Owners Test" in the same manner as for S corporations as amended by the American Jobs Creation Act of 2004 ("AJCA"),[10] regardless of the legal form of entity.
(4) Family Attribution should apply to the 20% Test.

Section 6166 currently provides that a business interest included in the decedent's estate will qualify as an interest in a "closely held business" if it satisfies either a "Number of Owners Test" or a "20% Test." The AJCA increased the maximum number of owners for S Corporation purposes but did not consider whether to make the § 6166 "Number of Owners Test" consistent.

As for the 20% Test, the existing statute applies a different measurement test for corporations and partnerships and is silent as to other types of entities. Our recommendations apply elements of both the existing corporate and partnership 20% Test rules and simplify the measurement for qualification.

The existing statute permits family attribution only for partnership interests and certain corporate interests. Our recommendations permit family attribution regardless of the type of entity.

Each of these recommended changes and reasons for change is described below in more detail.

1. Qualification Based upon Number of Owners.

Section 6166(b)(1)(B)(ii) and (C)(ii) provide that a decedent's interest in a business will qualify as an interest in a *closely held business* if the business has 45 or fewer partners or shareholders, respectively.[11] In this regard, corporations and partnerships appear to be treated the same. We generally recommend that the existing "Number of Owners Test" be amended to be consistent with similar S corporation provisions under § 1361(c)(1)(A)(ii), as amended by the AJCA, which increased the maximum number of S Corporation shareholders to 100 and, if the family elects, treats members of the decedent's family to be counted as one

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[10] I.R.C. § 1361(c)(1)(A)(ii)(2005).

[11] Before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), a business could not have more than 15 owners and qualify as a closely held business based upon the number of owners. While we agree that 45 or fewer owners is a much more realistic number of owners than is 15, it should be kept in mind that the increase in the permissible number of owners, like all of the estate tax provisions of EGTRRA, "sunsets" in 2010, after which the number of permissible owners drops back to 15, unless the increase is made permanent by further legislation.

shareholder. The same counting rules should apply to all types of entities to determine what is "closely held." Using the same rules as for S corporation status also promotes simplicity in administration and certainty in planning. It will assure owners of S corps that their interests will be considered "Closely Held" for purposes of § 6166 and owners of other types of entities that their interests will be treated consistently.

Accordingly, we recommend that:

(a) Section 6166(b)(1)(B) be changed to provide, consistent with § 1361, that an interest in a closely held business means an interest in a corporation, partnership or other legally recognized entity carrying on a trade or business, if such entity has 100 or fewer equity owners, meaning persons who are entitled to a share of the entity's assets upon liquidation of the entity (after payment of all entity obligations);

(b) Section 6166(b)(2)(B) be changed to provide, consistent with § 1361(c)(1), that for purposes of determining the number of equity owners of a business entity, a husband and wife (and their estates) are treated as one person;

(c) Section 6166(b)(2)(C), the entity attribution rule, be amended to provide that an individual who directly owns an equity interest in a business entity or who is treated as owning an equity interest in a business entity as a result of the application of the entity attribution rule will be counted as no more than one equity owner, irrespective of the number of direct or indirect interests (through one or more corporations, partnerships or trusts) the individual might hold;

(d) Section 6166(b)(2)(D) be changed to provide, consistent with § 1361(c)(1), that for purposes of determining the number of equity owners of a business entity, all members of an individual's family, as defined in § 1361(c)(1), be treated as one shareholder.

Before AJCA, § 1361 defined a "small business corporation" as a corporation meeting certain requirements, one of which was that the corporation have no more than 75 shareholders, with a husband and wife being treated as one shareholder for purposes of that limitation. AJCA increased the number of permissible shareholders to 100, and added certain family attribution rules to provide for purposes of determining the number of shareholders, with certain members of the same family being treated as a single shareholder.

Many closely held enterprises included in decedents' estates are owned not only by the decedent and other *individual* members of the decedent's family, but also by corporations, partnerships and trusts, the shareholders, partners or beneficiaries of which are also family members. In many cases, a closely held enterprise may have been started by two or three unrelated individuals who, over time, sell, give or otherwise transfer interests in the closely held enterprise to various members of their families, or to trusts or partnerships for their benefit (for asset protection, control or other reasons) with the result that the number of owners of the business can easily exceed 45 persons, even though the enterprise is still very illiquid.

For purposes of determining whether an entity has more than 45 owners,[12] § 6166 includes certain attribution rules, as follows:

(i) Section 6166(b)(2)(B), the *husband and wife attribution rule*, provides that certain business interests co-owned by a husband and wife as community property, as joint tenants, as tenants by the entireties, or as tenants in common, are treated as owned by one owner.

(ii) Section 6166(b)(2)(C), the *entity attribution rule*, provides that certain business interests held by corporations, partnerships or trusts are treated as owned proportionally by the shareholders, partners or present interest beneficiaries, as the case may be.

(iii) Section 6166(b)(2)(D), the *family attribution rule*, provides that all business interests held by the decedent or by any member of the decedent's family (within the meaning of § 267(c)(4))[13] are treated as owned by the decedent.

At least two issues are raised but not answered by these provisions. First, in counting owners for purposes of determining whether there are more than 45 owners, it seems that the *entity attribution rule* should operate not

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[12] Nothing in § 6166(b)(2) indicates that the attribution rules are in any way limited in application, so it would appear on the face of the statute that the attribution rules would apply for any purpose of § 6166. However, the legislative history of the attribution rules states that their only purpose was to prevent taxpayers from avoiding the limitation on the number of owners by using partnerships or trusts to artificially reduce the number of direct owners, and that the rules may not be used for other purposes, such as meeting the 20% ownership requirements of §§ 6166(b)(1)(B)(ii) and (C)(ii), or the more-than-35% of Adjusted Gross Estate test of § 6166(a), and the IRS has issued at least one private letter ruling. *See* H.R. REP. NO. 94-1380, at 32 (1976), HR, REP. NO. 95-1286, at 12-3, I.R.S. Priv. Ltr. Rul. 84-28-088 (Apr. 4, 1988), I.R.S. Priv. Ltr. Rul. 96-44-053 (Aug. 1, 1996).

[13] This includes brothers, sisters, spouse, ancestors and lineal descendants.

only to avoid the artificial *reduction* in the number of owners of a business, but also to avoid the artificial *increase* in the number as well. In other words, if the shareholders, partners and beneficiaries of corporations, partnerships and trusts are treated as proportionally owning any interest in the business held by the entity, then presumably the entity itself is not counted as an additional owner, and if only real parties in interest are considered, then any given individual will count as only one owner, irrespective of the number of corporations, partnerships or trusts through which the individual may indirectly own interests. It would be helpful if the statute was clarified on this point.

Second, it seems that, under the *family attribution rule*, since all interests held by members of the decedent's family (within the meaning of § 267(c)(4)) are treated as owned by the decedent, then all of such persons as a group would therefore be counted as only ***one*** owner for purposes of the 45 owner limitation. If so, and if the entity attribution rule is interpreted as described above, then the following would count as one person: the decedent; all family members of the decedent; all corporations, the stockholders of which are limited to such persons; all partnerships, the partners of which are limited to such persons; and all trusts, the present interest beneficiaries of which are limited to such persons. Again, there has been no guidance on this point.

2. *Qualification Based upon Proportion and Character of Decedent's Interest*

We recommend that the definition of a "Closely Held Entity" include any entity, regardless of legal form, in which a decedent's gross estate includes a 20% interest, measured as follows:

(a) **20% of Equity Test.** The 20% of equity test should be defined as the right to receive 20% of distributions either currently or on liquidation. This can avoid qualification disputes over valuation issues. It should apply to corporations as well as partnerships.
(b) **20% of Voting Rights.** The alternative test of 20% of voting rights should remain and apply to partnerships as well as corporations.

If the business has too many owners to qualify as a closely held business, then qualification as a closely held business under the existing § 6166 depends upon whether the decedent's estate includes a sufficient equity interest in the business. Section 6166(b)(1)(B)(i) and (C)(i) provide that a decedent's interest in a business will qualify as an interest in a *closely* *held business* if 20% or more of the *capital interest of a partnership* or 20% or more of the *value of*[14] *the voting stock* of a corporation is included in the decedent's gross estate.

Here there is a striking difference in treatment between corporations and partnerships. In the partnership setting, *any* capital interest, whether voting or non-voting, will qualify, but the interest must be a minimum of 20% of the equity of the business. In the corporate setting, by contrast, only *voting* stock will qualify and 20% of the value of the voting stock will qualify irrespective of how much of the total equity of the corporation is represented by the voting stock.

Thus, for example, where a *corporation* is capitalized as 5% voting stock and 95% non-voting stock, an estate holding 20% of the *voting* stock would qualify for installment payments, even though 20% of the value of the *voting* stock only represents 1% of the *total* capital equity. In contrast, an estate holding 100% of the *non*-voting stock would *not* qualify, even though 100% of that non-voting stock represents 95% of the capital equity. If a *partnership* is capitalized as 5% voting units and 95% non-voting units, an estate would have to include 20% of the *total* units, not just 20% of the voting units, to qualify; and the holding would so qualify even if all of the decedent's units were *non-voting* units (because the rule with respect to partnerships makes no distinction between voting and non-voting units). There is no apparent policy reason for such a difference in treatment between the two types of entities.

In our view, whether the entity is a corporation, partnership or other entity, the interest held by the decedent should qualify as an interest in a closely held business if the decedent holds 20% equity ownership or 20% voting rights, because in either case, that degree of voting control or equity ownership being vested in one person is indicative of a closely held business, and in either case, the business interest would still have to represent more than 35% of the decedent's adjusted gross estate.

3. *Family Attribution*

We recommend that Family Attribution apply for purposes of determining whether an entity interest qualifies as a "Closely Held Entity" under both the "Number of Owners Test" and the "20% Test." The estate still must own entity interests directly that constitute more than 35% of

[14] Exactly what is meant by 20% of the ***value*** of the voting stock, rather than simply saying 20% of the voting stock, is unclear, since the "value of" distinction does not appear with respect to partnerships.

the value of the adjusted gross estate to qualify for estate tax payments in installments.

We also recommend that the shortened payment period of § 6166(b)(7)(A)(i) and the increased interest rate of § 6166(b)(7)(A)(ii) be repealed.

Some estates do not own substantial enough closely held business interests to qualify for § 6166 payment deferral. The current statute permits estates to qualify under the "20% Test" by electing to attribute to the estate entity interests owned by the decedent's family members.[15] If the "family attribution election" is made, however, § 6166(b)(7) requires the deferred payments to be made over a shorter period of time and bear a higher interest rate than if the decedent had personally owned all of the family interests in the entity. The application of § 6166 would be simplified and consistent with the AJCA, if the payment and interest rules were the same regardless of whether family attribution were elected. In the AJCA, Congress applied family attribution in defining whether a business is a small business for purposes of eligibility to make an S election. The AJCA, specifically Code § 1361(c)(1), allows members of the decedent's family to be counted as one owner in determining the number of owners.[16] If ownership of any entity is concentrated enough to qualify as an S Corporation, it should be considered closely held for § 6166 deferral purposes. Both sections of the Code address the same fundamental class of business owners.

We can identify no policy reason for providing lesser benefits to a decedent's estate that owns in excess of 35% of the adjusted gross estate in

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[15] *See* I.R.C. § 6166(b)(7). For purposes of the "20% Test," family members are determined by § 267(c)(4) and include the decedent's spouse, siblings, ancestors and lineal descendants. Family attribution may only be used to initially qualify the entity interest as a "Closely Held Entity." The estate must own entity interests that constitute more than 35% of the value of the adjusted gross estate without inclusion on interests owned by other family members. The S corporation rule for counting shareholders under § 1361(c) is technically not an "attribution" provision, so we have assumed that the § 267(c)(4) family definition rules would be retained for the 20% Test. The S corporation family definition rules could attribute shares to the estate as an alternative to § 267(c)(4).

[16] The amendment must make it clear that, when § 1361(c) is applied for § 6166 purposes to the "Number of Owners Test," "members of the family" means the members of the decedent's family since the actual owner of the entity interest after death would often be an estate or trust. Section 1361(c)(1)(B) views up to six generations of a family as counted as a single owner. We also recommend that such treatment as a shareholder be automatic and should not require an election by the estate or owner of the entity interest as would otherwise be required by § 1361(c)(1)(D).

closely held entity interests that technically fail to qualify because the decedent's spouse, children, siblings or other relatives own interests in the same entity, requiring family attribution to qualify for §6166 installment payments.

C. Consolidating Multiple Entities into a Single Business Enterprise.

We recommend that:

(1) An estate be permitted to combine all interests in Closely Held Entities qualified as described above to determine if, together, such interests constitute more than 35% of the adjusted gross estate. Such combined entities may be directly owned (brother-sister entities) or indirectly owned (subsidiary entities).
(2) Repeal of the "Holding Company Election" of § 6166(b)(8). Our proposal would allow tiers of subsidiary entities to qualify as "Closely Held Entities" when combined with other entities, without penalty for a shorter payment period or increased interest rate.[17]
(3) Existing § 6166 references to a "trade or business" be amended to refer to the combined "Closely Held Enterprise," thus referring to all such combined Closely Held Entity interests (instead of each individual entity) to determine if assets are business assets or non-business assets that fail to qualify for § 6166 installment payment deferral.

The rules for determining whether any entity is "closely held" should be the same for (1) a single entity, regardless of the legal form (corporations, partnerships, LLCs, etc.), (2) commonly owned entities, (3) multiple tiers of entities within a group, or (4) any combination of these. We found no compelling policy reason why the rules for qualification should differ for any of those business structures.

1. Consolidating Multiple Commonly Owned (Brother-Sister) Entities

We recommend that § 6166(c) entity combination occur merely by reference to the "Closely Held Entity" qualifications provisions described above. Such "trade or business" inquiry would occur after all qualifying entities have been combined into a single "Business Enterprise," as described below.

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[17] *See* I.R.C. § 6166(b)(8)(A)(ii) and (iii).

As previously noted, § 6166 currently permits commonly owned entities (brother-sister entities) to qualify as a single business enterprise[18] by rules that differ from the rules defining a "closely held business."[19] Anomalies and inequities can arise under the current statute by reason of its attempt to define a "closely held business interest" by starting with the estate's ownership of individual entities, rather than by focusing instead on the "business enterprise," that may be conducted through multiple entities. This confusion also leads to inconsistencies in determining whether assets are part of the business.

2. *Consolidating Tiered Entities*

We recommend that the "Holding Company Election" of § 6166(b)(8) be repealed to allow subsidiary tiers of entities to qualify as "Closely Held Entities" without penalty for a shorter payment period or increased interest rate.[20] To implement this recommendation, a "proportionate look-through rule" similar to § 6166(b)(2)(C) would apply to each tier of entities; thus, to qualify, the estate must indirectly meet the "Number of Owners Test" or "20% Test" described above to qualify to combine the subsidiary interests for estate tax deferral.

We believe that these changes would make the statute better operate as intended. When a business entity, whether a corporation, a partnership, or other entity ("parent"), holds an interest in another business entity, whether a corporation, a partnership or other entity ("subsidiary"), then the value of the parent's interest in the subsidiary should be treated as value *attributable to assets used in carrying on a trade or business* to the extent of the value of the assets used in carrying on a trade or business, either by the parent, the subsidiary, or a lower tier subsidiary. Likewise, the value of the parent's interest in the subsidiary should be treated as value attributable to passive assets to the extent that the value of the assets of the subsidiary is attributable to passive assets (either directly owned or attributed from a lower tier subsidiary). Such attribution should apply in the following circumstances:

(a) Where the subsidiary is *wholly owned* by the parent.
   (i) Treas. Reg. § 301.7701-2(c)(2) already provides that a business entity that has a single owner and is not a corporation under Treas. Reg. § 301.7701-2(b) is disregarded as an entity separate

[18] *See id.* § 6166(c).
[19] *See id.* § 6166(1)(b)(1)(B) and (C).
[20] *Id.* § 6166(b)(8)(A)(ii) and (iii).

from its owner. Therefore, any business carried on directly by a non-corporate entity that is wholly owned by a higher tier entity should be treated as if it was carried on directly by the higher tier entity for purposes of § 6166.

(ii) Even if the lower tier entity ***is*** a corporation, if it is wholly owned, it is obviously fully under the control of the parent entity, and any assets or business activities of the wholly owned corporate subsidiary should be attributed to the parent entity. There is no apparent reason, for purposes of § 6166, to treat a wholly owned corporate subsidiary any different from a wholly owned non-corporate subsidiary.

(b) Where both the parent and the subsidiary are part of the same "*controlled group of corporations*" as defined in § 1563, or would be, but for the fact that the parent or the subsidiary or both is not a corporation.

(i) The legislative history shows the express intent that, where two or more corporations are so closely related that they form a controlled group of corporations under § 1563, they should be treated as a single business entity for purposes of § 6166. Section 1563 applies only to corporations, but for purposes of § 6166, there is no reason why two or more non-corporate entities should not be treated as part of the same business where the relationship of those entities to one another would cause them to be part of the same controlled group under §1563 if they *were* all corporations.

(c) Where the parent and the subsidiary would not be part of the same controlled group of corporations (if both were corporations), but based on all facts and circumstances, the entities are either *functionally related* or *subject to common managerial control or direction.*

(i) The legislative history shows that Congress expressly intended for two or more corporations that have such a relationship to be treated as a single business, such that the interest in one held by the other would not be considered passive, even if they did not meet the criteria for being part of the same controlled group of corporations.

(ii) This same concept should apply with respect to assets owned directly by the decedent, rather than in another entity. For example, if the decedent owns an interest in a corporation or partnership that operates its business from property owned directly by the decedent, the value of the property should be included in the value of the closely held business interest for all purposes of § 6166.

This is often necessitated where the business is subject to regulatory restrictions on real estate ownership such that the business itself cannot own the property directly.

(d) *Where the business of the subsidiary is attributed to the parent under § 537*, with respect to the excess accumulations tax under § 531, or would be, but for the fact that one or both of the entities is not a corporation.

  (i) Congress expressly stated its intention that the IRS promulgate regulations under § 6166 that would provide the circumstances under which two business entities would be treated as one, stating that the rules should be similar to the rules under § 531 for determining when the business of one corporation would be attributed to another corporation for purposes of the accumulated earnings tax. See Treas. Reg. § 1.537-3(b).

(e) Where the parent holds 20% or more of the equity ownership of the subsidiary, or the subsidiary has fewer than 45 owners (or 100 owners, if our recommendations are adopted), and 80% of the value of the assets of both entities are attributable to assets used in carrying on a trade or business, after applying these attribution rules.

  (i) This applies the "active corporation exception" to any type of business entity, and eliminates the requirement, with respect to corporations, that stock be voting stock, so that the rules for corporations and partnerships are consistent.

We believe that the foregoing is not a change to the intended function of § 6166, but merely a clarification that Congress had intended be made administratively through regulations. Application of the foregoing recommendations would not defeat Congress's intent that estate taxes should not be paid in installments with respect to passive assets not used in the trade or business.

We also believe that the legislation should clearly direct the IRS to issue further guidance on the application of § 6166 in the form of regulations, revenue rulings and private letter rulings to living taxpayers, and not just to estates of deceased taxpayers, and that the IRS should be liberal in resolving ambiguities in favor of the estate's qualification for installment payments. We especially emphasize private letter rulings to living taxpayers so that they can plan how to pay estate taxes without disrupting their businesses. After all, § 6166 neither eliminates nor reduces an estate's tax liability, but merely provides a vehicle for allowing the estate to pay the estate tax over time, with interest, to avoid the necessity of breaking up or liquidating family businesses. We recommend that

§ 6166(b)(2)(C) or a similar proportionate asset "look-though" rule apply to members of the controlled group that are not ***indirectly*** owned 100% by the decedent or ***primary*** holding company.[21]

Current law. Currently, when an estate owns a business that holds its assets in multiple tiers of entities (subsidiaries) for financing or regulatory purposes, to limit liability or for other non-tax reasons, the estate may entirely fail to qualify for installment payments, or, if it does qualify, it may be required to pay the estate tax in fewer installments and pay more interest than for a business owned in a single entity.

Furthermore, the existing statute is unclear as to whether Holding Company Elections are available for multiple tiers of entities, particularly when lower tier entities are owned by several upper tier entities in which the estate owns an interest. It is also unclear whether a single election is sufficient to elect for all tiers and subsidiaries or whether separate elections must be made for each entity.

In addition, it appears that if an estate makes a Holding Company Election as to *any* subsidiary entity, the payment term is shortened and interest charges are increased for the *entire* amount qualifying for deferral, even if the value of the entity qualified under the Holding Company Election is a relatively small amount of the total value qualifying for installment payment of estate taxes.[22]

There is no apparent policy reason why § 6166 payment deferral benefits should be significantly reduced for closely held businesses organized in multiple tiers of entities, as under the holding company election in § 6166(b)(8). We believe that Congress's intent to avoid forced sales of closely held businesses will be far better served if substance is elevated above form.[23] We believe the proposed change more closely implements

[21] *See* Treas. Reg. § 1.1362-2(c)(4) (2005) that simply states, "In the case of tiered partnerships, the rules of this section apply by looking through each tier."

[22] For example, assume an estate holds closely held stock in a business, apart from the value of the subsidiary, equal to 36% of the adjusted gross estate, and the value of the subsidiary stock is an additional 4% of the adjusted gross estate. If the estate makes the Holding Company Election to qualify the value of the subsidiary for § 6166 deferral, the estate loses the 2% interest rate and 5 year interest-only deferral on the *entire 40%* and not merely the incremental 4%. Therefore, the estate likely would forego such an election because the "penalty" exceeds the benefit of making the Holding Company election.

[23] This change would repeal the "holding company election" of § 6166(b)(8), which is currently available only to corporations and which shortens the deferral period and increases the interest rate. If the deferral limits and increased interest rate must be retained to preserve revenues, we recommend that the same election be available to all types of entities and that a single election would apply to all tiers of closely held entities, regardless of the

Congressional intent (including the intent of the holding company election and other changes made in 1984), than does the current state of the law and practice under § 6166 with respect to multiple-entity businesses.

Historical Background and Context to Existing §6166 Provisions Regarding Tiered Entities. Before 1984, § 6166 included no specific provision regarding tiered entities.[24] The passive asset rule arose because pre-1984 regulations permitted passive assets held by partnerships or corporations to qualify for installment payments, while passive assets held by an individual operating a proprietorship did not qualify for installment payments. In 1984, the law was changed to try to harmonize this treatment and, in the process, the Holding Company Election was also enacted, but the complexity and other inconsistencies that arise when multiple entities are used in a business have never been addressed as Congress then intended when this change was made. In any event, the 1984 change is now an inadequate tool for dealing with the proliferation of entity structures in business today. When § 6166(b)(8) and (b)(9) are read together, the policy reason for why these two provisions were added to the Code in 1984 is easy enough to grasp. Yet the structure and operation of these provisions adds needless complexity to the process of qualifying a multiple-entity enterprise under § 6166.

Before the addition of § 6166(b)(8) and (b)(9) as part of the Deficit Reduction Act of 1984,[25] if a decedent operated a business as a *sole proprietorship*, deferral of estate tax was only available for the portion of the tax attributable to the decedent's assets used in carrying on the trade or business, and deferral was not available for any of the decedent's other assets. If, however, the decedent operated his or her business in the *corporate* or *partnership* form, then all of the estate tax attributable to the corporation or partnership interest was eligible for deferral, even if a substantial amount of the assets of the entity were passive, portfolio-type assets, not used in carrying on a trade or business.[26] This rewarded taxpayers who stuffed such assets into business entities to obtain estate tax deferral, a

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number of tiers.

[24] § 6166(b)(2)(C) included a provision regarding indirect ownership, but that apparently applied only to the narrow question of how the number of owners were counted for the "Number of Owners Test" to determine if the interest in the entity was a "closely held business."

[25] Pub. L. No. 98-369, § 1021(a), (b)(1984).

[26] Therefore, until 1984, the existence of lower tier entities owned by corporations and partnerships was irrelevant because ALL of the assets, including the value of the lower tier entities, qualified for § 6166.

result clearly not consistent with the policy behind § 6166. Accordingly, § 6166(b)(8) and (b)(9) were added to limit the deferral to those corporate and partnership assets "used in carrying on a trade or business."[27]

"Passive Asset" Definition. More specifically, the "holding company election" of § 6166(b)(8) is actually an exception to a more general rule set out in the following § 6166(b)(9), and is therefore best understood by first reviewing § 6166(b)(9). Section 6166(b)(9)(A) sets forth the general rule that deferral is not available for that portion of a closely held business interest attributable to passive assets held by the business.[28] Subparagraph (B)(i) defines a "passive asset" as any asset *"other than an asset used in carrying on a trade or business."*[29] The legislative history demonstrates that while § 6166(b)(9) is generally aimed at liquid investment assets, such assets can still be considered to be "used in carrying on a trade or business" where they are:

> part of a partnership's or corporation's working capital or constitute reasonable reserves for financing of a specifically identified project. For example, a reserve for expansion of a factory building that is reasonably expected to be completed within two years of the time the contributions to the reserve fund are made would be a reasonable reserve.[30]

Subparagraph (B)(ii) specifically provides that the term "passive asset" includes any stock in another corporation *unless either:*

(1) The *two corporations* are treated as a single corporation under the "active corporation" exception of § 6166(b)(9)(B)(iii); *or*
(2) The stock of the subsidiary corporation is treated as held *directly* by the decedent, rather than indirectly through the parent corporation, by reason of a *holding company election under § 6166(b)(8)* and such stock is qualified under § 6166(a)(1), meaning that the stock, if held directly by the decedent, would satisfy all of the requirements of § 6166(a)(1).[31]

"Active Corporation Exception." The first exception to this "per se passive" rule of § 6166(b)(9)(B)(ii) is the *active corporation exception*

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[27] I.R.C. § 6166 (b)(8), (b)(9).
[28] *Id.* § 6166 (b)(9)(A).
[29] *Id.* § 6166 (b)(9)(B)(i).
[30] S. REP. NO. 98-369, at 714.
[31] Presumably this means that the stock deemed to be held directly by the decedent is 20% or more of the voting stock of the corporation.

found in subparagraph (iii), which provides that two corporations will be treated as a *single corporation*—and, therefore, the stock of the subsidiary will not be treated as a passive asset of the parent corporation—if three requirements are met:

First, either:

(1) The subsidiary has 45 or fewer shareholders, *or*
(2) The parent owns 20% or more *in value* of the *voting* stock of the subsidiary;[32] *and*

Second, 80% or more of the *value* of the assets of the parent, not counting the stock in the subsidiary, is *attributable* to assets used in carrying on a trade or business, *and*

Third, 80% or more of the *value* of the assets of the subsidiary is *attributable* to assets used in carrying on a trade or business.

If all three of the foregoing requirements are satisfied, then the per se passive rule does not apply, because the two corporations will be treated as a single corporation and the parent will be treated as if it owned the *assets* of the subsidiary, rather than the *stock* in the subsidiary. However, the statute is not clear as to whether, for the *value* of the assets of the parent or the subsidiary to be *attributable* to assets used in carrying on a trade or business, those assets must be directly owned by the parent or subsidiary and used in carrying on a trade or business, or if indirect ownership, through one or more other subsidiaries, is sufficient. After all, even if the other assets of the parent consist of interests in other businesses, the *value* of those *interests* will be based upon the *value* of the *businesses* themselves, and if the value of the businesses derives from assets used in carrying on a trade or business, then the value of an *interest* in the business would seem to be attributable to assets used in carrying on a trade or business, even if only indirectly.

In short, there is no guidance as to how to apply this exception (or any other part of § 6166) to a multi-tiered entity structure. It is unlikely that Congress intended that an enterprise consisting entirely of assets used in the business of the enterprise would not qualify under § 6166 merely because there were three tiers of entities in the organizational structure.

"Holding Company Election." The second exception to the per se passive rule, the *holding company election* under § 6166(b)(8), may be used in circumstances where the parent and the subsidiary cannot meet the

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[32] Note that the same language is used here as in § 6166(b)(2), with respect to ***value*** of ***voting*** stock.

requirements of the *active corporation exception*, which could be the result of any of the following:

(1) The subsidiary having more than 45 shareholders and the parent holding less than 20% of the voting stock of the subsidiary; or
(2) Less than 80% of the value of the subsidiary's assets being attributable to assets used in carrying on a trade or business; or
(3) Less than 80% of the parent's assets, other than the stock in the subsidiary, being used in carrying on a trade or business.

The holding company election results in diminished deferral, however. The estate which has made the holding company election is not entitled to make interest-only payments during the first four years, so the tax must be paid in 10 installments of principal and interest, with the first installment being due nine months after death. Moreover, the special 2% interest rate will not apply. Further, if the stock of the subsidiary *business company* is *not* "non-readily tradable" (i.e. if there is a market on a stock exchange or in an over-the-counter market for the stock), then the tax attributable to the stock will be payable in five installments of principal and interest, with the first installment being due nine months after death.[33]

Uncertain Application to Non-Corporate Multi-Tier Entities. Both the *active corporation exception* and the *holding company election* appear to be limited in their application to situations where *both* the parent and the subsidiary are *corporations*, rather than either or both being a partnership or other entity, presumably because these two provisions are both exceptions to the per se passive rule, which, by its terms, only applies where both the parent and the subsidiary are corporations. Nevertheless, these provisions raise the question of how non-corporate entities are to be treated. Are interests in partnerships necessarily not considered passive? Are partnerships *automatically* eligible for "look through" treatment such that where the parent is a partnership, the decedent is automatically treated as owning the subsidiary directly? If the parent is a corporation and the subsidiary is a partnership, are the partnership assets automatically attributed to the corporate parent? Alternatively, if a partnership interest owned by a corporation or *vice versa* is considered passive merely because it is an interest in another business entity, would the active corporation exception or the holding company election be available, if all of the requirements

[33] Note that the availability of the holding company election where the business company stock is readily tradable was added by EGTRRA, and is subject to the sunset provisions that take effect in 2011, unless the sunset provision is repealed. Pub. L. No. 107-16, § 901 (a)(1), (b)(2001).

are satisfied, *other than* the fact that one or both entities is not a corporation? Must the requirements of these exceptions be met where one entity is *wholly owned* or even *mostly owned* by another?

What if the corporation in which the decedent holds an interest owns liquid, readily-tradable corporate stock that is part of the corporation's working capital or part of the corporation's "reasonable reserves for financing of a specifically identified project that is reasonably expected to be completed within two years"?[34] In such a case, the stock would be passive under the plain meaning of § 6166(b)(9)(B)(ii), would not qualify for the active corporation exception of § 6166(b)(9)(B)(iii), and would, at best, qualify for only very limited deferral under the holding company election of § 6166(b)(8), even though Congress specifically said that such assets are not necessarily passive.

The complexity and difficulty of qualifying for installment payments as discussed above could be eliminated, and many of the questions raised above can be answered, by amending the statute to bring it more in line with the original intent as expressed by Congress in the legislative history of the amendment that added § 6166(b)(8) and (9). In explaining the amendment, the Senate Finance Committee stated as follows:

> The committee is aware that corporations may often own stock in other corporations for purposes other than as passive investments. For example, a group of corporations may be functionally related (e.g., a manufacturing corporation may own all or a part of the stock in one or more of its supplier corporations). Similarly, corporations that are engaged in unrelated lines of business may be subject to varying degrees of common ownership and managerial control and direction. *The committee intends that stock owned by a corporation, an interest in which qualifies for the installment payment provision, be considered as an active business asset (rather than a passive investment) if the corporations, viewed together, form a controlled group of corporations as defined in section 1563.* Additionally, even though the requirements for a controlled group (under sec. 1563) are not satisfied, stock owned by one corporation in another corporation *may be viewed as an active business asset, provided that based on all facts and cir-*

[34] Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 1113 (Comm. Print 1984).

> *cumstances, the businesses are either functionally related or subject to common managerial control and direction.*
>
> *The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision.* In general, these regulations should provide rules similar to the rules governing the accumulated earnings tax (sec. 531).[35]

The above-cited legislative history demonstrates that Congress did not intend for the 1984 amendments to make it more difficult for operating businesses to qualify for installment payments, merely because of choice of entity or structure of organization. Nevertheless, in the more than twenty years since § 6166(b)(8) and (9) were added to the Code, neither the regulations referenced above, nor any other guidance, has been forthcoming from the IRS. Accordingly, we believe that Congress should act either to clarify these rules within the statute itself or to mandate that, within a prescribed amount of time, the IRS issue the regulations that Congress intended, with rules of construction applying liberally for the benefit of taxpayers until those regulations are issued. We also recommend that Congress instruct the IRS to issue private letter rulings to living taxpayers.

We believe that the Congressional intent was that the payment of estate tax in installments should be available to ***any*** *business, irrespective of the number or type of entities used in the structure of the business, as long as the value of the business ultimately derives from trade or business activity rather than from the mere holding of passive investment assets.* We do not believe that there is any policy to be served by requiring that all of the trade or business assets be held in a single business entity to qualify for installment payments, especially since there are many legitimate reasons why businesses are structured as multiple tiers of entities. Consider the following examples:

(a) In California, if a closely held business's operating assets include real estate, such as the office building or retail store or warehouse where the business is carried on, there are certain *state* law incentives for *individuals* to own commercial real estate outright, rather than within any form of business entity, even though all of the other assets of the business may be held in a corporation or partnership. Accordingly, in

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[35] S. REP. NO. 98-369, at 715 (emphasis added).

many cases, the business is operated in the form of, for example, an LLC treated as a partnership (where there are two or more owners) or as a disregarded entity (if there is one owner and the entity is not treated as a corporation) for tax purposes, which holds title to all assets used in the business except for the real estate from which the business conducts its operations. The real estate is owned outright by the individual or various family members, and leased to the business under a "triple net lease" arrangement, meaning essentially that the "landlord" only has to collect rent and the business "tenant" pays for all upkeep, taxes, insurance, etc. If the real estate is viewed on its own, it might appear to be one business, and the LLC might appear to be another business. The substance, however, is that the building and the assets of the LLC are all assets used in carrying on the same trade or business, and should be viewed as such, irrespective of formalities of title caused by peculiarities of state law. Therefore, the building and the LLC should, for purposes of § 6166, be treated as if they were all held in the same entity.

(b) Compare PLR 9015009 (1/5/1990) to PLR 200518011 (1/14/2005). In the former PLR, the IRS gave technical advice that an interest in a partnership leasing a hotel property was not conducting a "trade or business" activity even though the decedent also owned an interest in the hotel operating corporation as well. The IRS tested each entity separately. Although the value of the combined assets constituted more than 35% of the adjusted gross estate, the value of the estate's interests in the operating corporation alone did not, so the estate was denied § 6166 benefits.[36] In the latter PLR, the decedent leased real estate to an automobile dealership he also owned and the IRS gave technical advice that the real estate "proprietorship" was not a passive asset, so the real estate and operating corporations could be combined and qualify for § 6166 benefits.[37]

(c) Another example is set forth in *Moore v. United States*, discussed further below.[38] *Moore* was decided before the enactment of § 6166(b)(8) and (9), but even under those provisions, the estate might not qualify for the full benefit of § 6166, even though the legislative history clearly indicates that it should. After all, the holding company in which the decedent owned an interest had assets that,

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[36] I.R.S. Priv. Ltr. Rul. 90-15-009 (Jan 5. 1990).

[37] I.R.S. Priv. Ltr. Rul. 2005-18-011 (Jan.14, 2005).

[38] 87-2 T.C.M. (CCH) ¶ 13,741 (1987).

as far as we can tell, consisted solely of stock in two other corporations, and that stock would necessarily be passive under § 6166(b)(9)(B)(i), *unless* one of the exceptions applied. It is not at all clear that the active corporation exception would apply, because the holding company would not be able to show that the value of 80% of its other assets was *attributable to assets used in carrying on a trade or business* unless that phrase includes assets owned indirectly through another subsidiary. The holding company election under § 6166(b)(8) would be available, but the benefits of deferral under that election are less favorable than would be the case if that election was not necessary, thus penalizing the estate for having been structured in a manner that was required by state law.

IRS Policy Not to Issue Advance Rulings. Not only has Treasury not issued any of the guidance Congress intended, but the IRS appears to have a policy of not issuing any private letter rulings on the meaning or application of § 6166 to ***living*** taxpayers trying to ensure that their estates will qualify for installment payments, even though the IRS routinely issues rulings to living individuals as to the prospective estate tax treatment of arrangements or transactions. Therefore, absent Congressional mandate, there is no way for a taxpayer to determine what position the IRS might assert with respect to any fact situation that does not fit squarely within the language of § 6166. In any event, the *Moore* case above demonstrates that the IRS might disallow the payment of estate tax in installments even where the facts demonstrate a classic case of a large estate tax liability attributable to a closely held business.

3. *Applying the 'Trade or Business' Standard to the Entire Business Enterprise*

We recommend that § 6166 be amended to distinguish "trade or business" assets from non-business assets with respect to the entire *Business Enterprise* including all qualifying Closely Held Entities rather than on an entity-by-entity basis. This change could be made relatively simply to define "Closely Held Entities" as those qualifying for combination above (by ownership percentages, control or function) without regard to which of those entities are engaging in an "active business." The "entities" would then be combined and the resulting "Business Enterprise" would then be tested (1) to determine if one or more active businesses exists within the related group of entities, and (2) which assets are used in the trades or businesses within the related group and which assets are not.

IRS rulings and court decisions have frequently determined whether assets are "business" assets or "non-business" assets on an entity-by-entity basis, rather than evaluating the assets based upon the entire enterprise that may be operated through multiple entities. When assets used in a single business enterprise are held in multiple entities, the definition of "the business" becomes unclear, which is why it is important to clearly define the "business enterprise" instead of the confusing "business" terminology under the existing statute. If each entity is viewed alone, the IRS may consider some assets to be "passive" assets, even though, when the related entities are viewed together as a single, combined enterprise, those assets may obviously be used in that business endeavor. To determine which assets are "Business" and "Non-Business"[39] assets, their function should be considered in the context of the larger "business enterprise." A business asset would be one that is held for the reasonable needs of the entire business enterprise and would be determined in a manner consistent with the accumulated earnings test under Code § 537, as recommended by Congress when it enacted amendments to § 6166 in 1984.

Section 6166 does not define the term "trade or business," which is subsumed into the definition of an "interest in a closely held business" in § 6166(b)(1). Section 6166(b)(9)(B)(i) generally defines ***passive*** assets as those assets that are ***not*** trade or business assets. Therefore, the terms are mutually exclusive.

A potential circular determination of "trade or business" can exist for business structures with multiple entities. Therefore, we recommend that the determination of whether a "trade or business" exists should be made only after multiple entities that form a group of related entities are consolidated as provided above.

By way of example, assume a decedent owned a 30% interest in a hotel building that is "triple net" leased to a hotel management company that operates the hotel and in which the decedent also owned a 30% interest. Assume the value of each separate entity is 34% of the decedent's adjusted gross estate and combined make up 68% of the decedent's adjusted gross estate. If the entities are separately tested for a "trade or business," the IRS has taken the position that ownership of real estate without also

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[39] Section 6166(b)(9) currently refers to "Passive Assets." We recommend that the term be changed to "Non-Business Assets" because the word "passive" carries common connotations from other provisions of the Code, notably § 469, that do not apply to § 6166 and tend to be confusing.

providing services is not an active business.[40] Therefore, the IRS might rule, after taxpayer was deceased,[41] that the real estate entity does not qualify to be combined with the operating management company and, consequently, the decedent's estate would not meet the more-than-35% of adjusted gross assets test so that none of the estate would qualify for installment payment of estate tax. On the other hand, if the entities were combined by virtue of the decedent's greater than 20% ownership interest in each entity and the "trade or business" determination were made as to all assets, then the value of the interests in both entities would qualify as being used in the hotel business. The entire value of both entities would qualify for § 6166 installment payments.

As a further example, assume a related group of entities exists and that some entities have made loans to other entities within the group, as is common where, for example, liability concerns require the use of multiple entities, transfers of cash from one entity to another must be documented as loans to respect the separate identity of each entity, thus avoiding any creditor attempt to "pierce the corporate veil." If the "trade or business" and "passive asset" test is applied on an entity-by-entity basis as a pre-condition to being eligible to be combined within the related group, the IRS might rule that an entity that has no operating business but has lent substantial amounts to other entities within the group (1) is not operating a business of lending, (2) owns no business assets, (3) is not eligible to be combined into the related party group and (4) owns only passive assets that do no qualify for installment payment of estate tax. If the "trade or business" test is irrelevant in determining whether the *entities should be combined*, and the "business of the related group" is that of the operating businesses borrowing the funds internally from a related entity, then the loans would clearly be related to the "business" of the group.

D. Distinguishing Business Assets from Non-Business Assets.

We recommend that Congress:

(1) Provide a clear definition of business assets eligible for estate tax deferral and that the term "Non-Business Asset" be substituted for "passive asset" as used in § 6166(b)(9)(B)(i).
(2) Provide testing the business purpose of the assets within the context of an entire business enterprise rather than on an entity-by-entity basis

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[40] *See* I.R.S. Priv. Ltr. Rul. 90-15-009 (Jan. 5, 1990)

[41] Reference is again made to the IRS's unwillingness to issue advance rulings on § 6166.

and by screening out purely passive assets by reference to the § 537 Accumulated Earnings Tax standard.[42]

(3) Repeal § 6166(b)(9)(B)(ii), defining stock in another corporation as a passive asset. This change would further include repeal of § 6166(b)(9)(B)(iii) and § 6166(b)(8)(A) as unnecessary.

Installment payments of estate tax are available only for assets held for the reasonable needs of a business. When assets used in a single business enterprise are held in multiple entities, the definition of "the business" becomes unclear. If each entity is viewed alone, the IRS may consider some assets to be "passive" assets[43] even though, when the related entities are viewed together as a single, combined enterprise, those assets may obviously be used in that business endeavor.[44] Combining interests in business for purposes of this test could increase or decrease the assets considered to be held for business purposes. To the extent § 6166 treats related entities as a single "business,"[45] the determination of whether assets are passive or used in the trade or business must similarly be made on a combined basis. Treasury has not issued regulations to clarify the distinction for over twenty years, failing to comply with Congressional intent as follows:

> ***The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision.*** In general, these regulations should provide rules similar to the rules governing the accumulated earnings tax (§ 531).[46]

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[42] Subchapter G was enacted to tax subchapter C corporations that unreasonably accumulated earnings or closely held C corporations that failed to make distributions to avoid double taxation of dividends. *See I.R.C.* §§ 531–37, 541–47. The purpose of Subchapter G was essentially to identify (and tax) excess accumulations of non-business assets within an entity. Therefore, reference is made to Treas. Reg. §§ 1.537-1 and -2 for determination of reasonable needs of a business.

[43] Section 6166(b)(9) currently refers to "Passive Assets." We recommend that the term be changed to "Non-Business Assets" because the word "passive" carries common connotations from other provisions of the Code, notably § 469, that are not applicable to § 6166 and tend to be confusing.

[44] The recommendation earlier that tiered entities should be viewed as a whole discusses this concept more fully. *See supra* note 20 and accompanying text.

[45] *See* I.R.C. § 6166 (b)(9)(B)(flush language), (b)(8)(A)(i), (b)(10) (A)(i), (c).

[46] S. REP. NO. 98-369, at 715 (emphasis added).

To remedy Treasury's failure to issue necessary regulations, we recommend that the legislative history clearly indicate that, until regulations are issued, the provisions of § 537 should be liberally applied to the benefit of the taxpayer with respect to the definition of "passive assets" under § 6166.[47]

This approach would put to rest the continuing uncertainties that arise over time as a result of piecemeal interpretations of § 6166 and changes in the way business entities are structured. A classic example of the IRS's possible narrow interpretation of § 6166 when dealing with a multiple-entity structure, and the willingness of some courts to accept that interpretation, is demonstrated in *Moore v. United States*.[48] This 1987 case involved an estate's stock in a closely held bank holding company, the sole assets of which consisted of virtually all of the stock of a subsidiary that operated a bank and all of the stock of another subsidiary that owned the bank's operating premises. Even though it was stipulated that this holding company structure was created in order to comply with Texas banking regulations, the IRS asserted, and the court agreed, that the estate could not qualify as to the holding company stock under the then applicable version of § 6166 because the holding company did not ***directly*** carry on a trade or business. The court recognized that there were "compelling policy reasons" for allowing § 6166 to apply but nevertheless held that it did not apply under the letter of the law, since the trade or business activity was carried out by the subsidiary corporations.[49] This particular anomaly was corrected, at least for some cases, by the 1984 enactment of the Holding Company Election under § 6166(b)(8), but that election is not avail-

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[47] If Congress were to look beyond the accumulated earnings regulations, the regulations that are the most analogous definition of "passive assets" under § 6166 are the S corporation regulations, primarily § 1362, relating to S corporation tax or termination of S corporation status as a consequence of "passive investment income." Subchapter S cross references to "passive investment income" or the related tax also appear in §§ 1366, 1375 and 6655. With respect to most types of income generally defined as "passive income," the regulations include exceptions for income derived in "the ordinary course of business" or "the active trade or business of renting property." Treas. Reg. § 1.1362-2(c)(5)(ii)(A)–(D)(iii)(2005); *See also* Treas. Reg. § 1.1362-2(c)(6) exs. (2005). Since the § 1.1362-2(c)(5) regulations were finalized in 1992, the IRS has issued numerous private letter rulings and technical advice to determine whether income is "passive income." Most of those PLRs were favorable to the taxpayers. The IRS appears unwilling to respond to PLR requests by taxpayers as to whether the entities and assets held by those entities would qualify for § 6166 installment payments before the death of the taxpayer, even while willing to rule on similar issues for S corporation purposes.

[48] 87 T.C.M. (CCH) at ¶ 13,741.

[49] *Id.*

able to businesses with a multiple entity structure in the form of partnerships or LLCs rather than corporations. Moreover, Congress at that time called for regulations to answer the fundamental question as to all business entities—as to when an interest in an entity is a business interest rather than a passive investment—but over 20 years later those regulations have not been issued, leading to confusion, uncertainty, and failure to use § 6166.

Furthermore, in some activities such as real estate ownership and management, the IRS appears to apply a de facto "material participation" requirement for qualification as a "trade or business," even though the statute imposes no such requirement.[50] By the time of death a decedent often will have retired from active participation in a closely held business but retain a substantial ownership interest. Accordingly, the statute should be amended to ensure that § 6166 qualification does not depend upon the personal efforts of the decedent or family members, but instead on whether, as a factual matter, the value of the assets is attributable to a business, regardless of who is operating that business.

E. Late Elections

We recommend that Section 6166 be amended to expressly permit an election to pay estate tax in installments to be filed on an amended (supplemental) or late return or one that is changed as a result of an audit.

The current statute prohibits an election on a late return and only permits deficiencies arising out of an audit to be added to the installments if the election previously was made on a timely filed return. Extending the right to elect should not cause abuse or disrupt compliance, and would eliminate the adverse impact when newly discovered information or audit adjustments otherwise make estate tax deferral necessary or appropriate.

It has been suggested that it may be "possible" to make an election to pay an estate tax deficiency in installments even though no election was made when the return was filed.[51] Increases in the tax due as a result of an

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[50] "Decedent's level of activity in connection with Properties 1, 2, and 3 determines whether the properties are part of a trade or business for purposes of section 6166." I.R.S. Priv. Ltr. Rul. 2005-18-047 (Jan. 27, 2006). "Although Decedent hired property management companies to manage the day-to-day operation of Properties 6, 7, and 8, this factor does not necessarily weigh against a determination that an active trade or business exists because the activities of an agent can be attributable to a decedent." *Id.* This seems to be an incorrect statement of law. The only issue is whether the activity is a "trade or business," and it makes no difference who manages that activity.

[51] *See* JERRY A. KASNER, POST-MORTEM TAX PLANNING § 9.03 [14] n. 101 (3d ed.

audit are not uncommon, particularly when closely held business interests are involved, because they are difficult to value. An upward adjustment in the value of the business interest can cause the value of the business interest to exceed 35% of the adjusted gross estate, and thus meet one of the requirements of qualification, where the value of the business, on the return as originally filed, did not meet that requirement, so no election was possible. In such a case, a tax could be due that was not otherwise due.

The liquidity relief provided by § 6166 should not depend on when the election is filed. We do not believe that there is any reason to prohibit an election to be made on a late or "amended" return because § 6166 is intended to facilitate payment of taxes but, unlike other elections, it does not reduce the amount of the tax. Furthermore, § 6166 does not authorize a refund of taxes already paid if a late election is made. Allowing an election for the first time on a late or amended return or resulting from examination changes would not have the potential for abuse or disrupt compliance. The computational difficulties presented when elections are not made on a timely return are no different than those arising from deficiencies when a timely election was made.[52]

F. Liens, Bonds and Security Issues

We recommend that § 6325(d) be amended to require that regulations articulate standards for subordination of the government's lien under § 6166 and the statutory standard be the same for § 6166 as for § 2032A special use valuation. We also recommend that the amendment or legislative history expressly provide that no request for subordination be denied until such regulations are issued, although such regulations may be issued as temporary.

We recommend that, instead of requiring the estate to post a bond in an amount up to twice the deferred tax as a condition of electing deferral under § 6166, the Code should expressly allow the executor to provide alternative means of assuring payment as a substitute for the special bond under § 6165 or the special lien under § 6324A. Regulations (supplemented by revenue procedures) should be required in order to offer alternatives such as (1) a lien against only those assets for which tax deferral is sought that is subordinated to existing creditors and renewals of existing lines of credit, and (2) covenants by which the executor undertakes not to take certain actions such as distributing funds from the secured assets oth-

1998) (referencing Rev. Rul. 67-161, 1967-1 CB 342).

[52] *See* Rev. Rul. 89-32, 1989-1 C.B. 307 (1989).

er than for permitted purposes (e.g., income taxes for pass-through entities) or to dispose of those assets in any way until the tax liability has been paid in a corresponding amount. Such covenants may also provide commercially reasonable terms such as limitations that only reasonable compensation be paid to related parties or that payments on loans to related parties not exceed arm's length terms.

In support of these recommendations, please note the following:

1. Subordination

Where an estate elects the deferral of estate tax payments under § 6166, the government has a special estate tax lien against the assets of the estate. The presence of such a pre-existing lien can make it difficult, if not impossible, for the business included in the estate to obtain third party financing unless the estate tax lien can be subordinated to the third party financing lien.

The lien provided for in § 6166 is a critical part of statutory scheme because, absent the lien, there is usually no other practical way for an executor to be relieved of personal liability for the unpaid taxes during the long deferral period under § 6166.

If the executor desires to be discharged from personal liability with respect to the deferred estate taxes, the executor is required to provide a bond, which is usually prohibitively expensive or not available, or to elect that a lien will be imposed with respect to the "6166 lien property." The lien under § 6324A also replaces the special estate tax lien imposed pursuant to § 6324(a)(1).

Since, however, such a lien can potentially cut the business off from access to third party credit, § 6325 provides for subordination. The statutory standard contemplates that regulations will be issued providing for more detail as to how and when subordination will be granted. Such regulatory standards are essential to provide consistency and some measure of predictability; without such regulations, the potential for inconsistency is equivalent to a national bank running a loan department without a loan committee or lending criteria. The special estate tax lien for the deferred tax liability under § 6166 can be subordinated under circumstances described in § 6325(d). However, in the 30 years since § 6325 was passed, no such regulations have been issued to provide predictability or consistency in how the relief is granted. Furthermore, the subordination relief is more limited with respect to liens under § 6166 than for liens under special use valuation under § 2032A (despite the fact that § 2032A offers a greater benefit to the estate than § 6166, because it reduces liability rather than merely deferring payment (with interest)). In addition, the standard for subordination needs to be consistent with the same considerations applied in protecting the government's payment right without using liens and bonds, as described below.

2. *Alternatives to Liens and Bonds*

The Code now appears to allow the IRS to require a § 6324A lien as a condition of § 6166 deferral. Certainly a bond in the amount of twice the tax deferred can be required under § 6165, and the IRS does indeed impose that requirement.[53] Since these bonds are often very difficult or expensive to obtain, the executor is often forced to offer a lien under § 6324A instead. Our understanding of current IRS policy is that a notice of tax lien is filed with respect to all such liens. The commercial stigma of a "tax lien" of any sort has an incredibly adverse effect on the reputation and credit standing of the business, suggesting, for example, non-compliance with the tax laws, and particularly imperiling businesses, such as construction companies, that require bonding capacity for their customer contracts. After all, a notice of tax lien does not state that the tax lien is imposed to secure an estate's obligation to make installment payments of estate tax, but appears the same as a lien imposed on a taxpayer for failure to pay taxes in bad faith. As a result, § 6166 deferral is out of the reach of many business owners and their families who are unwilling to take a chance on what will be required at the time to obtain deferral and keep it in place.

Furthermore, we have heard that procedures are starting to be implemented wherein a lien generally will not be accepted by the IRS in lieu of a bond if the only asset available to pledge is closely held stock or similar ownership interests, but that the IRS will accept a security interest in real estate in lieu of a bond or lien. If the business does not itself own sufficient equity in real estate (a circumstance that is likely to be increasingly common in today's service company), then the IRS will accept a pledge of real estate from another party, as we understand the current administrative practice. However, while this approach understandably simplifies the government's interest in obtaining adequate security, it at the same time would limit § 6166 relief to those businesses with real estate or to those families that have wealth independent of the business.

The foregoing IRS policy also seems to assume that the estate controls the enterprise and can arrange for a security interest to be placed on

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[53] *See* I.R.S. Priv. Rul. 2000-27-046 (Jul. 7, 2000).

enterprise property for the personal benefit of the owner, when, in fact, many interests qualifying for § 6166 payments are minority interests with non-family members or even adverse parties as co-owners. In this case, the administrative policy essentially eviscerates the entire purpose of § 6166 to avoid forced sales of businesses or interests in businesses. The inability to obtain § 6166 treatment for an owner of a illiquid, non-controlling interest in a closely held business essentially puts the estate owning that interest at the mercy of those controlling the business which is, in the purest sense, precisely the forced sale that Congress intended to avoid.

V. CONCLUSION

The saga of § 6166 establishes a consistent pattern of Congress adding provisions to § 6166, struggling to meet its clear intention that installment payment of estate taxes be available to owners of closely held businesses. The structure of § 6166 is antiquated and inconsistent between differing forms of ownership (corporations and partnerships) that do not address the form in which businesses are conducted in the real world.

APPENDIX A: ADDITIONAL BACKGROUND

Extensions of Time for Payment of Estate Tax—A Historical and Economic Perspective[54]

A. Tax Reform Act of 1976[55]

In 1976, significant changes were made to the federal gift and estate tax law, including unifying the gift and estate tax, creating the "unified credit," substantially increasing exemption amounts (and filing requirements), modifying the inclusion for property jointly owned by spouses, adding the § 2036(b) anti-Byrum provision, setting definitive rules for disclaimers and enacting ill-fated (and subsequently repealed) carry-over basis and generation-skipping taxes, as well as other changes.

Chief among the changes were to provide protections against forced sales of farms and closely held businesses through enactment of § 2032A special use valuation, a significantly changed automatic extension for the time to pay estate taxes for estates under § 6166A for estates holding a significant portion of the estate (65% of the adjusted gross estate or 50% of the taxable estate) and adding a new provision (§ 303) permitting redemption of shares for payment of estate tax without incurring dividend treatment for the redemption. The new automatic extension also permitted the executor to be discharged from personal liability and to enable the estate to provide security for the deferred tax through a lien, thereby avoiding a bond unless there was insufficient security for the unpaid tax.

Prior to the changes, estate tax payment could only be extended (1) by a discretionary (and non-reviewable) determination of hardship by the IRS or (2) an election to pay the tax over ten years if the closely held business constituted more than 35% of the gross estate or 50% of the taxable estate (50% of the gross estate for two or more businesses), secured by a bond of up to double the unpaid tax. The House report concluded, in its reasons for the changes:

> The present provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor is forced to sell a dece-

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[54] This Appendix is intended to provide a historical context to fundamental changes in § 6166 over its history rather than a comprehensive review of every technical and administrative revision.

[55] Pub. L. No. 94-455 (1976).

> dent's interest in a farm or other closely held business in order to pay the estate tax. This may occur even when the estate qualifies for the 10-year extension provided for closely held businesses. In these cases, it may take several years before a business can regain [enough cash to pay estate taxes] after the loss of one of its principal owners. Moreover, some businesses are not so profitable that they yield enough to pay both the estate tax and interest especially if the interest rate is high. . . . On the other hand, where a substantial portion of an estate consists of illiquid assets other than a farm or closely held business, it has been extremely difficult to obtain an extension on the grounds of "undue hardship" because the IRS generally takes a restrictive approach toward granting such extensions. Your committee believes that additional relief is needed by estates with liquidity problems.
>
> In addition, many executors have found it both difficult and expensive to obtain a bond to satisfy the extended payment requirements. Therefore, many executors refuse to elect the extended payment provisions because they must remain personally liable for tax for the entire length of the extension.[56]

Although significant improvements were made, changes in how businesses are structured that were relatively rare in 1976 have again placed estates in positions similar to the circumstances in 1976 that necessitated reform.

B. Economic Recovery Tax Act of 1981.[57]

Even greater changes were made to federal gift and estate law in 1981 by enacting an unlimited marital deduction, including QTIPs, and increasing the unified credit to $225,000 (scheduled to increase to $600,000) from the $60,000 exemption that had existed prior to the 1976 Act. ERTA repealed § 6166A and effectively integrated it with § 6166, making deferral of estate taxes available to more estates.[58] ERTA decreased the percentage threshold for qualification from 65% to 35% and liberalized the acceleration rules to permit dispositions of up to 50% from the prior 33 1/3%.[59]

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56 H.R. REP. NO. 94-1380, at 3384–85.

57 Pub. L. No. 97-34 (1981).

58 Pub. L. No. 97-34, § 422. ERTA also changed the § 6166(c) multiple-entity combination rule requiring "more than 20" to "20 or more" of the value of the business. *Id.*

59 *Id.*

In giving reasons for changes to § 6166 in ERTA, the House reported:

> The committee believes that simplification and clarity are needed in the provisions permitting deferred payment of estate taxes attributable to closely held businesses. Under present law, although both sections 6166 and 6166A permit deferred tax payments for illiquid estates, there are unnecessary differences between the two sections. The definition of a closely held business, the percentage of estate assets required to be represented by such an interest, the length and conditions of the deferral, the appropriate interest rate, and the conditions for acceleration vary between the sections.
>
> Because the existence of two deferral provisions with differing requirements creates confusion, the committee believes that these provisions should be simplified by merging the two sections to provide a single set of rules to govern the installment payment of estate taxes. . . .
>
> In addition, the committee believes that the provision of present law section 6166, which restrict eligibility for deferral to an estate in which the closely held business interest comprises 65% of the adjusted gross estate, have proven unduly restrictive. . . .
>
> Under present law, the decision of the IRS to deny an election to pay all or a portion of the estate tax attributable to closely held businesses generally is not subject to judicial review because no deficiency is involved. The committee believes that taxpayers should be provided with a judicial forum to resolve disputes involving an estate's eligibility for the deferral of estate tax attributable to interests in closely held businesses.
>
> Under present law, the redemption of certain stock in certain closely held businesses to pay estate taxes, funeral expenses, and administrative expenses is treated as a sale or exchange instead of a dividend (sec. 303). However, this provision contains a definition of an interest in a closely held business and rules for aggregating multiple interests in closely held businesses which are different from either of the provisions which permit deferred payment of the estate taxes attributable to interests in closely held businesses. The committee believes that the rules governing redemption of closely held business stock to pay estate taxes, fu-

> neral expenses, and administration expenses should be coordinated with the provisions governing the deferral of estate taxes attributable to interest in closely held businesses.[60]

From a practical standpoint, ERTA's generous income tax benefits, including depreciation deductions and incentive tax credits, which were intended to expand the economy had an unintended effect of spawning the "tax shelter" economy, overbuilding, see-through buildings and the eventual collapse of the Savings and Loan industry. In order to achieve the "tax shelter" effect, more and more businesses structured themselves as partnerships to enable them to pass through tax losses and credits to their partners. More and more businesses were formed as pass-through entities. Prior to that time, most businesses were operated as proprietorships and corporations. The Subchapter S Revision Act of 1982[61], coupled with the reduction in individual income tax rates compared to Subchapter C corporate rates, hastened the increase of pass-though entities by lowering barriers to Subchapter S elections.

C. Deficit Reduction Act of 1984[62]

Further amendments were made by Deficit Reduction Act of 1984 ("DRA") to again expand the application of § 6166 from the more restrictive interpretation of the regulations adopted by the Treasury Department. The Conference Report provided, in part:

> ***Present Law***
>
> Qualifying closely held businesses may be conducted as proprietorships, partnership, or corporations. Generally, only directly owned interests in active business operation are considered for purposes of the installment payment provisions. Present Treasury regulations take the position that the value of a trade or business carried on as a proprietorship includes only the value of those assets actually used in the trade or business. On the other hand, if the business is carried on as a partnership or a corporation, the value of the trade or business includes the value of all partnership or corporate assets, even though a portion of the partnership or corporate assets may be used for purposes other than carrying on a trade or business.

[60] H.R. REP. NO. 97-201, at 180–181 (1981).
[61] Pub. L. No. 97-354 (1982).
[62] Pub. L. No. 98-369.

House Bill

The House bill permits executors to elect to look through a passive holding corporation for purposes of determining whether the decedent owned an interest in a closely held business if 80% or more of the value of the holding corporation consists of the value of non-readily tradable stock in a single active business corporation. Only the value of qualifying stock owned by the holding corporation which is attributable to the value of assets (including working capital) actually used in an active business operation is considered for purposes of the installment payment provisions. If the election is made, the special 4% interest rate and 5-year deferral of principal payments are not available.

Senate Amendment

The Senate amendment is the same as the House bill except the Senate amendment also permits executors to elect to look through multiple tiers of passive holding corporation to determine whether the decedent owned an interest in a closely held business. The multiple tier look through is available only if at least 20% of the value of each corporation to be looked through is included (directly or indirectly) in the value of the decedent's gross estate. The Senate amendment also expands the House rule under which only the value of assets (including working capital) actually used in an active business are considered for purposes of the installment payment provision to provide that, in the case of all interests in partnership and corporations (whether or not a passive holding corporation is present), only the value of assets directly related to the reasonable needs of the business are considered.

Conference Agreement

The conference agreement follows the Senate amendment with technical modifications. Under the conference agreement, interest in active closely held corporations may be considered for purposes of the installment payment provision provided the indirectly owned interest would meet the requirements of that provision were it directly owned. Therefore, an indirectly owned interest in a single closely held corporation qualifies if the corporation has 15 or fewer shareholders or the decedent owned 20% or more of the corporation's voting stock. Also, the value of the business interest must constitute more than 35% of the value of the dece-

> dent's adjusted gross estate. As under present law, if a decedent owns interests in more than one closely held business, at least 20% of the value of each such business must be included in the decedent's estate if the business interests are to be aggregated for purposes of the installment payment provision.
>
> Additionally, the conference agreement retains the rule that in the case of all corporations and partnerships, only active business assets are considered for purposes of the installment payment provision....
>
> Finally, the conference agreement includes an exception under which multiple wholly owned subsidiaries of a passive holding company may be treated as one subsidiary corporation if the holding company has fifteen or fewer shareholders on June 22, 1984, and at all time prior to the owners' death, and if at least some of the subsidiaries are carrying on a trade or business. . . .[63]

D. Tax Reform Act of 1986.[64]

The Tax Reform Act of 1986 did not amend § 6166, but its effects significantly affected the application of § 6166 as well as the economy. The establishment of the passive loss rules and elimination of advantageous liquidation of Subchapter C corporations drove more and more businesses to forms of business that were pass-through entities for tax purposes. The rise of litigation involving businesses that failed from the tax-driven strategies encouraged by ERTA and the following economic fall as well as the consequent failure of significant accounting and law firms resulted in the development of the limited liability company and similar structures. Further relaxation of permitted ownership in S corporations created the rush of C corporations to elect S corporation status or to liquidate and reorganize as LLCs. The vast majority of closely held businesses are now taxed as either S corporations or partnerships.

As to real estate, the collapse of the real estate industry and resulting financial failure of many entities caused numerous bankruptcy filings. At the time, many entities filing for bankruptcy owned multiple properties. As a defense tactic, many entities successfully argued in an effort to forestall foreclosures of properties by lenders (and attendant recapture of prior tax benefits) that reorganization in bankruptcy was appropriate because

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[63] H.R. REP. NO. 98-861, at 1235–37 (1984) (Conf. Rep).
[64] Pub. L. No. 99-514 (1986).

they held multiple properties (some of which were in default and others were not). Lenders then began requiring that each real estate project be held in a single asset entity as a condition to providing financing. Real estate businesses were then forced into a business structure that required one or more tiers of entities that were not contemplated in 1984 when the "Holding Company" provisions were added to § 6166. Similarly, increasing perceived or real risks of liability from numerous sources encouraged owners of businesses other than real estate to structure their organizations in multiple entities, resulting in many more entities held in multiple brother-sister or tiers of corporations, limited liability partnerships and LLCs to reduce the risk of a failure of one business adversely affecting other businesses.

E. Subsequent Amendments.

Since the DRA of 1984, other changes to § 6166(b) include a change of the reference to the four percent interest rate to two percent to reflect the simplification for the accounting for interest paid in the administration of § 6166.[65]

Further changes were made by the Economic Growth and Taxpayer Relief and Reconciliation Act of 2001 to redefine "Non-Readily Tradable Stock" in the Holding Company rules of § 6166(b)(8)(B), to add a new § 6166(b)(10) applying to banks and similar lending enterprises, and to increase the number of shareholders and partners to 45 from 15.[66] The House Report provides the reason for the change as follows:

> The Committee finds that the present-law 15 partner limitation on partnerships and 15 shareholder limitation on corporations is restrictive and keeps estates of decedents who otherwise held an interest in a closely held business at death from claiming the benefits of installment payment of estate tax. Thus, the Committee wishes to expand the definition of partnerships and corporations to enable more estates of decedents with an interest in a closely held business to claim the benefits of installment payment of estate tax.[67]

The Senate Report similarly provides the following reason for the

[65] *See* I.R.S. Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

[66] Pub. L. No. 107-16, § 573 (2001).

[67] H.R. REP. NO. 107-37, at 42 (2001).

changes:

> The Committee finds that the present-law installment payment of estate tax provisions are restrictive and prevent estates of decedents who otherwise held an interest in a closely held business at death from claiming the benefits of installment payment of estate tax. Thus, the Committee wishes to expand and modify availability of the provision to enable more estates of decedents with an interest in a closely held business to claim the benefits of installment payment of estate tax.
>
> ***Explanation of Provision***
>
> The bill 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 bill 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 interests 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.[68]

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[68] STAFF of S. COMM. On Finance, 107th CONG., RESTORING EARNINGS TO LIFT INDIVIDUALS AND EMPOWER FAMILIES (RELIEF) Act of 2001, *available at* http://riacheckpoint.com/checkpoint?usid=20a741dd32e&1kn=mainFS&uqp=659757 (last visited March 21, 2006).

Statement of Sen. Chuck Grassley
Hearing, "*Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning*"
Thursday, April 3, 2008

Thank you, Mr. Chairman, and thank you for holding this series of hearings on the Death Tax. At the conclusion of today's session we will have effectively discussed the effects, alternatives and potential amendments to the Death tax in great depth. At this point, we should be driven to action regarding what is the ultimate fate of the estate and gift tax system. While I continue to favor complete repeal, I understand that we must come to a bi-partisan solution which will provide certainty and fairness to many individuals who are uneasy with the current situation.

It is troubling to me that the Congress has done nothing more than talk about potential reforms and have not taken effective action to remedy the fact that in 2011 the death tax will come back with impunity on the 2001 level. This situation is simply unacceptable.

During this session we have tried to stimulate the economy by getting money in the hands of consumers and small business people allowing them to invest the funds as they see fit and not at the whim of the government. By taking steps to simplify the death tax we will further this goal and free up even more funds which would have gone to expensive attorneys and have them instead reinvested into businesses or in the economy.

This simplification will strengthen these businesses and the economy while making it easier for families to pass their businesses and farms to their children directly without much complication or expense.

When I return to Iowa I want to be able to tell farmers and small businesses who are getting ready to harvest their fields that they can focus on the job at hand and don't have to worry about the potential trouble on the horizon regarding the Death Tax. They should not have to spend lots of time and money paying expensive attorneys to arrange their belongings for no other reason than to avoid the estate tax. For a small farmer or businessman, this time of year is busy enough without having to worry about the government repeatedly changing all the rules.

I again would like to thank the Chairman for holding these hearings, but I also would like to urge the committee to move quickly towards a mark up of an estate tax reform bill at its earliest convenience. We need a bill which will simplify the death tax as well as make those changes more permanent to provide individuals certainty and simplicity regarding the settling of their estate. A bill of this kind will ease anxiety and allow individuals to reinvest their money into their businesses and the economy as opposed to paying attorneys to keep their assets away from the government. If we can accomplish this goal it will be a great success to show we averted the potential disastrous effect of 2011 and helped to simplify the estate and gift tax provisions to the benefit of our constituents.

Thank you.

Testimony of
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Before the
SENATE FINANCE COMMITTEE
On
Portability of the Estate, Gift and Generation-Skipping Tax

April 3, 2008

I. Preliminary Remarks

It is an honor to appear before this distinguished Committee to testify regarding portability of the estate, gift, and generation-skipping tax ("GST") exemptions[1] to a surviving spouse. Portability would simplify estate planning and estate administration for married couples; carry out our clients' nontax goals; and increase consistency with existing tax policy without creating any new tax benefit.

Although I am chair of the Transfer Tax Study Committee of the American College of Trust and Estate Counsel ("ACTEC"), I am here as an invited witness in my individual capacity. However, the legislative proposal that appears as Exhibit A to my written testimony was prepared by ACTEC's Transfer Tax Study Committee and was unanimously approved by ACTEC's Board of Regents on March 10, 2008. Accordingly, when I speak in support of that proposal, I am authorized to speak on behalf of ACTEC, as well.

ACTEC is a non-profit professional association of approximately 2,600 trust and estate lawyers selected on the basis of professional reputation and ability in the field of trusts and estates and substantial contributions to that field through lecturing, writing, teaching, and bar leadership activities. ACTEC does not take positions on matters of tax policy and politics, including rates, exemptions, effective dates, and phase-ins. Nevertheless, on the basis of the extensive experience of our members in working with the estate, gift and generation-skipping transfer taxes as applied to our clients' circumstances, ACTEC offers technical observations concerning how the tax laws work and recommendations for making them operate more effectively to carry out the policies expressed by Congress.

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[1] The estate, gift and GST exemptions technically operate as a "unified (cumulative) credit" against the tax, but for simplicity they are commonly referred to as exemptions and in most cases operate exactly as exemptions would.

In my view, portability may be the best estate tax planning idea for a surviving spouse since the unlimited marital deduction in 1981. Portability has already received significant attention from Congress. Specifically, portability was an important feature of H.R. 5970, in the 109th Congress, which was passed by the House of Representatives on July 29, 2006, and set before the Senate as the subject of the cloture motion that failed by a 56-42 vote on August 3, 2006, as part of the effort of a number of Senators to work out a compromise on the future of the estate tax.

In my remarks today I will first describe portability, second, discuss reasons that compel me and my ACTEC Fellows to recommend the passage of estate tax legislation that includes portability, third, make a few observations regarding the use of portability in practice, and lastly compare H.R. 5970 to the ACTEC Proposal.

II. The Case for Portability

A. What is "Portability"?

In general, portability is the transfer of a the deceased spouse's unused exemption to the surviving spouse. Specifically, under current law, each citizen or resident has a $2 million exemption from estate tax. It is common to say that a married couple has twice that, or $4 million. That is not an accurate picture of how the estate tax system works. Rather, under current law, upon the death of the first spouse and the transfer of all assets to the surviving spouse, the $2 million exemption of the deceased spouse is lost. When the surviving spouse dies, her estate may contain the assets of both spouses, but the estate of the surviving spouse will only have a single $2 million exemption. In order to avoid wasting the deceased spouse's exemption, the deceased spouse must either transfer assets to someone other than the surviving spouse, or place the exemption amount in an irrevocable bypass trust. Those two options are often counter to what the couple desires. Portability solves this dilemma.

B. Evaluation of Portability.

In general, we recommend portability for four important reasons, namely to:

(1) Simplify transfer tax planning and after-death administration;

(2) Satisfy client desires to provide security and flexibility for the surviving spouse;

(3) Achieve greater consistency with existing tax policy that treats a married couple as a unit; and

(4) Importantly, accomplish by statute the same results that a married couple may achieve by complicated planning and estate administration.

1. <u>Simplification</u>. The most obvious feature of portability is that it vastly simplifies estate planning and after-death administration for a married couple.

    a. With portability, a married couple would no longer have to create a bypass trust upon the death of the deceased spouse, in order to use the exemption of the deceased spouse. Although "bypass" is easy to say, a number of complications come to mind in the use of a bypass trust.

    First, estate planners commonly use a marital deduction formula clause in drafting a bypass trust. The purpose is to ensure that the bypass trust receives the greatest amount possible covered by the exemption but does not go over the exemption thereby triggering estate tax. Instead, any amount in excess of the exemption amount would go to the survivor's trust, which qualifies for the marital deduction so that the two trusts together would make maximum use of the deceased spouse's exemption while protecting any excess from tax with the marital deduction. The result of making this optimal use of the exemption by a deceased spouse is a complicated formula virtually impossible to explain to anyone who is not an estate planning attorney or other professional.

    A second complication is that an irrevocable bypass trust is a separate taxpayer. This means the bypass trust needs a separate ID number and a separate income tax return. With portability, there would be no separate trust, the surviving spouse would continue to use her own social security number and would not have to file a separate income tax return in addition to the survivor's individual 1040.

    Third, after the death of the first spouse to die, the division of assets between the marital deduction trust and a bypass trust is typically accomplished after the filing of a federal estate tax return, due initially nine months after death. As a result, there needs to be a preliminary trust to hold the decedent's assets between the date of death and the funding of the trusts. The administrative trust in turn is a separate taxpayer, requiring yet another new ID number and an additional income tax return. With portability, there would be no need for an administrative trust; the decedent's assets would be treated as transferred to the surviving spouse on the date of death of the first spouse to die.

    b. Another complexity under current law is that the estate of the first spouse to die must contain sufficient assets to use the exemption of the deceased spouse. Unless the couple is confident of which spouse will die first, this means that each spouse must have assets in his or her name sufficient to use the exemption. The result is that complicated tax planning drives how a married couple hold title to their property, rather than nontax, personal reasons. This may require asset transfers from the spouse with the higher net worth to the other spouse, which might otherwise be unnecessary, undesirable, impractical, or in some other way be inconsistent with the couple's overall planning.

Even in a community property state, such as California, clients frequently have inheritances, property brought from a non-community property state, or assets owned before marriage that are separate property and create a different net worth for each spouse.

With portability, the deceased spouse's unused exemption would pass to the surviving spouse, regardless of the value of the deceased spouse's estate.

2. Conformity to Client Nontax Goals.

A second important reason we support portability is that clients typically prefer that the surviving spouse be the full owner of the couples' combined estate upon the death of the first spouse. A bypass trust divides ownership of the deceased spouse's estate between the income beneficiary and the remaindermen who receive the assets upon the death of the surviving spouse. Even if the surviving spouse holds a limited power of appointment over the bypass trust so that the survivor controls who owns the remainder, the surviving spouse is still faced with less than outright ownership of the assets in the bypass trust. This separate ownership raises issues of fiduciary duties owed to the remainder beneficiaries by the trustee, whether the trustee is the surviving spouse or someone else.

3. Consistency with Existing Tax Policy.

A third reason that portability makes sense is that it is consistent with other ways the tax law recognizes a married couple as, in effect, a single economic unit, e.g., joint income tax returns, gift-splitting for gift tax purposes, and the unlimited marital deduction.

a. For example, in 1981, when the marital deduction for transfers between spouses was made unlimited, the Finance Committee stated that "[t]he committee believes that a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes." S. Rep. No. 97-144, 97th Cong., 1st Sess. 127 (1981).

b. In addition, portability would permit the actual result for a married couple to match the way the exemption is often viewed and discussed, including by lawmakers, as, for example "$2 million per person, and $4 million for a married couple". Rarely do we hear the exemption referred to as $2 million per person, and $4 million per married couple who retains legal counsel and engages in careful, complex planning.

4. Portability Does Not Open a New Door.

> Not only are there significant reasons that favor portability, it is imporant to keep in mind that portability does not open a new door. Under current law, a married couple can achieve the same goal of use of the deceased spouse's exemption as portability does. The difference is that current law (1) requires a married couple to engage in complicated planning and put up with complex administration; and (2) impairs the security of sole ownership that a surviving spouse could otherwise enjoy.

In summary, portability would (1) simplify estate planning and estate administration for married couples; (2) carry out clients' nontax goals; and (3) increase consistency with existing tax policy. All these benefits can be obtained without giving a married couple a new tax benefit.

C. Who Will Benefit from Portability?

1. Portability should be most useful to a married couple with a combined estate of more than $2 million but no more than $4 million at the time of death of the surviving spouse. For convenience when I refer to $4 million, I am referring to double one exemption, which is currently $2 million per person. In these circumstances, the couple could use portability to both avoid all estate tax on their combined estate and avoid the use of a bypass trust for estate tax planning.

2. The greater the combined net worth of a married couple, the less useful portability will be. This is for two reasons: First, the higher the net worth, the more likely the couple will make distributions to children on the first death thereby using the exemption of the first spouse. Second, the larger the combined estate, the greater role that appreciation of the deceased spouse's estate in the survivor's estate will play.

III. H.R. 5970 and the ACTEC Proposal

A. H.R. 5970 and the "Break-through".

One of the technical challenges to implementing portability was the tracing problem. Tracing refers to tracking assets from the deceased spouse to the surviving spouse in order to determine how much unused exemption should be transferred to the surviving spouse's estate. H.R. 5970 solved this problem by transferring the entire unused exemption of the deceased spouse to the estate of the surviving spouse but capping the amount of unused exemption the survivor's estate can use to the same amount as the survivor's exemption. Therefore, the total exemption in the surviving spouse's estate would never exceed twice the amount of a single exemption.

Moreover, "capping" not only avoids difficult tracing, it also prevents abuse by a surviving spouse who would marry a series of ill paupers in order to accumulate their unused exemption. The unused exemption of all predeceased spouses would be capped at the amount of the surviving spouse's exemption.

ACTEC recognizes this technical break-through in H.R. 5970, and the ACTEC Proposal incorporates the capping technique.

I will turn now to the differences between H.R. 5970 and the ACTEC Proposal.

B. Relieve Burden of the Required Election.

First, under H.R. 5970, new section 2010(c)(6)(A) permits portability only if the executor of the deceased spouse's estate so elects. We believe that the election will be desirable in virtually every situation, and that a required election will be burdensome and a trap for the unwary.

A required election for portability is likely to result in the same confusion produced when we had a qualified terminable interest property trust ("QTIP") election for the marital deduction. The IRS required that simply listing assets on Schedule M of the federal estate tax return was not sufficient to obtain the marital deduction. An affirmative check-the-box election had to be made. This rule led to several private letter rulings that disallowed the marital deduction. As a result of these unfavorable rulings, and approximately 10 years later, a new rule was finally adopted that did not require a box to be checked to make the QTIP election.

C. Give Option to File Estate Tax Return or Income Tax Return for Deceased Spouse.

H.R. 5970 requires that the unused exemption of a deceased spouse cannot be transferred to the estate of the surviving spouse unless a federal estate tax return is filed for the deceased spouse. (As mentioned above, ACTEC recommends that the executor not be required to make an election for portability to apply.) Although the ACTEC proposal requires the timely filing of an estate tax return for the deceased spouse, we also suggest that there be an option of filing a special schedule to the deceased spouse's final income tax return as a substitute for an estate tax return.

The reason for the income tax filing option is that in any situation where portability would apply, then, by definition there would be no tax due on the deceased spouse's estate, and frequently, no estate tax return would be necessary, except to establish there was unused exemption. If there were tax, then there would be no unused exemption to transfer to the survivor's estate. The income tax option is offered as a less onerous way of complying with the need to notify the Internal Revenue Service (IRS) that portability would apply upon the death of the surviving spouse.

Although some might view the income tax return as an inappropriate vehicle for providing the fair notice the Service needs, the ACTEC proposal does not automatically allow any statement on an income tax return to suffice. We believe that the concern for fair notice should be addressed by Treasury, which would be authorized to issue "instructions, regulations, directions or forms".

D. Extend Portability to the Generation-Skipping Transfer Tax (section 102(a) & (b) of H.R. 5970 and Section 2631(c) of the Code).

Second, H.R. 5970 makes the exemption portable for gift and estate taxes, but not for the generation-skipping tax exemption. Our experience is that taxpayers who make taxable transfers often consider gifts at death to grandchildren. Moreover, linking the GST exemption to the estate and gift tax exemption will simplify planning and there is no reason to make the GST exemption different than the other transfer taxes. Like the gift and estate tax exemption, portability of the GST exemption is available under current law to taxpayers who engage in sophisticated estate planning. For these reasons, ACTEC recommends extension of portability to the GST exemption.

E. Clarify Whether Privity is Required.

Privity means that the exemption would only be portable between a married couple. Without requiring privity, there could be a transfer of an exemption from a deceased husband to a surviving wife, who would in turn transfer both her unused exemption and her first husband's unused exemption to a second husband.

H.R. 5970 did not appear to require privity, but that is not entirely clear. We believe if Congress intends to allow portability without privity, it is not entirely clear that Congress explicitly considered this issue or its implications. If the policy judgment regarding privity was not considered in H.R. 5970, that judgment should be made now. While ACTEC acknowledges that this is the type of judgment call that lawmakers should make, we believe that a privity requirement would adversely affect very few spouses and that most spouses would find privity to be a natural and acceptable requirement.

F. Clarify That a Surviving Spouse's Estate Can Receive Unused Exemption from More than One Deceased Spouse. (Section 102(a) of H.R. 5970 and New Section 2010(c)(4) and (5) of the Code).

It is relatively clear from H.R. 5970 that a surviving spouse who has lost two or more spouses to death may use the unused exemption of all such predeceased spouses, subject to a cap of the amount of the surviving spouse's exemption. Apparently H.R. 5970 permits a surviving spouse to accumulate exemptions from all prior deceased spouses but caps the amount of exemption that may be accumulated. We propose clarifying H.R. 5970 by inserting the word "all".

G. Broaden Treasury's Regulation Authority (Section 102(a) of H.R. 5970 and New Section 2010(c)(7) of the Code).

We recommend that Treasury be given broader authority to issue what are often viewed as "legislative regulations". The deliberate process of drafting regulations, with solicitation of public input through the notice and comment process and otherwise, is well-suited to fleshing out the administrative rules to govern the details of implementing portability.

In conclusion, portability is a great idea. I sincerely hope that with the support of this Committee, portability will be a great idea whose time has come.

EXHIBIT A

2008 Report on Study of Statutory Proposal for Simplification of Transfer Tax Planning for the Unified Credit and GST Exemption

In 1992, the Transfer Tax Study Committee recommended a proposal for the simplification of federal estate and generation-skipping transfer tax planning and compliance through the enactment of amendments to sections 2010 and 2631 of the Internal Revenue Code of 1986. The Committee updated this report in 2004 and is now further updating the proposal. This proposal is based on HR 5970 and not the version approved in 1992, except that this Report unlike HR 5970 applies to the GSTT as well as the gift tax and the estate tax. Like HR 5970, this Report assumes unification of the gift and estate tax.

The proposal would amend subsections 2010(c) and 2505(a), providing for the transfers of any unused portion of the applicable credit amount (unified credit) of a deceased spouse to the surviving spouse. For the most part the proposal adopts the amendments to section 2010(c) set forth in the "Estate Tax and Extension of Tax Relief Act of 2006," H. R. 5970 (109th Congress), which the House of Representatives passed on July 29, 2006. The amount of the transferable credit would not be limited to the tax that the property transferred to the spouse would generate but instead would be equal to the transferor spouse's entire (otherwise unused) applicable exclusion amount. This proposal would also amend subsection 2631 to create a new Section 2631(c) allowing the transfer of any unused portion of a decedent's GST exemption to the decedent's surviving spouse.

The Committee recommends re-adoption of the proposal as set forth and explained in this report. The Committee's report first explains the provisions of current law and the need for change, and then describes the proposed amendments to sections 2010, 2505 and 2631.

Current Law

By operation of the applicable credit amount, each decedent's estate is entitled to exclude a portion of its assets from estate taxation. The amount that is excludable is known as the "applicable exclusion amount," as set forth in section 2010(c)(2).

As amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, ("EGTRRA") the applicable exclusion amount for estate tax purposes is $2,000,000 in the case of decedents dying in 2008 and $3,500,000 in the case of decedents dying in 2009 reduced, in effect, however by the amount of the credit used to offset gift taxes otherwise payable. For gift tax purposes, the credit is equal to the tax generated by the first $1,000,000 of taxable transfers made by the individual.

Under EGTRRA, no estate taxes are imposed for decedents dying in 2010.

To the extent that the applicable credit amount is not used against taxable transfers by the individual, it is lost.

Each individual is entitled to a GST tax exemption under section 2631. Since 2003, the GST exemption is equal to the estate tax applicable exclusion amount. To the extent that the exemption is not allocable to GST transfers made by the individual during life or at death, it similarly will be lost.

Marital Deduction Planning

Under sections 2056 and 2523, transfers to the decedent's (surviving) spouse are deductible from taxable transfers, and thus do not generate a transfer tax against which the applicable credit amount can be taken. In other words, an individual who transfers all property to his or her spouse does not pay a tax but does not utilize the otherwise available credit. On the spouse's subsequent death, however, all of such property then remaining will be includible in that spouse's estate.

In the case of spousal estates of more than the applicable credit amount, accepted estate planning makes some of the assets taxable at the death of the first spouse to die, and the balance at the death of the surviving spouse, so that the applicable credit amount of each can be used. In the simple case of combined assets of $4,000,000 (in 2008), for example, the usual plan would result in $2,000,000 being subject to taxation in the estate of the first spouse to die, but not in the estate of the survivor. This result typically is obtained in estate planning documents through a formula that takes into account gifts made during lifetime that reduce the applicable credit amount as well as other adjustments. At least $2,000,000 is subject to taxation in the estate of the survivor. In each estate, the tax generated by the transfer tax is sheltered by that individual's applicable credit so no estate taxes are owed.

This type of transfer tax planning necessitates the creation of trusts to manage some or all of the family's joint assets. The only practicable way to prevent the property protected by the applicable credit amount of the deceased spouse from being subject to transfer taxation in the estate of the surviving spouse is to put the property in a trust over which the surviving spouse does not have any "strings" that would trigger gross estate inclusion. Even if the surviving spouse does not need a trust for property management purposes, such a trust must be created for tax planning reasons.

GST Exemption Planning

Each spouse is entitled to a $2,000,000 GST exemption (in 2008). It therefore is possible for a husband and wife collectively to shelter $4,000,000 worth of assets from the generation-skipping transfer tax (the "GST Tax"). In order to do so, however, each spouse must make a transfer of $2,000,000 that will be subject to the GST tax.

Unless the surviving spouse has sufficient assets to effectively use his or her GST exemption, the only practicable way to effectively utilize both spouses' GST exemptions, while preserving the resources for the use of the surviving spouse, is to create trusts. Generally, one or more trusts are structured so that the transferor's GST exemption can be applied to them (a credit shelter trust and/or a "Reverse QTIP Trust"). The balance of the assets then will pass to the surviving spouse in such a way that they will be includible in his or her gross estate (that is, either outright or in a marital trust), so that the surviving spouse will be, or will be deemed to be, the "transferor" of those assets under section 2631(a), allowing his or her GST exemption to be allocated to it.

For both estate tax and generation skipping transfer tax purposes, the amount that can be potentially sheltered from tax increases to $3,500,000 per individual in 2009. There is no GST tax for transfers occurring in 2010. The provisions of EGTRRA cease to apply after 2010 in accordance with the "sunset" provisions of EGTRRA.

Reasons for Change

Current transfer tax law can unnecessarily dictate the testamentary plans of decedents because trusts must be created to take advantage of the applicable credit amount and GST exemption allocable to the first spouse. Testators who otherwise would want to leave the entire estate to the surviving spouse outright are forced to put the property in trust in order to take advantage of these amounts.

In addition, in order for the estate of the first spouse to die to take advantage of the applicable credit amount, he or she must have in his or her estate assets at least equal to the "applicable exclusion amount" (that is, the amount of assets sheltered from tax by the applicable credit amount). This may require asset transfers from the wealthier spouse to the poorer spouse that might otherwise be unnecessary, undesirable, not practical either legally or practically, or otherwise inconsistent with the couple's overall planning.

This issue became increasingly acute under EGTRRA because the amount that can potentially be protected from the estate and GST tax has increased in steps to $2 million currently and $3,500,000 for 2009. In order to take maximum advantage of these exclusions, each of the spouses must have at least this amount in each's individual name. Further, assuming if the "sunset provisions" of EGTRRA take effect, that is, the amounts that can be protected are reduced to pre-EGTRRA levels after 2010, the amount so transferred will prove to have been unnecessary.

Married couples should be able to transfer assets with the protection of their combined applicable credit amounts regardless of the happenstance of who dies first, and regardless of their level of sophistication.

Couples can continue to utilize credit shelter trust planning if they prefer for tax or other reasons. Credit shelter trusts can result in somewhat lower overall estate tax costs for a couple since the appreciation of the assets held in such a trust will not be subject to estate tax whereas it would be if held by the surviving spouse outright. In addition, couples may prefer to leave all or a portion of their assets in trust for a survivor for non-tax reasons, e.g. financial management, protection against remarriage, an improvident spouse and the like.

Under the proposal, an individual cannot retransfer to a subsequent spouse any applicable credit amount or GST exemption that such individual acquires from a deceased spouse and does not use during such individual's lifetime or at his or her own death. The credit can be used by a surviving spouse only if a United States citizen or resident at time of death.

Proposed Amendment of Sections 2010(c)

Section 2010(c)

(c) Applicable Credit Amount-

(1) IN GENERAL- For purposes of this section, the applicable credit amount is the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the applicable exclusion amount.

(2) APPLICABLE EXCLUSION AMOUNT- For purposes of this subsection, the applicable exclusion amount is the sum of--

(A) the basic exclusion amount, and

(B) in the case of a surviving spouse, the aggregate deceased spousal unused exclusion amount.

(3) BASIC EXCLUSION AMOUNT-

(A) IN GENERAL- For purposes of this subsection, the basic exclusion amount is $__________.

(B) INFLATION ADJUSTMENT- In the case of any decedent dying in a calendar year after 2010, the dollar amount in subparagraph (A) shall be increased by an amount equal to--

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting 'calendar year 2009' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $100,000, such amount shall be rounded to the nearest multiple of $100,000.

(4) AGGREGATE DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT- For purposes of this subsection, the term 'aggregate deceased spousal unused exclusion amount' means the lesser of--

(A) the basic exclusion amount, or

(B) the sum of all deceased spousal unused exclusion amounts of the surviving spouse.

(5) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT- For purposes of this subsection, the term 'deceased spousal unused exclusion amount of the surviving spouse' means, with respect to each deceased spouse (of the surviving spouse) dying after December 31, 2009, the excess (if any) of--

(A) the basic exclusion amount of the deceased spouse, over

(B) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

(6) SPECIAL RULES-

(A) RETURN REQUIRED- A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse under paragraph (5) unless the executor of the estate of the deceased spouse files a timely filed (including extensions) estate tax return or sets forth adequate information on a timely filed (including extensions) income tax return, as provided in instructions, regulations or directions, or forms prepared by the Secretary, for the deceased spouse from which one can determine the deceased spouse's unused exclusion amount.

(B) EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT- Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

(7) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

Proposed Amendment of 2505(a)

2505(a)

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

(1) the applicable credit amount under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by

(2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.

Proposed Amendment of Section 2631

Section 2631(c)

(c) GST EXEMPTION AMOUNT-

(1) IN GENERAL- For purposes of subsection (a), the GST exemption amount for any calendar year shall be the sum of:

(A) the basic exclusion amount under section 2010(c) for such calendar year, and

(B) in the case of a surviving spouse, the aggregate deceased spousal GST unused exemption amount.

(2) AGGREGATE DECEASED SPOUSAL GST UNUSED EXEMPTION AMOUNT- For purposes of this section, the term `aggregate deceased spousal GST unused exemption amount' means the lesser of--

(A) the basic exclusion amount, or

(B) the sum of all deceased spousal GST unused exemption amounts of the surviving spouse.

(3) DECEASED SPOUSAL GST UNUSED EXEMPTION AMOUNT- For purposes of this section, the term `deceased spousal GST unused exemption amount of the surviving spouse' means, with respect to each deceased spouse (of the surviving spouse) dying after December 31, 2009, the deceased spouse's unused GST exemption remaining after application of section 2632(e).

(4) SPECIAL RULES-

(A) RETURN REQUIRED- A deceased spousal GST unused exclusion amount may not be taken into account by a surviving spouse under paragraph (3) unless the executor of the estate of the deceased spouse files a timely filed (including extensions) estate tax return or sets forth adequate information on a timely filed (including extensions) income tax return, as provided in instructions, regulations, directions, or forms prepared by the Secretary, for the deceased spouse from which one can determine the deceased spouse's GST unused exclusion amount.

(B) EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT- Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 13 with respect to a deceased spousal GST unused exemption amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

(5) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection.

Explanation of Amended Sections 2010 and 2505

Amended sections 2010 and 2505 provide that an individual transfers to the surviving spouse any unused portion of his or her applicable exclusion amount.

The amount of the credit that can be transferred to a surviving spouse is defined by proposed section 2010(c) as the basic exclusion amount in excess of the tax imposed on the transfer of the deceased spouse's estate. A taxpayer can accumulate credits from prior spouses but cannot transfer those accumulated credits to a surviving spouse. In other words, transfer of credit is allowed only between spouses who were in privity – that is, were married to each other. The aggregate amount that can be accumulated is the amount equal to the exclusion amount at the time of the surviving spouse's death.

The Committee believes that no estate would want to decline the transfer of an available credit. Accordingly, the proposal presumes that any unused exclusion amount is transferred to the surviving spouse; that is no election is required.

H.R. 5970 did not appear to require privity between spouses. It is unclear whether the drafters intended this result. The accompanying explanations do not provide insight into the drafters' intentions on this issue. The Committee believes that if Congress intends to allow portability from spouse to spouse to spouse without privity, it should make that policy judgment explicit. If the policy judgment underlying portability without privity was not considered in the drafting of H.R. 5970, that judgment should be made now. While acknowledging that this is a judgment call that lawmakers should make, the Committee believes that a privity requirement would adversely affect very few spouses and that most spouses would find privity to be a natural and acceptable requirement.

In some cases, there will be a revenue increase as a result of portability since the assets transferred outright to a surviving spouse may appreciate during the spouse's lifetime which appreciation then will be taxed at the death of the surviving spouse. If the first decedent creates a credit shelter trust the appreciation in the assets of the trust is not taxed at the death of the surviving spouse. On the other hand, revenue may be lost in the case of taxpayers who are not currently engaging in estate tax planning, including those whose estates consist primarily of jointly held property and other non-probate assets that pass entirely to the surviving spouse.

The examples below illustrate the application of the proposed amendments. Each example assumes that S has not made any lifetime gifts, unless otherwise stated.

Example (1): The Decedent, D, has made no prior taxable gifts and has a gross estate of zero. At D's death, the basic exclusion amount as defined in section 2010 (c)(3) is $2,000,000. D's surviving spouse, S, dies un-remarried when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $4,000,000, which is the sum of the basic exclusion amount at S's death plus D's unused exclusion amount.

Example (2): Assume the facts in example (1), except D has separate assets of $2,000,000, all of which he leaves to S. S's applicable exclusion amount is $4,000,000, which is the sum of the basic exclusion amount at S's death plus D's unused exclusion amount.

Example (3): Assume the facts in example (1), except D has separate assets of $1,000,000 all of which he leaves to his daughter. S's applicable exclusion amount is $3,000,000 which is the sum of the basic exclusion amount at S's death of $2,000,000 plus D's unused exclusion amount of $1,000,000.

Example (4): Decedent, D, has made $500,000 of prior taxable gifts and has separate assets of $500,000, all of which he leaves to his daughter. At D's death, the basic exclusion amount is $1,000,000. D's surviving spouse, S, dies un-remarried when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $2,000,000, which is S's basic exclusion amount. The deceased spousal unused exclusion amount is zero because the basic exclusion amount at D's death was $1,000,000, all of which was consumed by the $500,000 of prior taxable gifts and the $500,000 bequest to D's daughter.

Example (5): Assume the same facts in example (4), except after D's death, S marries D2. D2 has made no prior taxable gifts, and has a gross estate of $1,000,000 all of which he leaves to his daughter. At D2's death, the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $3,000,000 which is the sum of S's basic exclusion amount of $2,000,000 plus D2's unused exclusion amount of $1,000,000.

Example (6): Decedent, D, has made no prior taxable gifts and has separate assets of $2,000,000, all of which he leaves to his spouse S. At D's death, the basic exclusion amount is $2,000,000. After D's death, S marries D2. D2 has made no prior taxable gifts and has separate assets of $2,000,000, all of which he leaves to S. At D2's death, the basic exclusion amount is $2,000,000. S dies when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $4,000,000, which is the sum of S's basic exclusion amount of $2,000,000 plus the aggregate deceased spousal unused exclusion amount of $2,000,000. The aggregate deceased spousal unused exclusion amount as defined in section 2010(c)(4) is capped at the basic exclusion amount of $2,000,000 at S's death.

Example (7): Assume the same facts as in example (6), except the basic exclusion amount is $4,000,000 at S's death. S's applicable exclusion amount is $8,000,000, which is the sum of S's basic exclusion amount of $4,000,000 plus D's unused exclusion amount of $2,000,000 plus D2's unused exclusion amount of $2,000,000.

Example (8): Decedent, D, has made no prior taxable gifts and has separate property of $2,000,000 all of which he leaves to his spouse, S. At D's death, the basic exclusion amount is $2,000,000. S dies un-remarried with an estate of $3,000,000. At S's death the basic exclusion amount is $1,000,000. S's applicable exclusion amount is $2,000,000, which is the sum of the basic exclusion amount of $1,000,000 at S's death and the aggregate deceased spousal unused exclusion amount as defined in section 2010(c)(4) of $1,000,000, which is capped at the basic exclusion amount at S's death of $1,000,000 even though D had an unused exclusion amount of $2,000,000.

Example (9): Decedent has made no prior taxable gifts and has separate property of $2,000,000, all of which he leaves to his spouse, S. At D's death the basic exclusion amount is $2,000,000. After D's death, S marries D2. S has made no prior taxable gifts and has separate property of $4,000,000, all of which she leaves to D2. At S's death the basic exclusion amount is $2,000,000, and therefore S's applicable exclusion amount is $4,000,000, which is the sum of S's basic exclusion amount of $2,000,000 plus D's unused exclusion amount of $2,000,000. D2 dies un-remarried. At D2's death the basic exclusion amount is $3,000,000. D2's applicable exclusion amount is $5,000,000, which is the sum of D2's basic exclusion amount of $3,000,000 plus S's unused basic exclusion amount of $2,000,000. This assumes D's unused exclusion amount is not carried over to D2, with whom D had no privity. If privity were not required, then D2's applicable exclusion amount would be $6,000,000, which is the sum of D2's basic exclusion amount of $3,000,000 plus the lesser of D2's basic exclusion amount of $3,000,000 or S's unused applicable exclusion amount of $4,000,000.

Example (10): Decedent has made no prior taxable gifts and has a gross estate of zero. At D's death the basic exclusion amount is $2,000,000. After D's death, D's surviving spouse, S, gifts $4,000,000 during a year when the basic exclusion amount is $2,000,000. S's applicable exclusion amount is $4,000,000, which is the sum of the basic exclusion amount at the time of the gift and D's unused basic exclusion amount of $2,000,000. S incurs no gift tax in the year of the gift.

Explanation of Amended Section 2631

Amended Section 2631 would allow for the transfer of the decedent's unused GST exemption. The proposal allows a decedent to bequeath the entire estate to the surviving spouse and leave to the surviving spouse the making of generation-skipping transfers. The proposal thus avoids the necessity for decedents to create GST trusts in which the surviving spouse has an interest, in order to utilize the GST exemption.

The proposal does not prevent the creation of GST trusts by the decedent to take advantage of leveraging inherent in the time value of money.

The Committee believes that most estates with significant GST tax exposure already take advantage of the planning opportunities to avoid the GST tax. Thus, the proposal should merely simplify the planning process, without significant loss of tax revenue.

The following examples illustrate the application of amended section 2631:

Example (1): Decedent D has made no prior gifts and dies owning $1,500,000, all of which D leaves to D's spouse S. D dies when the basic exclusion amount is $2,000,000. S dies un-remarried when the basic exclusion amount is $2,000,000. S's GST exemption is $4,000,000, which is the sum of the basic exclusion amount of $2,000,000 in the year of her death and D's unused GST exemption of $2,000,000.

Example (2): Assume the same facts in example (1), except D dies with no assets. S's GST exemption is $4,000,000, which is the sum of the basic exclusion amount of $2,000,000 in the year of her death and D's unused GST exemption of $2,000,000.

Example (3): Decedent D has made no prior gifts and dies owning $2,000,000, of which D leaves $1,000,000 to D's grandchild GC (the child of D's son) and $1,000,000 to D's spouse S. D's son survives D. D dies when the basic exclusion amount is $2,000,000. D's executor does not affirmatively allocate D's GST exemption instead relying on the GST deemed allocation rules. S dies un-remarried when the basic exclusion amount is $2,000,000. S's GST exemption is $3,000,000, which is the sum of the basic exclusion amount of $2,000,000 in the year of S's death and D's unused GST exemption of $1,000,000 remaining after the deemed allocation of $1,000,000 left to GC.

Example (4): Decedent, D, has made no prior gifts and dies owning $2,000,000, all of which he leaves to a trust which provides all the net income to his son for life with the trust assets passing to D's grandchild GC upon D's son's death. D dies when the basic exclusion amount is $2,000,000. D's executor does not affirmatively allocate GST exemption and affirmatively elects out of the GST deemed allocation rules as permitted by section 2632. D's spouse, S, dies un-remarried when the basic exclusion amount is $2,000,000. S's GST exemption is $4,000,000, which is the sum of the $2,000,000 basic exclusion of $2,000,000 and D's unused GST exemption of $2,000,000. S or S's executor cannot allocate S's GST exemption to the testamentary trust established by D since S is not the transferor of that trust.

Example (5): Decedent D has made no prior gifts and dies owning $2,000,000 all of which he leaves to his spouse S. D dies when the basic exclusion amount is $2,000,000. After D's death, S marries D2. S dies with $4,000,000, all of which she leaves to D2. S made no prior gifts. At S's death, the basic exclusion amount is $2,000,000, and therefore S's GST exemption is $4,000,000, which is the sum of S's basic exclusion amount of $2,000,000 plus D's unused exclusion amount of $2,000,000. D2 dies un-remarried when the basic exclusion amount is $3,000,000. D2's GST exemption is $5,000,000, which is the sum of the basic exclusion amount of $3,000,000 at D2's death and S's unused GST exemption (traceable to her own basic exclusion amount) of $2,000,000. This assumes that D's unused GST exemption goes unused and cannot be transferred to D2, with whom D had no privity. If privity were not required, then D2's GST exemption would be $6,000,000, which is the sum of D2's basic exclusion amount of $3,000,000 plus the lesser of D2's basic exclusion amount of $3,000,000 or S's GST exemption of $4,000,000.

United States Senate Committee on Finance Hearing
Outside the Box on Estate Tax Reform:
Reviewing Ideas to Simplify Planning
April 3, 2008

Questions Submitted for the Record

Questions for Ms. Kovar:

[Note: the responses to the following questions assumes the 2008 federal estate tax exemption of $2,000,000 per person and also assumes that the husband is the first spouse to die.]

Senator Baucus

1) **What provision in the tax Code currently causes the biggest problem for taxpayers in estate planning? Apart from the rate and exemption, in your opinion, if Congress could only make one additional change, what should it be and why?**

The biggest problem for taxpayers is the disappearance of a deceased spouse's exemption upon the death of the first spouse to die. This problem is the "biggest" for 4 reasons, as explained below:

(1) The problem is widespread because it applies to all married couples whose combined estates might exceed the amount of the surviving spouse's exemption. For these couples, the only way to save the exemption of the deceased spouse (without bequests to someone else) is the use of a bypass or "credit shelter" trust. Portability would allow these deceased spouses to give their estates to their surviving spouses without the use of a complicated estate plan that includes a credit shelter trust.

The availability of portability does not mean that all couples would take advantage of it for many reasons, but for couples whose combined estates do not exceed their combined exemptions, portability offers the opportunity for a significantly simpler and less costly estate plan.

(2) The loss of the exemption on the first death is unfair; that loss treats married couples differently, even though their combined taxable estates are the same. For example, couple "A" have a combined estate value of $4,000,000, consisting of $2 million owned by each spouse. The first to die gives his or her estate to the survivor. The couple does not have an estate plan when the first spouse dies. If the exemption for the surviving spouse is $2,000,000, then $2,000,000 will be subject to estate tax upon the death of the surviving spouse.

Couple B has the same $4,000,000 estate, except that they retain an estate planning attorney to draft a "credit-shelter" trust, which uses the exemption of the deceased spouse to shelter his estate from taxation. The surviving spouse's taxable estate is only $2,000,000 and is protected from estate tax by her single exemption. Therefore, Couple A and B have the same combined estate but there is tax on $2,000,000 for Couple A and none for Couple B.

Couple "C" has a $4,000,000 combined estate and their estate planning attorney prepares a credit-shelter trust for them. However, upon the death of the surviving spouse, and even though the couple has a credit-shelter trust, the surviving spouse's estate will still incur a federal estate tax because all the assets were in the estate of the surviving spouse, and the deceased spouse's estate has no assets that could use his exemption.

In summary, even though three couples held the same combined estate of $4,000,000, only one couple, Couple B, avoids estate tax because Couple B: 1) Used a credit-shelter trust; and 2) arranged their estates so that each spouse owned at least $2,000,000 at the time of death.

(3) A credit-shelter trust plan is complicated, and as a result, costly to draft and administer and difficult for the taxpayer to understand. A typical plan includes a "marital deduction formula" clause, which is designed to maximize the use of the deceased spouse's exemption without triggering federal estate tax on the first death. In addition, a couple's assets need to be divided between them so that each spouse would have sufficient assets to use that spouse's exemption if that spouse is the first to die. This division can be time-consuming and frequently does not coincide with the couple's non-tax goals.

A credit-shelter trust requires 1) division of a married couple's assets between the credit shelter trust and the marital deduction trust(s), 2) three separate taxpayers and income tax returns; and 3) administration of three trusts (the marital trust(s), the administrative trust, and the survivor's trust).

(4) In addition to unfairness, cost, and complexity, a credit shelter trust is a frequent source of litigation. One cause of litigation is the division of ownership between the surviving spouse and the children of the marriage. The spouse and children may disagree on trust administration issues, such as appropriate investments and distributions that are in the discretion of the trustee, who owes a duty to both the spouse and the children.

If only one change could be made to the Tax Code, I would urge the Congress to enact portability---a statutory transfer of a deceased spouse's unused exemption to the surviving spouse. Portability would eliminate the tax incentive to use a credit-shelter trust, with its accompanying complexity, unfairness, cost and potential for litigation, for couples whose combined estates do not exceed double the exemption of the surviving spouse.

2) Portability of exemptions would allow the transfer of a deceased spouse's unused exemption to the surviving spouse.

a) Could an exemption continue to be transferred to spouse to spouse? For example, what if husband #1 died, transferring his exemption to his wife. If his wife later remarries husband #2, who later dies, will his estate be able to use the exemption of husband #1?

Portability legislation should make clear that husband #2 cannot use the unused exemption of husband #1. Otherwise, the unused exemption of husband #1, then husband #2, could float indefinitely as each succeeding surviving spouse passed the exemption to the next spouse. For example, as suggested by the above question, if husband #2 would "inherit" unused exemption from husband #1, then husband #2 could transfer husband #1's unused exemption to husband #2's surviving spouse and so on. This potential for infinite portability would bring complexity and would not be within the reasonable expectation of a married couple.

b)Similar to the previous scenario, what if a wife has two spouses who have predeceased her. Would the wife's estate be able to use three exemptions, her own, plus those of her former husbands?

Portability legislation should make clear that a surviving spouse may use the unused exemption of all of her predeceased spouses. However, in order to avoid potential abuse, there should be a "cap" on the total exemption that could be used by the surviving spouse. The cap would be the lesser of the deceased spouses' unused exemptions and double the amount of the exemption of the surviving spouse.

c) Are there steps that should be taken to limit the continual transfer of exemptions between taxpayers?

Yes, as indicated in #2(a) above, transfers of exemption should stop upon the death of the first surviving spouse. For example, if husband #1 dies and his unused exemption is transferred to his surviving spouse, then the surviving wife marries a second time, and the surviving wife dies before husband #2, husband #2 cannot use the unused exemption of husband #1. In other words the transfer of exemptions should only take place between a married couple, sometimes called "privity." Husband #2 cannot use the unused exemption of husband #1 because husband #1 and #2 were not married to each other.

Senator Grassley

1) An issue in your testimony seemed to be that there should be a requirement of privity between the spouses who could have the portable exemption. Could you explain the rationale for the privity requirement and how it differs from simply capping the amount of exemption that each spouse may use ultimately at death?

Privity means that the deceased spouse's unused exemption can only be used by his surviving wife and not by the second husband of the surviving wife. Portability can occur only between a deceased spouse and his surviving spouse. The rationale for privity is that deceased husband #1, for example, would not intend for his unused exemption to be used by husband#2 to pass assets to the children of husband #2. Husband #1 would have no desire to have his exemption used to benefit the children of husband #2. Whereas, between a married couple, there is a reasonable assumption that a deceased husband would approve the use of his unused exemption by the couple's mutual children, or even by the husband's step-children (the children of the wife's first marriage.) If the latter is not the case, then the married couple has the option to establish a credit-shelter trust, which could ensure that the deceased husband's unused exemption benefits only the children of the deceased husband and his surviving spouse.

Whereas the "capping" of the exemption of multiple predeceased husbands (for example) relates to the amount of the exemption, privity relates to the recipient of the exemption.

2) Do you think there needs to be an election which activates the portability of the exemption or should it be automatic?

Without question or qualification, the exemption should be automatic. The executor of the deceased spouse's estate would allow any of his unused exemption to shelter his surviving wife's estate. An election would be burdensome and a trap for the unwary.

An election for portability is likely to result in the same confusion produced when we had a qualified terminable interest property trust ("QTIP") election for the marital deduction. The IRS required that simply listing assets on Schedule M of the federal estate tax return was not sufficient to obtain the marital deduction. An affirmative check-the-box election had to be made. This rule led to several private letter rulings that disallowed the marital deduction. As a result of these unfavorable rulings, and approximately 10 years later, a new rule was finally adopted that did not require a box to be checked to make the QTIP election.

There is no reasonable expectation that an executor would be interested in subjecting the surviving spouse's estate to tax if portability avoided tax. Therefore, the law should not impose a procedural requirement that would trigger taxation; the law should not impose a trap for the unwary.

3) Who would benefit from portability?

All married couples, regardless of the size of their estates, would be able to use portability. In other words whether an estate is $4,000,000 or $20,000,000, the deceased spouse's unused exemption could be transferred by statute to the surviving spouse, and a credit shelter trust would not be required to make use of the deceased spouse's exemption.
However, in practice, portability would most often be used by a married couple whose combined estates do not exceed twice the amount of a single exemption. For example, the deceased spouse could transfer his $2,000,000 estate to his surviving wife, then the surviving wife could transfer their combined estate of $4,000,000 to their children without paying any estate tax. Therefore, there would be incentive to use portability because there would be no estate tax on the death of the survivor even without the use of a credit-shelter trust. The only reason to use a credit-shelter trust would be for non-tax reasons.

The estate planning issues are different for a combined estate of a married couple that exceeds twice the amount of the exemption upon the death of a surviving spouse (assuming there will be a cap on the amount of the unused exemption of a deceased spouse by the amount of the exemption at the time of the death of the surviving spouse.) For example, for a couple who have a combined estate of $10,000,000, and assuming the current exemption of $2,000,000, portability would only permit that couple to transfer $4,000,000 to their beneficiaries without estate tax. The remaining $6,000,000 would be subject to tax. Therefore, unlike the couple with a combined estate of $4,000,000, the couple with $10,000,000 could not avoid federal estate tax by relying on portability. The couple with $10,000,000 would be more likely to use a credit shelter trust instead of portability in order to shelter appreciation of the assets in the credit shelter trust.

4) How would the executor of the surviving spouse's estate determine how much unused exemption was left over from the deceased spouse's estate?

The executor of the deceased spouse's estate would file a federal estate tax return, which would show the amount of the unused exemption. ACTEC recommends that the executor be given the choice of filing a federal estate tax return or attach a special schedule to the decedent's final income tax return.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TESTIMONY OF ROBY B. SAWYERS BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning
April 3, 2008

Mr. Chairman, Ranking Member Grassley, and Members of the Committee, thank you for the opportunity of testifying today on issues related to simplifying planning associated with the estate and gift tax including the re-unification of the estate and gift tax exemption amounts.

My name is Roby Sawyers. I am a practicing CPA and professor in the College of Management at North Carolina State University. I am also a member of the American Institute of Certified Public Accountant's (AICPA) Tax Executive Committee, chaired the AICPA's Transfer Tax Reform Task Force and was a contributing member of the Joint Task Force on Federal Wealth Transfer Taxes. Much of my testimony today comes from the previous reports issued by those task forces.

In order to provide certainty to taxpayers, the AICPA encourages Congress to make permanent changes to the estate tax prior to its scheduled repeal in 2010. A written statement for the record outlining the AICPA's priority list of seven suggested reforms of the transfer tax system was provided to this Committee for consideration following last month's hearing on alternatives to the federal estate tax system.

My testimony today focuses on three issues surrounding the decoupling of the estate and gift tax exemptions:

- First, taxpayers and practitioners face planning difficulties as a result of decoupling the estate and gift tax exemption amounts in 2004. Under the law prior to the passage of the

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),[1] the estate and gift tax exemption was unified and could be used to offset both lifetime gifts and bequests at death. This policy was well understood by taxpayers and simplified estate and gift tax planning by reducing the number of tax and non-tax variables that must be considered in deciding whether to transfer assets during life or at death. However, under current law, while the estate tax exemption and generation skipping transfer (GST) tax exemption stand at $2 million in 2008 and increase to $3.5 million in 2009, the gift tax exemption remains at $1 million.[2]

- Second, as a result of the decoupling, taxpayers including small business owners may be discouraged from making orderly lifetime gifts of property and to engage in business succession planning. Historically, the gift tax has been less expensive than the estate tax, providing an incentive for taxpayers to make intrafamily transfers during life.[3] That policy has several advantages including a potential acceleration of tax revenue to the

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[1] P.L. 107-16

[2] Concern that taxpayers might make tax-free gifts of low-basis or income-producing assets to taxpayers in lower tax brackets and thus erode the income tax apparently led Congress to limit the gift tax exclusion amount to $1 million. For further discussion of this issue, see Part II (The Gift Tax) of the *Report on Reform of Federal Wealth Transfer Taxes* published by the American Bar Association in 2004.

[3] Before 1977, gift tax rates were lower than estate tax rates. Today, while the estate and gift tax use the same tax rate schedule, the gift tax is calculated on a tax exclusive basis while the estate tax is calculated on a tax inclusive basis. As demonstrated in the following example, this results in an effective gift tax rate that is lower than the effective estate tax rate: A taxpayer dies with a taxable estate of $3 million subject to a 50 percent tax rate. The estate tax on the $3 million is $1.5 million ($3 million x 50 percent) leaving the taxpayer's heir $1.5 million. The estate pays an effective tax rate of 50 percent ($1.5 million estate tax divided by $3 million of assets). With the same $3 million of assets, the taxpayer could have made a gift during life of $2 million subject to the same 50 percent tax rate. The tax on this $2 million gift is $1 million for an effective tax rate of 33.3 percent ($1 million of gift tax divided by $3 million of assets). Valuation rules and the annual exclusion also increase the benefit of making lifetime gifts as opposed to bequests at death. The decoupling of the gift and estate tax exemptions has the opposite effect and may make lifetime gifts more expensive. In addition, taxpayers must weigh the advantage of lower transfer taxes with the potential for higher income taxes. Under IRC Section 1014, a taxpayer receiving inherited

Government. However, the primary advantage is that it encourages the lifetime distribution of family capital to younger generations. It encourages small business owners to plan for the orderly transfer of management and control of their businesses during life. It encourages older taxpayers to make gifts of cash and other property to younger generations. It is these younger taxpayers, who need the capital in order to buy homes, raise and educate their children and purchase other goods and services. Reunification of the estate and gift tax exemption should result in a greater propensity to make both taxable and nontaxable gifts and provide a stimulus to the economy.

- The third issue is a direct result of the uncertainty surrounding the future of the estate tax. A donor's making of both nontaxable and taxable gifts often reflects prudent tax planning in the face of a future estate tax. However, the prospect of no estate tax in 2010 may make individuals reluctant to make taxable lifetime gifts that otherwise would be sensible for nontax reasons including business succession planning.[4] It also puts CPAs and other tax practitioners in an awkward position as properly advising a client as to the benefits of making lifetime gifts requires an assumption as to whether the estate tax will indeed be repealed. The uncertainty concerning the future of the estate tax makes the decision much more difficult for taxpayers and their advisors.

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property generally receives a basis equal to the property's fair market value at death while under IRC Section 1015, a taxpayer receiving a gift generally receives a carryover basis equal to the donor's basis.

[4] In a recent report, the Congressional Research Service finds that gift tax revenues fell by approximately half (as a percent of total estate and gift tax revenues) after the enactment of the EGTRRA ("Estate and Gift Tax Revenues: Past and Projected in 2008," Nonna A. Noto, RL34418, March 19, 2008).

Recommendations:

In summary, the AICPA suggests that the estate, GST, and gift tax exemptions be re-unified. Reunification will simplify planning for taxpayers and avoid all the cumbersome number juggling now required, provide an incentive for small business owners to make business succession plans, and provide an incentive for taxpayers to make intrafamily transfers of wealth during life.

If the estate tax and GST tax are permanently repealed, the AICPA encourages Congress to reunify the estate and gift taxes during any phase-out period and repeal the GST tax immediately. Immediate repeal of the GST tax would have minimal revenue effect, because, in most situations, taxpayers are not going to find it difficult to defer imposition of this tax until the end of the phase-out period. Likewise, if the current estate tax system is retained, we encourage Congress to immediately reunify the estate tax, gift tax and GST tax exemption amounts in order to simplify planning and provide an incentive for small business owners to plan for orderly succession of their business interests and others to make lifetime transfers of property to family members.

We hope you and others in Congress will consider these suggestions in the debate about estate tax reform. We look forward to working with Congress to achieve simplicity, effectiveness, and efficiency as Congress considers changes to the current estate and gift tax system. Thank you for the opportunity to share these views with you.

United States Senate Committee on Finance Hearing
Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning
April 3, 2008

Questions Submitted for the Record From Roby Sawyers

Questions from Senator Baucus:

1) What provision in the tax Code currently causes the biggest problem for taxpayers in estate planning? Apart from the rate and exemption, in your opinion, if Congress could only make one additional change, what should it be and why?

Response:

Without changing the tax rate or exemption amount, providing portability of the estate, gift and generation skipping transfer tax exemption amounts by statute would simplify estate planning for those of moderate wealth. While the benefits of portability can be accomplished through the use of credit shelter trusts, the costs of setting up and administering such trusts can be avoided if portability is simply allowed as a matter of law. More importantly, allowing portability of the exemption amounts would ensure that taxpayers without professional legal and tax advice (or those that receive bad advice) would receive the same benefits as taxpayers with access to competent legal and tax advice.

Portability does introduce issues of administrability. For example, how should the IRS keep track of the unused exemption amounts, particularly for taxpayers that would otherwise not be required to file estate tax returns? One option would be to require the filing of an information return in order to retain any unused exemption amount for a surviving spouse. Another issue relates to the calculation of the allowable exemption in the case of taxpayers that marry multiple times. One option would be to limit the total amount of the exemption available to a decedent regardless of the number of marriages.

2) Dr. Sawyers, how important is reunification to a taxpayer?

Response:

The unequal exemption amounts complicate what is an already difficult analysis for a family to consider. While prudent estate planning often calls for making taxable lifetime gifts, it is difficult to convince taxpayers to implement an estate plan that includes the current payment of tax which may not be incurred at death due to a larger estate tax exemption.

While the tax exclusive nature of the gift tax, the use of valuation discounting techniques and the gift tax annual exclusion may result in a lower transfer tax being paid on lifetime gifts than a bequest, reunification is important in that compared to the current system, it decreases the cost of making lifetime gifts. This has the meritorious effect of encouraging small business owners to plan for the orderly lifetime transfer of management and control of their businesses to younger generations and provides an incentive for all taxpayers to make additional gifts of cash and other property to younger generations.

3) Dr. Sawyers, you stated that the decoupling of the estate and gift taxes created planning difficulties. Explain why this is the case.

Response:

In addition to the planning difficulties discussed in my response to question 2, having different estate and gift tax exemption amounts often results in more complicated estate plans than would be needed under a unified system.

Frequently, parents would like to structure their estate planning to take maximum advantage of their estate, gift and generation skipping transfer tax exemptions by setting up trusts during lifetime and at death for their children. When the exemption levels are different – the gift tax exemption is one amount while the estate and generation skipping transfer tax amounts are another - parents find themselves creating a tripartite structure. First, the parents will set up a trust to transfer to their children a portion of the family business equal in amount to their combined lifetime gift tax exemption (currently $2,000,000.) Then, the will of the first spouse to die leaves a portion of the business equal to the difference in value between the estate exemption and that spouse's gift exemption to a second trust for descendants. Then, the will of the surviving spouse, who could die many years later, creates a third trust in order to take advantage of the remaining exemption equal to the difference between the spouse's estate exemption and the spouse's lifetime gift exemption used to create the first trust. When coupled with the fact that the trusts created here may be meant for more than one generation of descendants, so that the generation-skipping transfer tax exemption is also considered, it becomes even more complicated and confusing.

Unification of the gift and estate tax exemptions would allow for a more timely transfer of a small business or family farm to descendants. Rather than transfer the business or farm piecemeal over many years, it is more likely that the assets could be transferred during the life of the original small business owner or farmer (at the same time that the owner is ready to pass on the reins of the business to the next generation) rather than having to wait until the death of both spouses, making for a more orderly transfer of management and control.

4) Dr. Sawyers, you state that another problem of decoupling is that it discourages small businesses succession planning during life. Has there been a decline in lifetime gifts because of this rule?

Response:

Decoupling of the gift tax and estate tax exemption amounts makes it more expensive for a small business owner to make lifetime gifts. Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L 107-16), the lifetime exemption for gifts was set at $1 million while the combined exemption for gifts and bequests continued to increase to the current level of $2 million. Accordingly, once an individual has made $1 million of cumulative lifetime gifts, a gift tax must be paid on any additional gifts in excess of the annual exclusion amount. In contrast, a $2 million bequest of assets can pass to heirs free of estate tax.

According to the Congressional Research Service ("Estate and Gift Tax Revenues: Past and Projected in 2008, RL34418, March 19, 2008), gift tax revenues fell by about half after enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L 107-16). In fiscal years 1999 through 2001, gift tax collections averaged $4.2 billion per year. In the six years after enactment, gift tax collections averaged only $1.8 billion per year. As a percent of total estate and gift tax revenue, the gift tax accounted for roughly 15 percent in 1999 through 2001 compared to 7 percent in 2002-2007.

So while we know that gift taxes have decreased in the last several years, determining exactly why they have declined is another matter. It is likely that the possibility of the future repeal of the estate tax also contributed to the decline. While making taxable gifts is often prudent when faced with a future estate tax, the prospect of estate tax repeal may have caused wealthy taxpayers to forego making taxable gifts.

Questions from Senator Kerry:

1) Under current law, an executor of an estate that includes real property used in farming or another trade or business generally may elect for estate tax purposes to value the property based on its current-use value, rather than based on its highest and best use. Do you think that this provision is helpful to small family businesses? Do you have suggestions for improvements to this provision?

Response:

The special use valuation rules under I.R.C. section 2032A provide very limited relief to small family businesses. In 2005, 199 estates claimed a special use valuation

under section 2032A (JCX-23-08, April 2, 2008). Experiences of practitioners indicate that the provision is of limited use due primarily to its rigid requirements including that taxpayers inheriting the property continue to use the property in a qualified manner for 10 years after the decedent's death. The complexity of the provisions may also result in inequitable treatment of taxpayers with and without professional advice.

Rather than modifying the rules of section 2032A, a simpler and more equitable approach to providing estate tax relief to small business owners, farmers and other taxpayers (including homeowners) who die holding illiquid assets is to increase the estate tax exclusion amount in a significant way in order to remove many taxpayers from the estate tax. As I noted in my testimony on April 3, of the $24.7 billion in estate tax paid with taxable returns filed in 2006, over 70% was attributable to the 4,282 returns with a gross estate in excess of $5 million.

2) Under current law, an executor may elect to pay an estate tax attributable to an interest in a closely held business in two or more, but in no more than 10, equal installments. Has this provision been helpful to small businesses? Do you have suggestions for improving this provision?

Response:

Closely held businesses often hold illiquid assets that are not readily converted to cash. As a result, by providing the ability to defer the payment of estate taxes and pay interest at a below-market rate, I.R.C. section 6166 has undoubtedly been helpful to some small businesses. However, as a practical matter, the number of estates electing to defer taxes under section 6166 has been small. For example, the Joint Committee on Taxation reports that for taxpayers dying in 2001, only 488 estates including small business assets elected deferral of tax liability under section 6166. For estate tax returns filed in 2005, only 182 estates made a section 6166 election (JCX-23-08, April 2, 2008).

In fact, many estates hold illiquid assets or assets that can not be easily converted to cash (real estate, retirement assets, etc.) without incurring significant income tax and other costs. In order to make section 6166 more useful, Congress should consider modifying the provisions to broaden its application to all estates, not just those holding closely held businesses. Such a provision would be simple and less disruptive to small businesses and other taxpayers in that it would eliminate the need to artificially structure a business in a certain way in order to meet the rigid requirements of current section 6166, and would avoid having to determine whether a closely held business qualifies as an active business.

3) For estates of a decedent dying in 2003 or earlier, there was permitted a deduction for the value of the qualified family-owned business interests of the decedent. Under present law, the qualified family-owned business deduction will be available for decedents dying after 2010. I support the concept of a deduction for

qualified-family owned business interests. I have heard from practitioners that this provision was complicated and difficult to administer. What are your thoughts about this provision? Do you have suggestions for improving this provision?

Response:

As with other targeted relief provisions, the requirements under I.R.C. section 2057 providing a deduction for a qualified family owned business interest are complex and difficult to satisfy resulting in limited use by taxpayers. For example, in 2001, of the over 15,000 estates with closely held business assets, just over 1,000 elected section 2057 (JCX-23-08, April 2, 2008).

While the rules of section 2057 might be tweaked to broaden the applicability of the provision and to reduce the complexity of the rules, offering broader relief such as increasing the estate tax exclusion amount would be simpler and provide more equitable relief for small business owners, farmers and other taxpayers with illiquid assets.

Senator Charles E. Schumer

Opening Statement
Senate Finance Committee Hearing on the Estate Tax
April 3, 2008

Thank you, Mr. Chairman, for scheduling this series of hearings on the estate tax. We all know that reform is on the horizon, and it will probably take place sometime next year, since the administrative and legal problems that would be caused by one year of estate tax repeal in 2010 are simply huge.

Any long-term reform in this area will be expensive, of course, but I know that the Committee will work in a bipartisan way to ensure that we don't allow foreseeable problems to come to pass, and that we don't allow 2001 law to come back again in 2011. There is a middle ground out there that we can reach that will be fair to families and businesses alike if people are able to set aside their ideological differences and work out a true compromise.

Ironically, those who favor complete repeal of the estate tax – or any taxes on investment income, for that matter – now find themselves in a position where they will be able to get a less favorable reform than they could have several years ago, back when President Bush first got elected. By insisting on full repeal then, rather than a compromise, they let external events dictate the future outcome. Now, the long-term budget picture is more ominous, and we simply won't be able to afford in 2009 what might have been affordable in 2001. But I feel confident that we will work something out.

I wanted to take a moment this morning to add some context to the estate tax issue, because there is an angle to this topic that gets little attention. I also wanted to suggest a couple of reforms that I believe any estate tax compromise should include.

First, some context. The Finance Committee has many members from states where agricultural and ranching issues are very important – and members stand up for those interests, as they should.

Why is this an important factor in the estate tax debate? **Because if you are from a rural or agricultural state, given a certain amount of revenue that can be set aside for a particular estate tax reform, you prefer an option that maximizes the exemption amount, in order to get the vast majority of your constituents off the estate tax entirely.** You are much less sensitive to the rate. I wouldn't go so far as to say that those members believe the rate is unimportant, but the exemption amount is more important. This is not a criticism of any particular reform proposal; I am simply pointing out the obvious.

However, if you are from a state that has a lot of people, in addition to (or as opposed to) a lot of farms and ranches, then you are more likely to have numerous constituents that have accumulated significant assets before they die, whether those assets are from investments, or inheritances, or personal savings, or housing, or collectibles. **Generally speaking, if you have a lot of people in your state, given a certain amount to spend on estate tax reform, then your constituents as a whole will be better off with a reform that lowers the rate, even if that means the exemption cannot be raised as much.**

This friendly tension between the rate and the exemption, and how a state's population and economy may impact the most desirable overall policy, is not discussed often enough when people consider permanent estate tax reform.

My personal view has always been that small businesses or farms that are passed on from one generation to the next should not incur any estate tax, although I understand how difficult the rules are to write in this area, and the previous attempt with QFOBI was complicated and too restrictive. But when the Committee drafts a proposal next year, I hope it will consider how different combinations of exemptions and rates can have disparate impacts depending on the economies and populations of our states. **What works best for New York may not work best for another state, and I intend to make sure that the long-term reform that becomes law is good for New Yorkers.**

Second, let me briefly mention a couple of common-sense reforms. Again, given a certain amount of revenue to work with, these reforms may mean that we can raise the exemption or lower the rate a little bit less, but that fact does not reduce their importance. I know that members of today's panel are addressing these particular issues.

- We should make sure that one spouse's unused credit can be automatically passed to the surviving spouse, even if the spouse that died had done no estate planning. In other words, we should eliminate the need to do estate planning for all but the wealthiest Americans. This is a common-sense reform that I know has bipartisan support. If we eliminate the need for families to set up a credit-transfer trust, the impact of the estate tax will be more equitable, and it will be a major step towards tax simplification.

  We might be able to raise the exemption a little less since every couple will effectively have a total exemption of twice the statutory limit, whereas today this is only true for couple that have done estate planning. But this reform is the right thing to do.

- We should also set the lifetime gift tax exclusion and the estate tax exemption at the same amount. They used to be the same before 2001, but since then, the gift tax exemption has been fixed while the estate tax exemption has been rising. This sets up the perverse result that people are less willing to give away their assets while they are alive.

  We should want wealthy individuals and small business owners to give assets to their heirs before they die. I think it's an essential common-sense reform to make these two amounts equal again, even if it means the overall exclusion is raised a little bit less.

Mr. Chairman, I have now used up most of my time. The only thing I would ask at this stage is whether the members of the panel agree that the two reforms that I have laid out, assuming we stick with an estate tax model, are indeed ideas that they believe should be in a final compromise.

Thank you, Mr. Chairman.

COMMUNICATIONS

Testimony of Dick Patten
President
American Family Business Institute

U.S. Senate Finance Committee
Hearing
"Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning"

April 3, 2008

Chairman Baucus, Ranking Member Grassley, and Members of the Committee. I appreciate the opportunity to address the committee about the death tax, a subject very important to me and the hundreds of family business owners and farmers which I represent as President of the American Family Business Institute. For us, the death tax is not just another less-desirable source of revenue. It is an unjust confiscation of life-earnings, which often results in the forced sale of family-owned farms and businesses.

Today the Senate Finance Committee heard testimony from four witnesses. The testimony of the first three witnesses was largely a distraction from the real issue. These witnesses – representatives of the various tax-planning industries – proposed "band-aid" solutions which will provide limited tax relief, but maintain the death tax in its essential form. These proposals assume that my members – the family-farmers and business-owners – are only advocating a simpler confiscation of their legacies when they die. My members – and 68% of Americans[1] – want the death tax to be abolished.

The final witness, Ms. Diana Aviv, represented the ideological position which is at the heart of the death tax – the belief that government should use tax policy to redistribute property. Ms. Aviv made it clear that she wants tax policy to ensure that earned wealth is redistributed to the big foundations and charities she represents. Ironically enough, it is the death tax which most directly harms those who make the greatest philanthropic contributions by damaging their wealth making potential, a fact that seems lost on Ms. Aviv.

Though it is tempting to ignore and dismiss Ms. Aviv's testimony as ideological, I believe it is important to address her fallacious view of the effect of the death tax on charity. Some members of Congress might be led to think that the death tax is the primary incentive for entrepreneurs to give to charitable causes. This would be far from the truth.

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[1] Harris Interactive Poll, April 2007.

Review of Diana Aviv's testimony

Early in her testimony, Ms. Aviv made the argument that without the death tax, charitable giving from America's wealthiest citizens would be considerably reduced. She stated "Congress has provided even greater motivation for Americans to give back to their communities through their estates by permitting unlimited deductions for charitable contributions when calculating estate taxes...these incentives have had a significant influence on the how – and how much – Americans give to support charitable causes."[2] In support of this argument, Ms. Aviv cited a 2004 study by the Congressional Budget Office.[3] Though Aviv's claim and the CBO study may seem plausible at first glance, the actual economic reality is very different, as demonstrated by the following studies and data.

Ms. Aviv's claim only represents one side of charitable giving – that which is motivated by the incentives of the death tax. The other side is the personal, altruistic and spiritual motivations for making a charitable gift. In fact, charitable giving because of religious, moral, or altruistic sentiment is an American tradition that predates the death tax by 300 years. The effect of the death tax on philanthropy depends on which of these motivations is more influential in effecting donor giving. If the incentives for giving were entirely material – which no one maintains – then Ms. Aviv's argument would be sound. However, if spiritual and altruistic motivations provide the primary impetus for making gifts, then the death tax can at most only affect the timing of the gift, and at worse can decrease the overall wealth available to make charitable bequests.

The economist David Joulfaian published a study with the Treasury Department in 2005, in which he compared the effects of two different estate tax rates in two different years on charitable giving. Joulfaian minimized statistical error by examining data on "decedents in 1976 and 1982, two regimes that embody substantially different tax rate schedules but where the measurement of wealth and charitable bequests is virtually identical."[4] In 1976 the estate tax had a top rate of 77%, while in 1982 the top tax rate was 65%. Despite the lower estate tax in 1982, there was an increase in charitable bequests by estates subjected to the tax cuts. Joulfaian concluded that "Descriptive statistics on the pattern of giving in 1976 and 1982 show that giving to charity did not decline in the aftermath of tax rate reductions in 1982, and suggest that estate taxation may have little effect on bequests."[5]

Further research has been conducted on the incentives of the death tax and serves to confirm Joulfaian's findings. As a result of the reductions in the death tax from 55% to 48% between 2001 and 2004, one might expect the size of bequests to shrink. However, just the opposite has occurred, with the size of the average bequest (on estate tax returns)

[2] Diana Aviv, Testimony to U.S. Senate Finance Committee, Hearing on "Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning," April 3, 2008, 2.
[3] Congressional Budget Office, *The Estate Tax and Charitable Giving,* July 2004.
[4] David Joulfaian, "Estate Taxes and Charitable Bequests: Evidence from Two Tax Regimes," U.S. Department of Treasury," Office of Tax Analysis, OTA Paper 92 (March 2005), 6.
[5] Ibid.

growing more than 40% during that time period.[6] Moreover, the percent of taxable estate tax returns that made a charitable bequest grew from 20.6% in 1999-2001 to 21.2% for the period 2002-2004.[7] In fact, another voice of charities, the Giving Institute, reported in their 2005 annual publication, *Giving USA,* that "Despite predictions, there has been no observed impact on charitable giving from the gradual change in estate tax filing requirements."[8]

On the other side of the coin, survey data shows that personal donor intent outweighs tax benefits as the incentive for making a contribution. In fact, a survey of the wealthiest families found that the primary motivating factor for increasing their charitable giving is to "find a worthy cause that you feel passionate about."[9]

Regardless of the evidence, one gets the impression that Ms. Aviv would stick by her opposition to repeal. Ms. Aviv, as demonstrated by the following comments, is strongly motivated by an ideological commitment to income redistribution. For her, charity is not so much about voluntary giving to serve other humans, as much as it is a means to "make sure that all people of all generations start out equal."[10]

A true humanitarian is not interested in how much wealth is redistributed, but in how much human suffering is alleviated. Ms.Aviv is concerned that "There are too many people of immense wealth who have benefited from large windfalls who are not giving as they should."[11] Hence, it is seems likely that she would be content with a decline in total giving, so long as the leveling of family inheritances through the death tax achieved her desired egalitarian ends.

In this way, Ms. Aviv hardly is an appropriate advocate for charities. It would be one thing if she honestly misunderstood the data, and was genuinely concerned that the repeal of the death tax would result in a substantial loss in donations and hence in aid to the less fortunate. However, she made the mistake at today's hearing of airing her true, ulterior motive. As such, she has lost her credibility and should be disregarded.

The true story is that the death tax destroys wealth producing potential, thereby decreasing the overall level of economic activity and concomitantly, the level of future philanthropic activity. The average American family-business owner or farmer, as well as their future heirs, are rooted members in their local communities. They have a direct interest in sustaining and improving the ground from which their enterprise has grown.

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[6] Joint Economic Committee calculations based on data from Internal Revenue Service, "Estate Tax Returns," (various years), online at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html
[7] Ibid.
[8] JEC calculation using data from AAFRC Trust for Philanthropy, *Giving USA 2005*, (New York, NY: AAFRC Trust for Philanthropy, 2005), 29.
[9] Paul G. Schervish and John J. Havens, "Extended Report of the Wealth with Responsibility Study," Social Welfare Research Institute, Boston College (March 2001), 27
[10] Diana Aviv, Testimony to U.S. Senate Finance Committee, Hearing on "Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning," April 3, 2008, response to questions from Senators.
[11] Ibid.

These individuals are often life-long, committed altruists. Encouraging and promoting the longevity of their involvement in their community is in the interest of all charities.

The death tax ends or reduces their charitable involvement to the extent that it often results in the complete or partial sale of the enterprise. Though charities may benefit from final large donations designed to reduce total tax liability, they lose the long-term involvement of the family in the charity. The economic data presented above shows that the death tax results in no discernible benefit to charities, meaning that it very well may harm charities by destroying their donors' financial base.

A survey by two scholars at Boston College indicates that many wealthy Americans would make considerably greater charitable contributions, except for the death tax. According to the survey, respondents indicated that they expected to contribute 28% more in taxes than they desired, while they would be contributing 17% less to heirs and 10% less to charity than desired.[12] In the absence of the death tax one would expect the contribution to charity to markedly increase.

Conclusion

Members of the Committee, the death tax should not be preserved to provide the salaries of the tax-planning industry, nor should it be maintained on incorrect economic assumptions about its impact on philanthropy. On the contrary, the evidence – documented in multiple prior testimonies – shows that the real problem with the death tax is its harm to capital development and economic growth, particularly for closely held (family-owned) farms and businesses.

These enterprises are often asset-rich but cash-poor operations. They may have millions of dollars worth of lumber, productive land and livestock, machinery, and inventory, but they do not have adequate liquid assets (cash or easily convertible stock) which can be used to pay the tax. When the tax comes due on the heirs of these enterprises, they are often forced to sell, take an expensive, business-crippling loan, or split off profitable operations.

Towards the end of the hearing, Senator Jon Kyl cited the study by economist Alicia Munnell, in which she explains that "the compliance costs of the transfer tax system may well approach the revenue yield." A tax that imposes such a high cost on the economy – particularly on its most hard-working producers – has outlasted its purpose.

For as often as Congress likes to claim that it cares about the family-farm and business, it is time to see real action on a law that threatens the existence of these institutions. Please mark-up legislation this year to repeal the death tax. Thank you.

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[12] Schervish and Havens, 35.

Dick Patten
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Testimony to:

The U.S. Senate Finance Committee
Hearing on "Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning"
April 3, 2008

The first death tax in the United States was enacted in 1797 in the form of a Stamp Tax, which required the purchase of federal tax stamps to transfer property from an estate. The tax died five years later when Thomas Jefferson signed its repeal. Thomas Jefferson recognized the problem of wealth disparity and launched a fight against primogeniture, the practice of passing estates intact to the eldest son. He insisted, however, that the government had no business using its power of taxation to benefit from the deaths of its people. Jefferson absolutely rejected the concept of redistribution as a tool for achieving social equity.

> "Our wish... is that... equality of rights [be] maintained, and that state of property, equal or unequal, which results to every man from his own industry or that of his fathers."
> --**Thomas Jefferson**: 2nd Inaugural Address, 1805.

> "The laws of civil society, indeed, for the encouragement of industry, give the property of the parent to his family on his death, and in most civilized countries permit him even to give it, by testament, to whom he pleases."
> --**Thomas Jefferson** to Thomas Earle, 1823.

> "To take from one because it is thought that his own industry and that of his father's has acquired too much, in order to spare to others, who, or whose fathers have not exercised equal industry and skill, is to violate arbitrarily the first principle of association--'the *guarantee* to every one of a free exercise of his industry and the fruits acquired by it.'"
> --**Thomas Jefferson**: Note in Destutt de Tracy's "Political Economy," 1816.

> "If the overgrown wealth of an individual is deemed dangerous to the State, the best corrective is the law of equal inheritance to all in equal degree; and the better, as this enforces a law of nature, while extra-taxation violates it."
> --**Thomas Jefferson**: Note in Destutt de Tracy's "Political Economy," 1816.

"The taxes with which we are familiar class themselves readily according to the basis on which they rest. 1. Capital. 2. Income. 3. Consumption. These may be considered as commensurate; Consumption being generally equal to Income, and Income the annual profit of Capital. A government may select either of these bases for the establishment of its system of taxation, and so frame it as to reach the faculties of every member of the society, and to draw from him his equal proportion of the public contributions; and, if this be correctly obtained, it is the perfection of the function of taxation. But when once a government has assumed its basis, to select and tax special articles from either of the other classes, is double taxation. For example, if the system be established on the basis of Income, and his just proportion on that scale has been already drawn from every one, to step into the field of Consumption and tax special articles in that, as broadcloth or homespun, wine or whiskey, a coach or a wagon, is doubly taxing the same article. For that portion of Income with which these articles are purchased, having already paid its tax as Income, to pay another tax on the thing it purchased, is paying twice for the same thing; it is an aggrievance on the citizens who use these articles in exoneration of those who do not, contrary to the most sacred of the duties of a government, to do equal and impartial justice to all its citizens."
--**Thomas Jefferson**: Note to Destutt de Tracy's "Political Economy," 1816.

"Private fortunes are destroyed by public as well as by private extravagance. And this is the tendency of all human governments."
--**Thomas Jefferson** to Samuel Kercheval, 1816.

"[If government has] a right of demanding *ad libitum* and of taxing us themselves to the full amount of their demand if we do not comply with it, [this would leave] us without anything we can call property."
--**Thomas Jefferson**: Reply to Lord North, 1775.

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April 3, 2008

The Honorable Max Baucus
Chairman
U.S. Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Charles Grassley
Ranking Member
U.S. Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Baucus and Ranking Member Grassley:

I appreciate this opportunity to present thoughts on behalf of the National Cattlemen's Beef Association (NCBA) with regards to the Finance Committee hearing entitled "Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning." Producer-directed and consumer-focused, NCBA is the largest and oldest organization representing America's cattle producers, and it is dedicated to preserving and advancing the beef industry.

Tax policy has a profound impact on the business climate for farmers and ranchers, and relief from the Death Tax is a top priority for cattlemen. NCBA is eager to engage with you and other members of the Committee to explore "outside the box" ideas that can lead to the enactment of meaningful legislation.

Our nation's structure for addressing the transfer of assets at the time of death is a significant burden on cattle producers. The current law generates costs to taxpayers, the economy and the environment that far outweigh any potential benefits. With a great deal of uncertainty in estate tax law over the next three years, this situation will only get worse. It is imperative for Congress to carefully evaluate all aspects of this issue in order to quickly bring about legislation that will eliminate or significantly reduce the burden of estate and gift taxes on family farms, ranches and small businesses. Such legislation should *not* increase the gift or estate tax liability for farmers or ranchers and should *not* repeal the stepped-up basis provisions.

NCBA policy has long supported full and permanent repeal of the Death Tax as the ultimate solution. However, appreciating that today's hearing is meant to focus on evaluating technical aspects of the law rather than on the merits of repeal, I would like to highlight several items of particular interest to cattle producers.

First, an unlimited or considerably increased estate tax exemption is an essential component of reform. It is important to recognize that beef producers largely operate in an asset-rich, cash-poor business model; a cattleman's biggest asset is his land. Urban expansion is continuing to pressure property values and, more recently, high commodity prices driven by unprecedented demand for food, feed and fuel have contributed to sharp increases in agricultural land values. Further compounding the situation, economies of scale have driven families that are wholly dependent upon farming and ranching income to expand the scope of their operations. Very few cattlemen or cattlewomen are "getting rich" in today's business climate; if anything it is the opposite. Regardless, these factors continue to compel a significant increase in the value of farming and ranching estates. It is essential that any legislation reflect this dynamic situation.

Even with a large increase in the exemption, some farms and ranches will still be impacted by the tax simply by "luck" of geography. For the reasons outlined above, land values continue to far outstrip inflation in some regions of the country, and for families seeking to maintain their operation for generations to come, it is inevitable that their estate will exceed the exemption threshold. Congressional action on this issue should recognize this reality by eliminating or significantly reducing estate tax rates.

NCBA also strongly encourages the Committee to evaluate improvements to special use valuations. Specifically, NCBA urges the removal of limitations on special use valuations such as Section 2032A, which states that if an executor may value their property based on its "qualified use" rather than its "highest and best use." This valuation can considerably reduce the estate tax burden on family farms and ranches by more accurately reflecting the value of property that has been and will continue to be used for farming and ranching purposes. NCBA stands ready to work with the Committee on this important aspect of the law.

Finally, NCBA is supportive of allowing a surviving spouse to utilize the unused portion of their partner's exemption. A couple seeking to prepare for the transfer of their farm or ranch to the next generation should not have to go through the time and expense of splitting assets solely to ensure that they can utilize the entire portion of the estate tax exemption. NCBA feels that portability would address that issue, and thus further reduce the burden of the Death Tax.

NCBA appreciates the Committee's focus on this issue. The reality is that regardless of all political beliefs and budgetary constraints, the Death Tax continues to be a momentous burden to farmers and ranchers. For that reason, it is imperative that we work together to explore new approaches that can successfully navigate the legislative labyrinth. The aforementioned policy suggestions represent several key priorities supported by American cattle producers, and I hope that you will carefully consider them. I would also note, however, that this list is not meant as a constraint to the dialogue; NCBA is eager to work with you to explore all aspects of this issue.

Thank you again for holding this hearing, "Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning." Congress must take steps to address the challenge facing cattle producers as they struggle to plan for the transfer of their livelihood from one generation to the next, and this hearing is a clear indication of your commitment to that objective. As you contemplate legislative action, I hope that you will carefully weigh the potential impacts on family farms, ranches and small businesses. As discussed above, this group often faces unique challenges, and it is critical that their interests are taken into account. U.S. cattle producers need your leadership to bring about certainty and relief from the Death Tax, and I look forward to continuing to work with you on this important issue.

Sincerely,

Andy Groseta

Andy Groseta
President, National Cattlemen's Beef Association
Arizona Cattle Producer