MAJOR ESTATE AND GIFT TAX ISSUES

HEARING

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 23, S. 395, S. 404, S. 557, S. 574, S. 858 and S. 995

JUNE 5, 1981

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MAJOR ESTATE AND GIFT TAX ISSUES

FRIDAY, JUNE 5, 1981

U.S. SENATE,
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Steven D. Symms (chairman) presiding.

Present: Senators Dole, Symms, Grassley, Long, Byrd, and Boren.

[The press release announcing this hearing and the bills S. 23, S. 395, and S. 955 and the joint committee print of same follow:]

[Press Release No. 81-131, May 13, 1981]

FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION TO CONTINUE HEARINGS ON MAJOR ESTATE TAX ISSUES

Senator Steve Symms, Chairman of the Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing to discuss major estate tax issues on June 5, 1981. The Subcommittee will continue to review the issues raised in its hearing of May 1, 1981.

The hearing will begin at 9 a.m. in Room 2221 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Symms noted that testimony before the Subcommittee has demonstrated the considerable public concern over the impact of estate taxes on family farms and businesses. According to Symms, "it is clear that the estate and gift tax laws no longer primarily tax the very wealthy. Witnesses before the Subcommittee have confirmed that the present estate tax unduly burdens small enterprises and may even tend to increase the concentration of wealth as small farms and businesses are absorbed into larger enterprises."

Senator Symms stated that the June 5 hearing would focus on particular problems of the estate and gift tax laws, including the special use valuation for farm property and the interaction of estate tax laws with the gift tax. Witnesses are urged to direct their testimony to the general purpose of the estate and gift tax or to the legislative solutions that have been proposed for specific problems.

To focus the issues to be considered at the June 5 hearing, the Subcommittee will continue its review of pending bills that are designed to broadly revise the estate and gift tax laws and minimize the burden on small- and moderate-size estates. In addition, the Subcommittee will review two other bills that address technical problems with the special use valuation, section 2032A of the Internal Revenue Code, and a proposal providing for the annual filing of gift tax returns.

The more general estate and gift tax bills before the Subcommittee are:

S. 404—Introduced by Senator Symms and Senators Jepsen and Boren. Would repeal the Federal estate and gift tax.

S. 395—Introduced by Senators Wallop, Boren, Byrd, Durenberger, Symms, Baucus, Bentsen, Matsunaga, and others. Would increase the Federal estate and gift tax exclusion to $600,000, provide an unlimited marital deduction and make other revisions in the estate and gift tax laws.

S. 858—Introduced by Senator Durenberger and Senator Thurmond. Would increase the Federal estate and gift tax exclusion to $600,000 and revise rules governing the special use valuation.

S. 574—Introduced by Senator Kassebaum and others. Would allow a marital deduction up to $750,000 and provide a similar deduction for heirs other than the spouse.

The additional bills to be considered are:

S. 23—Introduced by Senator Dole with Senators Percy and Hatfield. Would make clear that crop share rentals qualify as a standard of valuation under section 2032A.

S. 557—Introduced by Senator Cochran. Would allow estates that filed estate tax returns before July 13, 1978, to elect the special use valuation.

S. 955—Introduced by Senator Byrd of Virginia and Senator Packwood. Would permit reporting of the gift tax on an annual basis and end the requirement of quarterly returns.

Requests to Testify. Witnesses who desire to testify at the hearing must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, *to be received no later than close of business on May 29, 1981.* Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated Testimony. Senator Symms urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. The procedure will enable the Subcommittee to receive a wider expression of views than it might otherwise obtain. Senator Symms urges very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act. Senator Symms stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) All witnesses must submit written statements of their testimony.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by noon on Thursday, June 4, 1981.

Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for the oral summary.

Written statements. Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, not later than *Friday, June 5, 1981.* On the first page of your written statement please indicate the date and subject of the hearing.

DESCRIPTION OF ADDITIONAL ESTATE AND GIFT TAX BILLS (S. 23, S. 557, AND S. 955)

INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on June 5, 1981, regarding particular problems of the estate and gift tax laws, including the special use valuation for farm property and the interaction of the estate tax laws with the gift tax. This hearing is a continuation of the Subcommittee's review of the estate and gift tax laws that it began with its hearing on May 1, 1981. A staff pamphlet (JCS-16-81) was prepared in connection with the May 1, 1981, hearing, which contained a brief description of present law, background information on estate and gift tax laws, a discussion of the issues involving modifications to the estate and gift tax laws, and a description of four bills, S. 404, S. 858, S. 395, and S. 574.

The hearing to be held on June 5, 1981, will continue the Subcommittee's review of these four bills and, in addition, will review two other bills (S. 23 and S. 557) that address technical problems with the provision that permits special use valuation (Code section 2032A) and a bill (S. 955) that provides for the filing of gift tax returns, and payment of gift taxes, on an annual basis. This document, prepared in connection with the June 5 hearing, provides a description of the three additional bills (S. 23, S. 557, and S. 955) and supplements the pamphlet prepared for the May 1 hearing (JCS-16-81). The description of each bill contains a summary of present law, a description of the issues raised by the bill, a description of the bill, an estimate of the revenue effect of the bill, and a description of any prior Congressional action.

I. SUMMARY

1. S. 23--Senators Dole, Percy, Kassebaum, and Hatfield

USE OF NET SHARE RENTAL INFORMATION TO VALUE FARM AND BUSINESS REAL PROPERTY ON THE BASIS OF CURRENT USE

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value rather than full fair market value, provided that the gross estate may not be reduced more than $500,000 (Code sec. 2032A). In general, the current use valuation may be determined under a "multiple factor" approval or by a capitalization of income formula that is primarily based on cash rentals for comparable farm land.

The bill would provide that if there is no comparable land from which to determine the average gross cash rental, then the average net share rental could be substituted for the average gross cash rental in applying the formula method of valuation.

2. S. 557--Senator Cochran

TRANSITIONAL RULE FOR ELECTION OF CURRENT USE VALUATION OF FARM OR OTHER BUSINESS REAL PROPERTY

For estate tax purposes, real property must ordinarily be valued at its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at current use value rather than full fair market value, provided that the gross estate may not be reduced more than $500,000 (Code sec. 2032A).

The election for special valuation must be made not later than the due date for the estate tax return (Code sec. 2032A(d)(1)). It is to be made in the manner as prescribed under Treasury regulations.

The bill provides a special rule for returns required to be filed before July 13, 1978. Under this special rule, an election could be made by an estate required to file before such date no later than the 90th day after the later of the date of enactment of the bill. In addition, the bill extends the statute of limitations to allow claims for refund to be made until 90 days after the end of this special election period.

II. DESCRIPTION OF BILLS

1. S. 23--Senators Dole, Percy, Kassebaum, and Hatfield

USE OF NET SHARE RENTAL INFORMATION TO VALUE FARM AND BUSINESS REAL PROPERTY ON THE BASIS OF CURRENT USE

Present law and background

In general

For estate tax purposes, real property must ordinarily be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $500,000 (Code sec. 2032A).

Qualification requirements

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

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1/ The "adjusted value" of the gross estate or of specific property is its gross value less any mortgages or other indebtedness, payment of which are secured by an interest in the property included in the gross estate (or by the specific property).

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

3/ The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2032A(a) and (b)).4/

Valuation methods

Under present law, the current use value of eligible real estate can be determined under either of two methods: (1) the multiple factor method or (2) the formula method.

Multiple factor method.--The current use value of all qualified real property may be determined under the multiple factor method (sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property.

Formula method.--If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued under the formula method (Code sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for the comparable land from the average annual gross cash rental for comparable land used for farming, and (2) dividing that amount by the average annual effective interest for all new Federal Land Bank loans.5/

On July 19, 1978, the Department of the Treasury issued proposed regulations defining gross cash rental for purposes of the formula method. Under the proposed regulations, if no comparable farm property had been leased on a cash basis, then the formula method could be applied by converting crop share rentals into cash rentals. If the crops were sold for cash in a qualified transaction, the selling price would be considered the gross cash rental. If no qualified sale occurred, then the gross cash rental would equal the cash value of the crops on the date received on an established public agricultural commodities market.

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

5/ Each average annual computation must be made on the basis of the 5 most recent calendar years before the decedent's death.

On September 10, 1979, the Department of the Treasury withdrew the portion of the regulations relating to gross cash rental proposed in July and published another proposed regulation defining gross cash rental. The new proposed regulations provided that crop share rentals could not be used under the formula method. Rather, if the formula valuation method were used, the executor was required to document to the Internal Revenue Service those tracts of comparable property that were rented solely for cash.

Final regulations were published on July 31, 1980 (Treasury decision 7710).6/ The final regulations adopted the definition of gross cash rental contained in the September 10, 1979, proposed regulations. Consequently, under the final regulations, if no comparable land in the same locality is rented solely for cash, the formula method may not be used and qualified farm property may be valued based on its current use only by the multiple factor method.

Issue

The issue is whether qualified farm property may be valued under the formula method by using crop share rentals if no comparable land is leased solely for cash but comparable land is leased partially or completely on a crop share basis.

Explanation of the bill

The bill would provide that if there is no comparable land in the same locality from which to determine the average annual gross cash rental, then the average net share rental could be substituted for the average gross cash rental in applying the formula method. The net share rental would be (1) the value of the produce grown on the leased land received by the lessor, reduced by (2) the cash operating expenses of growing the produce that are paid, under the terms of the lease, by the lessor.

Prior Congressional action

On March 4, 1980, the Subcommittee on Taxation and Debt Management of the Committee on Finance held a hearing on two bills (S. 1859, 96th Cong., and S. 2201, 96th Cong.), which were identical in substance to the present bill. No further action was taken on S. 1859 or S. 2201.

On August 4, 1980, the Subcommittee held a hearing on another bill (S. 2967, 96th Cong.), which contained a provision identical in substance to the present bill. No further action was taken on S. 2967.

6/ 45 Fed. Reg. 50736 (1980).

Effective date

The provisions of S. 23 would apply to estates of decedents dying after the date of enactment of the bill.

Revenue effect

It is estimated that this bill would have no effect on fiscal year 1981 budget receipts and would reduce budget receipts by less than $5 million in fiscal year 1982 and by $25 million annually for fiscal years 1983 and thereafter.

2. S. 557--Senator Cochran

TRANSITIONAL RULE FOR ELECTION OF CURRENT USE VALUATION OF FARM OR OTHER BUSINESS REAL PROPERTY

Present law and background

In general

For estate tax purposes, real property must ordinarily be valued based upon its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $500,000 (Code sec. 2032A).

Qualification requirements

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his death; (2) the value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property), is at least 50 percent of the adjusted value1/ of the decedent's gross estate; (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;2/ (4) the real property qualifying for current use valuation passes to a qualified heir;3/ (5) such real property has been owned by the decedent or a member of his family and used or held for use as a farm or closely held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there has been material participation in the operation of the farm or closely held business by the decedent

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1/ The "adjusted value" of the gross estate (or of specific property) is its gross value less any mortgages or other indebtedness, payment of which are secured by an interest in property included in the gross estate (or by the specific property).

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

3/ The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (Code secs. 2032A(a) and (b)).4/

Valuation methods

Under present law, the current use value of eligible real estate can be determined under either of two methods: (1) the multiple factor method or (2) the formula method.

Multiple factor method.--The current use value of all qualified real property may be determined under the multiple factor method (Code sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation or real estate (for example, comparable sales) and any other factors that fairly value the property.

Formula method.--If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued under the formula method (Code sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for the comparable land from the average annual gross cash rental for comparable land used for farming, and (2) dividing that amount by the average annual effective interest for all new Federal Land Bank loans.5/

Election of special valuation

The election for current use valuation must be made not later than the due date for the estate tax return (Code sec. 2032A(d)(1)). It is to be made in the manner prescribed under Treasury regulations.

Background

These provisions were enacted by the Tax Reform Act of 1976 and were effective with respect to estates of decedents dying after December 31, 1976.

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

5/ Each average annual computation must be made on the basis of the 5 most recent calendar years before the decedent's death.

In June 1977, the Internal Revenue Service issued a revised estate tax form (Form 706). This form indicated the manner in which the election was to be exercised.

On July 13, 1978, proposed regulations relating to the manner of exercising the election were published. Under the proposed regulations, the current use valuation provision was to be available only if there were some nonfarm use for the property. The proposed regulations also provided that elections of current use valuation were generally irrevocable. A special rule was provided, however, permitting estates making the elections before 30 days after adoption of final regulations (i.e., August 30, 1980) to revoke their elections, but only if the revocations were filed before January 31, 1981.

On July 19, 1978, the Department of the Treasury issued additional proposed regulations interpreting the material participation qualification requirements (Code secs. 2032A(b)(1)(ii), (c)(7)(B), and (e)(6)), and defining gross cash rental for purposes of the formula valuation method (Code sec. 2032A(e)(7)(A)). These proposed regulations, like those of July 13, 1978, provided that the current use valuation provision was to be available only if the real property had a higher use than farming.

The proposed regulations also provided that if no comparable farm property in the locality of the decedent's property had been leased on a cash basis, then the formula method could be applied by converting crop share rentals into cash rentals. If the crops were sold for cash in a qualified transaction, the selling price would be considered the gross cash rental. If no qualified sale occurred, then the gross cash rental would equal the cash value of the crops on the date received on an established public agricultural commodities market.

On September 10, 1979, the Department of the Treasury withdrew the proposed definition of gross cash rental and published another proposed regulation defining gross cash rental. The new proposed regulation provides that crop share rentals could not be used under the formula method. The Internal Revenue Service also issued on that date a news release indicating that current use value would be available with respect to any real property which satisfied the requirements of section 2032A, even if there were no other highest and best use for the property.

Final regulations were published July 31, 1980 (Treasury decision 7710).6/

Issue

The issue is whether special transitional rules should be provided to permit special valuation elections to be made after the time prescribed under present law with respect to certain estates.

6/ 45 Fed. Reg. 50736 (1980).

Explanation of the bill

The bill would provide a special rule for estate tax returns required to be filed before July 13, 1978 (the date on which the first proposed regulations were published). Under this special rule, an estate required to file its estate tax return before July 13, 1978 (without regard to any extensions of time to file) could make or revoke a current use valuation election during the 90-day period after the date of enactment of the bill. In addition, the bill would extend the statute of limitations to allow claims for refund to be made until 90 days after the end of this special election period.

Effective date

The provisions of the bill would be effective with respect to estates of decedents dying after December 31, 1976, whose estate tax returns were required to be filed before July 13, 1978 (without regard to extensions of time to file).

Revenue effect

It is estimated that this bill would reduce budget receipts by $15 million in fiscal year 1981 and by less than $5 million in fiscal year 1982.

3. S. 955--Senators Byrd (of Virginia) and Packwood

ANNUAL PAYMENT OF GIFT TAX

Present law

Prior to 1971, gift tax returns were required to be filed, and any gift tax liability paid, on an annual basis. The due date for filing this return, and for payment of any gift tax, was the April 15 following the calendar year in which the gift was made.

The Excise, Estate and Gift Tax Adjustment Act of 1970 changed these requirements so that gift tax returns be filed, and any gift tax paid, on a quarterly basis. The due date for filing the quarterly return was the 15th day of the second month following the close of the calendar year (e.g., May 15 for gifts made in the first calendar quarter).

The Tax Reform Act of 1976 further modified these rules so that a quarterly gift tax return is required only if the sum of (1) the taxable gifts made during the calendar quarter plus (2) all other taxable gifts made during the calendar year (and for which a return has not been required to be filed) exceeds $25,000. If a quarterly return is required, the due date for filing this return, and for payment of any gift tax, is the 15th day of the second month following the close of the calendar quarter for which a return is required. If all taxable transfers made in a calendar year do not exceed $25,000, a gift tax return must be filed, and any gift tax paid, by the filing date for gifts made during the fourth calendar quarter of the calendar year (i.e., February 15th of the following calendar year).

In 1979, P.L. 96-167 provided that the due date for an annual return (in cases where gifts are less than $25,000) or a return for the fourth calendar quarter is April 15th of the following calendar year. This is the same due date for filing individual income tax returns for calendar year taxpayers.

Issue

The issue is whether gift tax returns should be filed, and any gift tax paid, on an annual basis.

Explanation of the bill

The bill provides that gift tax returns are to be filed, and any gift tax paid, on an annual basis. In general, the due date for filing the annual gift tax return would be the April 15th of the following calendar year. However, for a calendar year in which the donor dies, the gift tax return for that year is required to be filed no later than the due date for filing the donor's estate tax return (including extensions).

Effective date

The bill would apply with respect to gifts made after December 31, 1981.

Revenue effect

It is estimated that this bill would reduce budget receipts by $20 million in fiscal year 1981, by $65 million in fiscal year 1982, and by less than $5 million annually each fiscal year thereafter.

Prior Congressional action

In the 96th Congress, the Finance Committee reported, and the Senate passed, a provision (sec. 6 of H.R. 5505) substantially identical to S. 955. This provision was deleted from H.R. 5505 by the House of Representatives.

Senator SYMMS [chairman, presiding]. The subcommittee will now commence the second day of hearings we are having to address the estate and gift tax.

The Chair would like to announce that due to my personal schedule, we want to have these hearings over with by noon.

I want to first say, that I want to thank all of the witnesses who are here and the ones that will shortly appear for their testimony.

I think it is important that your testimony be made a part of our record to substantiate the necessity, in my view, of abolishing the death tax.

Yesterday, at the White House, we were told a story by Senator Durenberger, in the presence of the President, about a young farmer in Minnesota, who came up and talked to him. He could tell by looking at this young farmer that he was a hard working young man. He was 35 years old. He came up to Senator Durenberger after a meeting they had had and said "Senator, you see that old lady out there?" He said, "Yes." "Well, that is my mother." He said, "I am the only person left in the family. I am farming the farm for my parents. My dad has already died. That lady out there is my mother. She has cancer. The doctors have given her less than a year to live, and when she dies, then I am going to have to buy that farm again from you, Senator, the U.S. Government."

This kind of a tragic situation is taking place all across America, not from wealthy people, but from people certainly from the middle class, producing sector of our society. People that have a life insurance policy and a home, or a small home or a small business, are finding that they are in a situation that they can no longer afford the death tax, because of the present laws.

So, I would really look forward to hearing from the witnesses.

Our first witness this morning is Senator Carl T. Curtis.

I do not see Senator Curtis in the room. So, I think what we will do is call up the first panel and then we will go back to Senator Curtis, a former member of this committee when he arrives.

Is Congressman Al Ullman here?

[No response.]

Senator SYMMS. Is Mike McKevitt here?

[No response.]

Senator SYMMS. Peter Nelson?

[No response.]

Senator SYMMS. Bob Weil?

Mr. WEIL. Yes, Mr. Chairman.

Senator SYMMS. Bob, why don't you come up and Bill Schuler, H. Stewart Dunn, Jr., Louis J. Appell, and Bob Stathan.

Gentlemen, what I would like to do is to ask you to try to condense your statements within a 5-minute period each. Your entire statements will be placed in the record.

I would pose one question to the panel and to each panel.

I have suggested to the administration that in the present tax bill that is now being talked about, the so-called compromise that is now floating around Washington, D.C., that rather than make the changes that have been recommended by the administration, that we just very simply figure out what the Treasury revenue loss would be on a single year of enactment of this new $600 exemption or the $192,000 credit; however you wish to view it.

Apply that on what it would reduce the rate by that much on the present estate tax law and over a 4- or 5-year period, completely phase out the estate and gift tax so it is no longer on the books.

You might be thinking about that. I would appreciate any comments that any of you might have on that, also, this morning.

So, if you would, Bob Weil, why don't you go ahead and start.

Mr. WEIL. Thank you, Mr. Chairman.

STATEMENT OF ROBERT S. WEIL, WEIL BROS. COTTON, INC., MONTGOMERY, ALA.

Mr. WEIL. Mr. Chairman, members of the committee, thank you for the privilege of appearing before you today.

My name is Robert S. Weil, of Montgomery, Ala. I am chairman of the board of Weil Bros. Cotton, Inc., a firm engaged in the merchandising of American raw cotton to textile mills in this country and throughout the world.

We are a family business, established in 1878, 103 years ago. The fourth generation of our family is actively engaged in this business today.

We came here today aware of the many hazards and obstacles and sometimes the struggles in the perpetuation of a family business. But none of these compare with the deleterious effect which the estate and gift tax laws and regulations have on closely held corporations.

Family and privately held businesses have long been the backbone of the American free enterprise system. They led the Nation's economic growth in the past century and many developed into today's leading corporations.

However, today the estate and gift tax laws inhibit the closely held business from growing beyond the point of being a small business.

An entrepreneur can spend his entire productive life plowing his profits back into his business, and when he dies the value of his business is included in his estate and is taxable.

Since he has insufficient outside resources, and since there is no public market in which he can sell his stock, his business must then redeem stock from his estate so that the estate will have the cash to pay the estate taxes.

Hence, the cash comes not from the individual but from the business. The tax then is not on the individual, but the tax is on the business.

This has the opposite effect of capital formation. It is capital depletion.

Now, let us examine the severity the tax impact can have on business.

Assuming a man works for 40 years and can lay back $25,000 a year, or $40,000 a year for 25 years, he accumulates a business worth $1 million. When he pays the estate tax—that business has to be drained of one-third of its capital.

If he does twice as well and the business is worth $2 million, the Government drain will be 40 percent of the company's capital.

A modern-day Henry Ford, who meets with more success, and develops a business the size of $5 million, his estate bill would drain over half the capital of his business.

But, long before that time comes, that modern-day Henry Ford would see, as he approaches the $5 million size business, that out of every dollar net profit he makes, he will wind up with 15 cents, because his income tax will take 48 percent, and estate taxes 70 percent of the balance.

These days, $5 million is a large estate, but it is not a large business. By today's standards, a company which cannot grow beyond $5 million is in no position to challenge the established corporations in our country.

Without the incentive to work hard and to make that company grow, wherefrom will come the modern Henry Ford to challenge a faltering Chrysler?

Granted that such success is in the minority, but how will the majority reach for the sky when the sky cannot be seen for the ceiling?

Seeing that the prospect is near confiscation at death, an entrepreneur then looks to the means of handing down his business to his children, and he trains them to carry on the enterprise.

He cannot sell the business to the children because they do not have the resources.

He may give the stock in the business to his children, but to make that gift, he must pay a substantial gift tax.

Were it a public company, he could sell enough of his stock in the market to raise the money to pay the tax. But since there is no market for his stock, again, the company must redeem the stock from its owner.

Such redemption would be taxed as ordinary income. The owner would find himself redeeming at the rate of $100 to capture $30 to pay the tax. So that the combined income tax and gift tax he would pay would exceed the value of the gift.

Here is another example of confiscatory consequences.

Let us just digress here to mention that the cruelest trap in the tax law that affects private business is the laws of attribution. Whatever abuses the laws of attribution is meant to prevent, they are so eminently unfair to the part owner of a closely held family corporation, that they should be forthwith repealed.

Since neither sale nor gift to the next generation is practical, an entrepreneur looks for other choices. He can liquidate the business or he can go public. But either of these choices defeats the purpose of having his family business and also involves a number of other hazards and costs.

He can enter into a number of sophisticated insurance or legal schemes involving trusts or personal holding companies or other devices that may be established with very expensive lawyers.

However, even these remedies only offer a limited solution. The path of least resistence and the most frequent recourse is for the family of a private business to sell out to a large national firm. It is here that the focus of the adverse effect of the tax laws shifts from the business to the public interest.

The selling out to large public companies tends to concentrate economic power into fewer hands, tending more to monopoly than to diverse competitive enterprise.

The big fish eat up the little fish. One can see it in the department stores, in the textile mills, and most seriously of all, the newspapers.

Second, the selling out of businesses to large national firms has a destructive effect on local charitable institutions, be they health care or welfare agencies, schools or museums.

Traditionally, it has been the local business which has supported local independent institutions. When a local business sells out to a national chain, its support usually becomes as remote as the national headquarters may be from that locality.

Finally, let us review the estate and gift tax laws in their proper perspective. Estate taxes annually raise some $6 billion, a small percentage of the national budget.

Their purpose is not so much to raise revenue, as to attack concentrations of wealth.

If this is their purpose, estate taxes have their shoes on backwards. They tax the deceased in whose hands the wealth is powerless, but they ignore the power of the surviving beneficiary.

Whatever their purpose, it was never meant that the estate and gift tax should deplete capital resources of American businesses.

Therefore, it is our recommendation that the passage of ownership in a closely held corporation, by bequest or gift, should be exempt from any estate and gift tax.

Sale of stock in any closely held company should be taxed the same as the sale of stock of any publicly held company, except that any such stock acquired through gift or bequest would be subject first to recapture of the tax which would have been paid on such a transfer, bequest or gift, any gain to take the basis of such bequest of gift value; provided however, that the aggregate of the recaptured taxes, plus the capital gains tax, should not exceed the current ordinary income tax which would have been applicable at the time of sale.

Mr. Chairman, members of the committee, we hope you will take sure and certain action to exempt the passage of ownership in privately held companies from estate and gift taxation, and thus, insure the innate growing strength of American, privately held companies to prosper from one generation to another.

Thank you for your attentivenesses to this urgent appeal.

Senator SYMMS. Thank you very much.

The Chair would like to announce that we will try to stay within the 5-minute rule.

Mr. Weil, your statement was so good, and the Chair enjoyed it so much, we let you run over, because I found myself in complete agreement with what you were saying. I think it does set a good tone for, even though it wasn't planned that you would be first, I think you set a good tone for the hearing here today.

Of course, the Chair does welcome those who have differing points of view, but with less enthusiasm. [Laughter.]

Anyway, I would like to say that I think it is important that we get all of your statements in our hearing record to substantiate our efforts to repeal the terrible estate and gift tax which I like to refer to as the "death tax," because that is what it is. It is the single most obnoxious tax in the American Internal Revenue Service system.

When you say it is the most obnoxious, I think you have to agree to the fact that is from within quite a group of obnoxious taxes, when we start taxing people in excess of 50 percent of their earnings or of investment income, I think that is also certainly bad to our society and our economy.

But, I appreciate your statement.

Mr. WEIL. Thank you, Senator Symms.

Senator SYMMS. Now, if we could hear from Bill Schuler.

All of your entire statements will be part of our record.

We would like to have you go ahead now, Mr. Schuler.

STATEMENT OF WILLIAM M. SCHULER, BIRMINGHAM, ALA.

Mr. SCHULER. Gentlemen, I am deeply honored to have the opportunity to discuss possible changes in the inheritance tax laws.

I am particularly concerned about the effects of presently existing inheritance tax laws on closely held corporations.

These inheritance tax laws are confiscatory, work an economic hardship on the employees of a closely held corporation, and create problems in the economy that aren't generally apparent on the surface.

Assuming a net estate of approximately $30 million, no marital exemption, the taxes due are $20 million.

Should you elect for a 303 redemption, over a 10-year period, the taxes plus the interest exceed the total value of the estate by $4 million.

Should you elect for a 15-year redemption, taxes and interest exceed the total value of the estate by $20 million.

Now think about this. The present rate on a 10-year redemption, for taxes and interest, exceed the total value of the estate by $4 million.

On a 15-year redemption, the taxes, plus the interest, exceed the value of the estate by $20 million.

Section 531 of the Internal Revenue Code prevents accumulation of surplus in anticipation of death, so the stock must be redeemed by the corporation.

All support figures are shown in exhibit 1, in my statement.

This absolutely is confiscatory and kills incentive.

You may think that the problem outlined is an isolated example and doesn't merit too much consideration, but you are wrong. There are thousands of inheritance tax problems identical to this.

These people have simply been so busy in the day-to-day operations of their business that they haven't taken the time to determine the value of their estate, compute the tax and figure how they are going to pay these punitive taxes.

I started my company with $1,500 and borrowed capital. Through hard work, determination and perseverance, I have succeeded in building two companies that employ approximately 450 people.

At age 58, I hate to think that my life's work will be wiped out by these inheritance tax laws. There is no way my estate can make these inheritance tax payments, plus the prevailing Internal Revenue Service interest rates.

This leads to only one possible solution. Sell the company.

The Fortune 500 companies fully realize that the inheritance tax laws will give them an opportunity to purchase the most successful privately held corporations.

On one hand, you are concerned with the concentration of wealth in the hands of multinational corporations, and on the other hand, the inheritance tax laws force this concentration.

This is not beneficial to the best interest of the people of this country.

Any 303 redemption over a 10-year period would merely siphon off all the cash needed to keep these companies competitive in the marketplace.

The passage of bill 404 would solve all the problems of the highly successful privately held corporations.

The other bills before this committee merely increase the estate tax exemption or credits and skirt the basic problem. These privately held corporations create a large number of jobs in America.

The theme of the new administration is to get the economy going with new machinery and equipment to modernize our plants. This will not be accomplished by draining the cash out of corporations over a 10- or 15-year period.

There are approximately 25,000 closely held corporations with assets in excess of $5 million. Approximately 10,000 of these are extremely successful and employ approximately 250 people.

This means that 2.5 million jobs are dependent on this sector. Assuming a family of 4, this means that 10 million people are directly or indirectly affected by the drainage of cash from these profitable companies.

The question comes up, where are we going to get the money to replace these inheritance tax revenues? This money will come from two sources, increased employment and increased corporation taxes as a result of reinvestment of the cash.

We are planning to spend $750,000, at Alibaster Industries next year for new machinery and equipment. We know that for every $30,000 expenditure, we will provide one new permanent job.

If for any reason I passed away, none of the expenditures for machinery and equipment would be possible because the money would have to go for inheritance taxes or the company would have to be disposed of.

I consider the inheritance tax laws to be the ultimate success penalty.

Thank you very much, gentlemen.

Senator SYMMS. Thank you very much, for a very excellent statement. I failed to mention that when the opening speaker spoke, that Senator Heflin intended to be here to introduce you, Mr. Weil, but he didn't realize you were going to be the first one up.

So, I am sure he may show up later. But he did intend to be here, but he thought you would be on around 10 o'clock.

Next, we would like to hear from Stewart Dunn, Jr.

STATEMENT OF H. STEWART DUNN, JR., OF IVINS, PHILLIPS & BARKER

Mr. DUNN. Senator Symms, I won't read my statement. But I will just make a few comments about the point that I wish to address.

Like the other speakers here, I favor your bill to repeal the estate and gift tax laws, but if it should become impossible to accomplish that goal, I would like to focus on one specific moderation that I feel is particularly important in light of the problems you are hearing today.

That is the valuation of the closely held business. Much of what you are doing has come about due to concern about the valuation of the family farm.

In your introductory comment you illustrated that with the story of Senator Durenberger.

But, too little attention has been given to the valuation of the family-held business.

I have been in this area of practice for 25 years. When I entered practice, if a family had a $1 million business which comprised his entire taxable estate, at the death of the owner of that business, there would have been a tax of $326,000. The marginal rate would have been 37 percent. The average rate would have been 33 percent.

Today, if that business had not prospered at all, was totally static and had gone up by nothing more than the valuation increase due to inflation, the same person having the same taxable estate, would have an estate of $3.3 million due to inflation, would pay estate taxes of $1.5 million, would have a marginal rate of 53 percent and an effective rate of 45 percent.

What I would like to call to your attention is the problem in the present legal standard in determining the value of a closely held business for estate tax purposes.

That standard is the so-called fair market value standard, what a willing buyer would pay a willing seller, both being aware of all the relevant facts.

This standard is simply fictional because we are dealing almost invariably with a minority interest. Even though the decedent may have been the moving force behind the company, he may not own complete control of the company and normally owns less than 50 percent.

There is simply no practical market for such an interest. The standard of the willing buyer is fictional, because no one is willing to buy into a minority interest in a closely held family business unless the price is at a totally depressed figure.

The fictional standard worked reasonably well in times gone by, because really what you are doing is trying to say what would be the current value of the two features that the buyer purchases.

One feature he is purchasing is the right to some dividend stream, assuming the company is able to pay dividends, and the other is the expectation of being able to dispose of that interest at some gain, at a later date, a very uncertain date.

Once these two figures are determined, subject to all the vagaries, they are then reduced to present value.

When we are dealing with a interest rate of 6 percent, the present value is one factor. That is what the courts are looking at today.

But when you are looking at an interest rate of 18 percent or 15 percent, the valuation of that closely held business interest is grossly overstated.

What I strongly recommend to you in the event middle grounds are required is that there be a redefinition of the valuation of closely held business interests.

It would be ideal to have some bright line that would be clear and simple. We have studied and tried to come up with that. Because of the diversity of American business, however, a bright line approach appears to be impractical.

What we urge upon you is a definition of family business, based on definitions that are presently in the Code, but broad enough so that there is no cap.

Why should we try to penalize a family business that is successful as opposed to one that is unsuccessful.

You saw in the farm situation where you have a $500,000 cap, that such cap quickly became outdated.

So, with no cap, and applying the valuation standards presently in the Code, I suggest that you reduce the valuation of closely held business interests by 50 percent. That will give you, if the middle ground is necessary, a standard that will result in realistic valuation of closely held business interests, taking into account today's inflation rate and the discount factor.

Thank you, Senator Symms.

Senator SYMMS. Thank you very much. That is a very excellent suggestion.

Louis Appell.

Mr. APPELL. Yes, sir.

Senator SYMMS. You are next, Mr. Appell.

STATEMENT OF LOUIS J. APPELL, JR., PRESIDENT, SUSQUEHANNA BROADCASTING CO., YORK, PA.

Mr. APPELL. Mr. Chairman, I am president of Susquehanna Broadcasting Co. Our headquarters are located in York, Pa.

I appreciate your giving me the opportunity to present my thoughts. I would like to reemphasize much of what Mr. Weil and Mr. Schuler have said.

For several generations, both sides of my family have been actively involved in the creation and development of family businesses.

We began in the early 1800's as a small pottery manufacturer, and have over the years, expanded into several other fields which are concentrated into four closely held corporations.

The largest company, Susquehanna Broadcasting Co., comprises two divisions. As our name indicates, one is involved in the broadcasting industry. It currently operates 14 radio stations, 1 television station, and 3 cable TV systems.

Susquehanna's second division manufactures ceramic table serving ware and gifts under the name of Pfaltzgraff which was my mother's family name. Some of you may have seen our products from time to time in stores in the Washington, D.C., area. The Pfaltzgraff business began over 150 years ago.

In total, Susquehanna provides employment for over 1,800 persons.

We have three other family companies: One which is engaged in the outdoor advertising business in Pennsylvania; one which owns and operates a dairy farm; and one engaged in real estate.

When my father died 30 years ago this month, the businesses just described were very much smaller than they are today. This fact, combined with appropriate tax planning, enabled us to meet his estate tax obligations without excessive hardship.

Liquidation of assets was, of course, necessary, but our business interests survived virtually intact. The situation that faces us today is incomparably different.

In the intervening 30 years, our business interests have flourished thanks to some good luck and, I hope, to some capable management.

The small companies which 30 years ago employed perhaps 200 people, now provide jobs for nearly 2,000 persons. We have dedicated our lives to seeing our companies grow in a healthy, controlled fashion.

Earnings to a very substantial degree have been retained in the businesses to support that growth.

However, under present laws, our very success will likely be our undoing.

Because of punitive estate and gift tax rates, our children and their children will be faced with almost insurmountable problems in raising liquid funds to pay death taxes.

The sale of substantial portions of our interests, if not all, will be forced upon them, perhaps during unfavorable times and certainly under uncomfortable circumstances.

Significant progress toward solving our estate tax problems can only involve the disposal of family business interests, some of which have been in the family for generations.

My mother is 81 years old. In all of her years, she has managed to accumulate a net estate of approximately $1 million, largely made up of her residence and personal property.

The very small interest she has in family companies has largely been disposed of through gifts. Upon her death, taxes and other settlement costs will consume 33 cents of every dollar. The marginal tax rate will be 39 percent.

What is a relatively modest estate in these inflationary times will shrink from $1 million to approximately $670,000. Certainly a harsh penalty, but manageable and not yet confiscatory.

Let us now proceed from a real example to a somewhat hypothetical one.

Let us assume our companies have a worth of $20 million and that ownership is equally divided among my brother, my sister and me.

Assuming it is possible to use the marital deduction in each case, the total cumulative Federal estate taxes payable upon our deaths and that of our spouses will be $8 million, with a marginal rate of approximately 57 percent.

Remember, this assumes no other significant assets and the use of the marital deduction in each case, a possibility that may or may not exist.

Remember too, that the $8 million is for Federal taxes only. State taxes and settlement expenses will deplete the estate an additional $1.5 to $2 million.

It is obvious that our family cannot maintain our business interests under such circumstances.

As a country, we seem determined to penalize at every turn those who are innovative, creative, motivated and above all successful, those, in short, who provide investment capital and provide jobs.

Getting down to my recommendations, I would recommend the estate tax be entirely eliminated. If that is not possible, the estate taxes imposed on family businesses and income taxes imposed on investment assets should be significantly reduced.

Thank you very much for giving me this opportunity.

Senator SYMMS. Thank you very much, for a very excellent statement.

I might mention that Senator Boren has made a very impressive case here before this committee at our past hearing about why it is that there are several large newspaper chains that own so many newspapers.

I think that your—although you are not in the newspaper business, you are in the broadcasting business, you would be a likely candidate to be soaked up by some giant corporation which is in the radio-television business.

Mr. APPELL. That is a very appropriate parallel.

Senator SYMMS. It is a very appropriate parallel, and I think it is one that is not necessary—it is very unfortunate to see these family newspapers and family broadcasting stations sold off.

Senator Heflin is here now. He wanted to introduce Mr. Weil, before he testified, but we got the cart ahead of the horse, but we are very glad to have you with us, Senator Heflin.

Senator HEFLIN. Thank you. I had anticipated that Mr. Weil would not be on until about 9:30. I am delighted to see you, Bobby.

Mr. Weil is one of Alabama's greatest citizens. From a family viewpoint, his business of Weil Bros., in the cotton business, celebrated their 100th anniversary. I went down to enjoy all of the festivities of that celebration a few months ago.

So, the Weil family has been in the cotton business for years, over 100 years. He is a great citizen. He has contributed so much to so many aspects of the cultural, educational, and civic life that we are proud of him.

He is a former president of the American Cotton Shippers Association and the Atlantic Cotton Association.

I am delighted to see you here. I vouch for you. [Laughter.]

Senator SYMMS. Thank you very much.

Senator Heflin, we are glad to have you with us.

We are also glad to have Senator Dole, Senator Long, and Senator Byrd here.

Did any of you want to make any comments on our hearing today? You are welcome to.

Senator LONG. Yes, thank you, Mr. Chairman.

STATEMENT OF HON. RUSSELL B. LONG, U.S. SENATOR, STATE OF LOUISIANA

Senator LONG. Mr. Chairman, it seems to me that we ought to reduce the estate tax rates. I think that a 70-percent rate gets pretty ridiculous.

If you assume an estate of over $600,000, as is the case with people who have honestly accumulated a substantial estate, this proposal would exempt these estates for $600,000, so that no tax would apply to the part of the estate up to $600,000.

Then, in short order, this puts you up to a 60-percent bracket. The thought that occurs to me is that 60 percent is altogether too high. I, for one, don't object to paying a modest tax. To start at 35 percent is, I think, altogether too much. It seems to me that you ought to start out at a much lesser point.

But, I also think it doesn't make too much sense to totally exempt some people. A person has a good fortune, inherits a lot of money. I know some very nice people who made a ton of money through just a complete accident of fate. Somebody found gas or oil beneath their property so they get a huge amount of money.

That does not mean their moral character or fiber is a bit stronger than the guy down the road. Oftentimes, it sort of tends to corrupt them a little bit, make them reduce their talents rather than increase them. Some of them spend that money unwisely and on high living.

My thought is that we should have it so that when they pass on we spread it around a little bit. It is awfully easy for people to make money when they have it, if they have good business and banking advice and they follow it. It is a lot easier to make the second million than the first million.

I am sure you are all familiar with that story about the boy who was working on his second million dollars and some friends of his said, "I didn't know you had $1 million." He said, "Oh, I don't, but I read it is a lot easier to make the second million than it is to make the first million."

My thought is, why shouldn't people who have had the benefit of everything society can offer, oftentimes through no particular merit, spread some of it around society when the good Lord calls them home, even if it is only a matter of putting some of it with some of those workers who worked their backside off in order to give these people a chance to make all that dough.

If they don't want to do anything to benefit humanity with the money, pay some of it in taxes.

But, on the other hand, would you not also agree that 60 percent going to taxes is altogether too high?

Mr. DUNN. Senator Long, if I may respond to your comment. In the testimony I gave, I think I addressed your points exactly.

My point was that, under existing law, the valuation techniques value interests in closely held businesses in an unrealistic way.

We need to do something for the closely held business parallel to what was attempted in section 2032(a) for the small farm. But it ought to be for any closely held business, and it ought to have a method of placing a more realistic value on closely held business interests.

That way there would be a tax, but you wouldn't force the family to sell out.

Mr. WEIL. Senator Long, may I comment, too, sir?

Senator LONG. Surely.

Mr. WEIL. I think there is a very important distinction between taxing an individual on death and taxing a business.

As long as the money in the business is not taken out of the business, it is working. It is helping our economy. It is giving jobs. It is constructive. It is the only way we are going to build up competition in this country to challenge the big companies we already have on stream.

Now, I think it is one thing to tax the man who strikes oil and lives high and so on and so on, but it is something quite different to tax a business, which you are doing indirectly, because when you tax an estate that is where he, the owner, is going to get his money if he owns a privately held business. Especially if he spent all his life building that business up and piling profits back in the business, and I think it is important to make that distinction.

As long as the money stays in the business, I hope we won't tax that money, we won't tax that business. We won't penalize that business simply because it is a privately held business.

Once it comes out of that business, once the owner sells it, once it is distributed, yes, tax it. Then that goes to the individual. It is no longer working in the business.

Senator LONG. Well, I have seen many a study that indicates where employees own some stock in the business, they take more interest in it, they are more productive, they assume more responsibility and I have not seen any other study to the contrary.

Now, I have a bill in that would say it is deductible if you want to leave your stock in the business or any part of it to your employees.

What is wrong about that?

Mr. SCHULER. They don't understand the business, Senator.

Senator LONG. They don't understand it?

Mr. SCHULER. That's correct. They don't even know how to read the financial statements.

Senator LONG. You know, you make me think of this old sharecropper who worked for a lifetime to make the landowner rich.

So, when it got to where he was no longer productive he went to this landowner, who also owned the general store where the poor fellow spent what little he could keep after he raised the crops, and he said, "Now, Mr. Smith, I worked all my life for you to where I can't work any more. Now you are rich and I am poor. I can't work any more. I don't have anything to show for it. I have this horrible aching back. Don't you feel you owe me something?"

Mr. Smith thought about it a moment and said to the clerk back in the back, "Hey, come get this man a bottle of Sloan's liniment to rub on his aching back."

Now it sounds to me that is what you are advocating. I am ashamed of you if you stand here and speak for affluent people and advocate that kind of answer to a social problem.

Do you really believe that that sharecropper out there didn't know anything about farming?

Mr. SCHULER. Senator, let me say this. If you are going to own stock in a company, and you are going to understand the function and operation of that company, you have to be able to read the financial statements. You have to understand the reemployment of capital in the business.

These people may know how to lay out steel, and may be hard-working people, but they would rather have that money in that envelope every Friday, rather than be concerned with what the investment of that money is.

Now, there are very few people who follow the policy that you advocate.

Senator LONG. Well, I know some who have shown a great deal of concern about people that made them rich and worked loyally and faithfully for them, when they had a chance.

I would just suggest to you that you see if you can sell that in a labor hall or union hall anywhere in America. See if you can sell that to 90 percent of the people who get out and work hard for a living and don't happen to own any stock. Just see if you can sell it to them that they don't really know anything about the business they are working for and slaving in day by day.

Frankly, I don't think you are speaking for many people when you express that point of view. My guess is you are speaking for less than 1 percent of America

The workers in a plant are potentially the most knowledgeable shareholders you could find for a business.

Nobody would know better than them what kind of management they have, because they are the guys who are working for that management. Nobody would know better than them whether their management is efficient and worth keeping on the job.

They know better than the shareholder who is sitting up there reading that stockholders' report you are talking about. They know what is going on inside that plant.

I think management misses a point when it fails to see to it that the employees do become shareholders in the companies.

Most companies are, starting with A.T. & T. and going right on down the list, of the largest 100 companies in America, encouraging with incentives, where they pay half the cost, or whatever, to make shareholders out of the employees.

Mr. SCHULER. Senator, these companies you refer to are listed with the New York Stock Exchange. They have a ready market for their stock.

In a closely held company, you don't have a ready market for that stock.

Now, I agree with what Mr. Weil says here, that he mentioned to you earlier, that the tax is essentially on the business. Because you cannot accumulate enough cash in the company in anticipation of death.

So, if you have a 303 redemption, you have to pull that money out of the business. For 10 or 15 years, this is a severe penalty on the company.

Now, prior to 1976, the interest rates were 4 percent. Let's assume they are going to be 90 percent of whatever the prevailing rate is in September and that could be anywhere from 18 to 16 percent or what not.

Now this is a confiscatory situation and it penalizes the very same workers that you are talking about.

Senator SYMMS. Right. I thank you very much for the point.

We have not had a chance to hear from Mr. Stathan. You did not testify yet.

We would like to have your statement. We are going to try to stay within the 5-minute rule and then go around the table and give all the Senators an opportunity to make comments, if they wish.

STATEMENT OF STEVAN WOLF, NATIONAL FAMILY BUSINESS COUNCIL

Mr. WOLF. Mr. Chairman, Mr. Stathan was not able to be here this morning. I will be making the presentation on behalf of the National Family Business Council.

My name is Stevan Wolf. I am the general manager of our family business, the Leddy Lane Co., in Westville, N.J.

I am also the chairman of Government affairs of the National Family Business Council.

The National Family Business Council appreciates this opportunity to present its views on the needed revision in the Federal estate and gift tax laws.

As you have been hearing, and I am sure will continue to hear, there are many technical issues that should be dealt with for the revision of our Federal estate and gift tax laws.

The National Family Business Council in its prepared text has recommended the following changes to help eliminate what we refer to as the family business tax.

One, we agree with the President's statement this morning or yesterday afternoon on the unlimited marital deduction.

This, we feel, would be a first step in allowing some consideration to be given to the working heirs that would ultimately take over the ownership of our family businesses on the death of the second parent.

A reduction in the estate and gift tax rates that Senator Long has just mentioned from the present maximum of 70 percent to a maximum of 30 percent, is also something we could agree to.

An increase in the tax credit that would allow up to $1 million to pass on to the heirs of the family business.

We feel this and the reduced rate would serve to help correct the inflationary injustices that have been created by the current law.

We also feel we would like to see a relax in the provisions in the present law for the extension of time to pay for the tax of a closely held business.

We are of the opinion that these installment provisions should be broadened so that where the value of an interest in a family firm is only 25 percent of the value of the gross estate or 35 percent of the taxable estate. Payments can be made under the 15-year installment provision.

The special use valuation in the present law has been helpful for estates composed largely of farm land. But the provision has generally not been—not aided those estates of closely held businesses.

We favor a special valuation rule for closely held businesses that would allow an executor to value a closely held business for estate tax purposes at 50 percent of the market value.

Finally, the $3,000 annual gift exclusion is too low and frequently taxpayers are not even aware of the requirement to pay the tax.

The annual exclusion should have been increased years ago. We favor increasing its annual gift tax exclusion to $10,000, which also helps with the inflation problem that we have.

The National Family Business Council's most active members represent the next generation of family business owners.

We look ahead and we see many real problems for us for the current Federal estate tax laws.

Yes, we can plan for this event, but it takes valuable time, money, and emotional strength.

We would rather be actively seeking ways to handle our business challenges of the 1980's. These business challenges include finding solutions to more innovation, productivity, employment that would thus create growth and profit for our businesses.

The estate and gift tax as it is now, operates to discourage savings, investment and productivity. In effect, it penalizes the widows and children of those decedents who took the risks of being in business for themselves and working throughout their lives to become profitable.

This disincentive to success results in fewer jobs, reduces productivity and adds to economic decline.

Right now it is financially sound to sell or close your business rather than take the time to effectively plan for the death of the family business owner. This discourages us from insisting that our fathers maintain our family businesses for us.

Allow us, the Nation's future business leaders, the same opportunity that our fathers and mothers had when they began our family businesses.

Remove the estate tax obstacle and give us an incentive to carry on in our parents' tradition of free enterprise so that we can help ourselves and our economy.

We are the core of the American system and the future of the free enterprise in our country.

Mr. Chairman, I appreciate this opportunity to be here today to express the views of the National Family Business Council on the need for changes in the estate, Federal estate and gift tax.

May I also add that last year I was a part of a Small Business Administration Office of Advocacy, special task force on small business continuity.

Their No. 1 priority that was determined by this group of individuals was to alleviate the tax burden on generation transfers and family business.

Their recommendation the estate and gift tax, if not repealed, should be abated by raising current tax credits to the equivalent of $2 million exemption.

This committee should have that report. Right now it is in the hands of the Office of Advocacy of the SBA. It has not been published.

I would like to see it submitted into the record of this committee hearing. It is very important that you have that.

May I also offer in closing, the services and cooperation of our organization to assist you in any way possible in your efforts in regard to the estate and gift taxation.

Thank you.

Senator SYMMS. Thank you very much.

The Chair would like to announce for the members of the committee that are here that we started out of order this morning. So, we are still waiting to hear from Senator Curtis and the panel that Congressman Ullman will be with.

At this time, we will recognize, according to the early bird rule, Senators who are here, if they have questions. If we could possibly do it, I would appreciate if we could limit our questions to 2 or 3 minutes rather than 5.

I think Senator Dole, you were the first one here in the room.

Senator DOLE. I have no questions. I know that you have a number of witnesses.

I do have a statement to be made a part of the record. I think it should be encouraging to all of the witnesses that we are talking about something that is probably going to happen.

What we need to do now is to fashion the package on estate taxes. It was a part of the President's proposal. It is also part of the chairman of the Ways and Means Committee's proposal. It will be a part of our overall tax proposal. We just don't have it completely put together yet.

So any input you have will be helpful. I am sure not everyone will be totally satisfied, but we are moving in the right direction.

I will ask this statement be made a part of the record, Senator Symms.

Senator SYMMS. Thank you. Your statement will be made a part of the record, Mr. Chairman.

[Senator Dole's statement follows:]

STATEMENT OF SENATOR DOLE

Mr. Chairman, this is the second hearing this year by this subcommittee examining major issues of estate and gift taxation. I congratulate you for your continuing effort to focus attention on the inequities often caused by our present system of inheritance taxes, particularly the impact on family-owned farms and small businesses. It is gratifying to note that developments in recent weeks have greatly increased the likelihood that Congress will undertake major estate tax reform this year, and that the President of the United States will support such a reform.

Today, along with other issues, the subcommittee is taking a look at S. 23, a bill that I have introduced along with Senator Percy, Senator Kassebaum, and Senator Hatfield. My proposal addresses a major problem of availability of the special use valuation for farm property in a number of States. Senator Wallop and Senator Durenberger have also addressed this issue in their comprehensive estate tax reform bills, S. 395 and S. 858. Basically, the point of S. 23 is to guarantee that crop share rentals may be used in the formula method of determining current use value of qualified farm property.

Mr. Chairman, for purposes of estate tax, family farms can be valued at current use value rather than highest and best use value. Unfortunately, final regulations on section 2032A issued by the Treasury Department last year disallow use of crop share rentals as a standard of valuation for this purpose. However, preliminary Treasury regulations proposed in 1978 stated that crop share rentals could be used by converting them into cash rentals. The Treasury Department had an opportunity to revert to this earlier position on April 27, when Assistant Secretary Chapoton testified before the Subcommittee on Oversight of the Internal Revenue Service concerning the section 2032A regulations. Unfortunately, while the Treasury did modify its position on several aspects of the regulations, it held to its position on crop share rentals. However, the Department did indicate its willingness to discuss legislative changes on this issue, and I hope they will give serious consideration to endorsing S. 23.

The bill simply provides that if gross cash rental of farm property cannot be determined, the crop share rental may be substituted. The distinction is important. In many States, including the State of Kansas, it is rare to find farm land leased on a cash basis. Crop share leases are much more common in these States, so it is discriminatory to exclude such leases for purposes of computing the special use valuation.

Mr. Chairman, in passing the Revenue Act of 1976 Congress clearly intended special use valuation to be available to farmers. An interpretation that ignores the typical practice in many Farm States obviously frustrates the intent of Congress. I would urge the Treasury Department again to reconsider its position on crop share rentals, or at least to support the legislative change that I and many of my colleagues favor. There is no justification for unequal application of the law, but I am afraid that is what we have now.

Senator SYMMS. Senator Byrd.

Senator BYRD. I will yield my time at this point, Mr. Chairman.

May I ask you this question though, I have a bill which will be heard, is to be heard today, S. 955. It is a noncontroversial matter dealing with the filing of gift tax returns.

Could you indicate the timing on that?

Senator SYMMS. I will have to yield to the chairman of the full committee on that.

Senator Dole.

Senator BYRD. It would be appreciated—if you could indicate some time when S. 955 might be taken up. It is on the agenda for today.

Senator DOLE. We can take it up today.

Senator BYRD. Later on in the session.

Senator DOLE. We will do it right now.

There is no objection to it?

Senator BYRD. Well, it was approved by the Finance Committee last year, and I think approved by the Senate last year. It was favored by Treasury.

Today, under current law, an individual must file a gift tax return, 2½ months after the gift tax is made.

This would make it on an annual basis rather than on a quarterly basis.

Senator DOLE. Far as I am concerned we can pass it out right now.

Senator BYRD. Very good.

Senator SYMMS. If there is no objection, the bill is passed.

Senator BYRD. Thank you. [Laughter.]

Senator SYMMS. Senator Boren.

Senator BOREN. Thank you, Mr. Chairman.

I want to echo what Senator Dole has said in regard to the package which was announced yesterday at the White House. The President did very clearly include the reform of the estate and gift tax as a part of the package he has now endorsed.

I am elated by that. I think we have an excellent chance now. We want to pass the bill. We want to write the best possible bill that we can because it is going to become law. This may be one of the few chances that we will ever have to write a bill that will be an appropriate one.

I wish we could handle it right now. No, I am just kidding about that. But, I would like to ask one question.

Senator SYMMS. Don't joke about it with me in the chair. [Laughter.]

Senator BOREN. With this group we probably could do it.

The cost of the—maybe Mr. Wolf can answer this. Do you know what the loss or revenue would be in terms of the proposal to value stock in closely held businesses at 50 percent of market value?

Do you know what the revenue impact would be of that proposal?

Mr. WOLF. Senator Boren, I can't answer that not being a technician. I work in my own family business, but could possibly secure that information for you.

So, I don't have an answer for you at this time.

Senator BOREN. All right. We will have staff work that figure out.

Mr. WOLF. Thank you.

Senator BOREN. I appreciate the suggestion. Thank you.

Mr. WOLF. Thank you.

Senator DOLE. Let me just indicate that when we passed out the bill of Senator Byrd, we had gone into executive session, the full committee.

Now we are back to the subcommittee.

Senator SYMMS. Thank you, Mr. Chairman. [Laughter.]

Senator BYRD. I like the expeditious way this committee operates. [Laughter.]

Senator SYMMS. Senator Grassley, did you have any comments or questions?

Senator GRASSLEY. No, I yield my time at this point. Thank you.

Senator SYMMS. Thank you very much, Senator.

Members of the panel, we certainly appreciate your comments and your commentary. We appreciate your being with us this morning.

I thank you very much.

Mr. WEIL. Thank you, Senator Symms.

Mr. SCHULER. Thank you, Senator.

Mr. DUNN. Thank you.

Mr. APPELL. Thank you, Senator.

Mr. WOLF. Thank you.

[Statements follow:]

SUMMARY OF TESTIMONY OF ROBERT S. WEIL, MONTGOMERY, ALABAMA, BEFORE THE SENATE FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION, FRIDAY, JUNE 5, 1981.

Estate taxes have a deleterious effect on the perpetuation of a closely held family business.

Incidence of estate tax is on the deceased stockholder, but payment of the tax results in a drain on the capital of the company.

Gift taxes and illiquidity deter passing of a business from one generation to the next without ruinous tax consequences.

After a business approaches $5,000,000.00 in size, the combined income and estate tax effect on earnings is near-confiscatory - 85 percent! Owners get discouraged from continuing business.

(The laws on attribution are a trap and should be repealed.)

Owners of growing family businesses are left with these choices:

a. Liquidation
b. Going public
c. Embarking on highly sophisticated tax avoidance devices
d. Selling out to a larger company - which is the path of least resistance and most frequent; as in for instance:

    Department Stores
    Textile Industry
    Newspapers (Very dangerous)

Sell-outs shift focus to public interest, because of

a. Trends toward monopoly and away from competitive free market.

b. Undermining of support of local institutions of locally owned business.

(Estate Tax Law has "shoes on backwards" because it taxes the deceased instead of the beneficiary.)

It is therefore recommended that (1) transfers of closely held businesses by bequest or gift be exempt from tax, (2) unreasonable accumulations tax will prevent hoarding of profits, and (3) a subsequent sale of shares in closely held businesses be subject to recapture of transfer tax plus capital gains, but not to exceed currently applicable ordinary income tax.

TESTIMONY OF ROBERT S. WEIL, MONTGOMERY, ALABAMA, BEFORE THE SENATE FINANCE SUB-COMMITTEE ON ESTATE AND GIFT TAXATION, FRIDAY, JUNE 5, 1981.

Mr. Chairman and members of the Committee. Thank you for the privilege of appearing before you today.

My name is Robert S. Weil of Montgomery, Alabama. I am Chairman of the Board of Weil Brothers Cotton, Inc., a firm engaged in the merchandising of American raw cotton to textile mills in this country and throughout the world. We are a family business established in 1878, 103 years ago, and the fourth generation of our family is actively engaged in this business today.

We are keenly aware of the many hazards and obstacles, and sometimes the struggles in the perpetuation of a family business, but none of these compare with the deleterious effect which the Estate and Gift Tax Laws and Regulations have on closely held corporations.

Family and privately held businesses have long been the backbone of the American free enterprise system. They led the nation's economic growth in the past century and many developed into today's leading corporations.

Today, however, the Estate and Gift Tax Laws inhibit a closely held business from growing beyond the point of being a small business. An entrepreneur can spend his entire productive life plowing his profits back into his business, and when he dies, the value of his business is included in his estate and is taxable. Since he has insufficient outside resources and since there is no public market in which he can sell his stock, his business then must redeem stock from his estate so that the estate will have the cash to pay estate taxes - hence the cash comes not from the individual but from the business. This has the opposite effect of capital formation; it is capital depletion.

Let us examine what the severity of the tax impact can be on such a business. A man who plows back an average of $25,000.00 a year for forty years or $40,000.00 for twenty-five years, may die with a business worth a million dollars. To pay his estate tax, his business will be drained of more than one-third its capital. If the same man had plowed back double its earnings and died with a two million dollar business, the government would drain almost forty percent of the company's capital.

Let's consider a modern day Henry Ford who meets with such success that he can develop over his lifetime, or perhaps a second generation Ford who can increase the size of his business so that he dies with a business worth five million dollars. His estate tax bill would drain over half of the capital from his business. Long before he dies, our modern Henry Ford would see that once his business exceeded five million dollars, the estate tax would take 70¢ of every dollar he would accumulate from then on. He would consider that he would pay forty-eight percent corporate income tax on his earnings and this, with a seventy percent estate tax would allow his firm to retain only 15¢ out of every dollar of his net profit, and from that point, the government almost confiscates his profits with a take of eighty-five percent.

By today's standards, a company which can not grow beyond five million dollars is in no position to challenge the established corporations in our company. Without the incentive to work harder and make the company grow, where will come the modern day Henry Ford to challenge a faltering Chrysler? Granted, that such successes are in the minority, but how will the majority reach for the sky when the sky can not be seen for the ceiling?

Seeing this prospect of near confiscation at death, an entrepreneur then looks to a means of handing down his business to his children whom he trains to carry on the enterprise. He can not sell the business to his children for they do not have the resources. He may give the stock in his business to his children, but to make the gift, he must pay a substantial gift tax. Were it a public company, he could sell enough of his stock on the market to raise the money to pay the tax. Since there is no market for his stock, again the company must redeem the stock from its owner, and such a redemption would be taxed as ordinary income. The owner would find himself redeeming at the rate of $100.00 to capture $30.00 to pay the tax, so that the combined income tax and gift tax he would pay would exceed the value of the gift. So, here is another example of confiscatory consequences.

(Just here, let us digress to point how the cruelest trap in the tax law affects private business. This trap is the law on attribution. A family member owning less than fifty percent of the stock of the corporation is held to the same inflexible constraints in disposing of his stock, if his stock, combined with that of others of his family, equals fifty percent of the outstanding stock of the corporation - even if the stock of the other members of the family is not involved. Whatever abuses the laws on attribution are meant to prevent they are so eminently unfair to the part owner of a closely held family corporation that they should be forthwith repealed. If it is the desire of this Committee, we should be happy to submit a paper on this separate, but painful, aspect of the tax law.)

Since neither sale nor gift to the next generation is practicable, this entrepreneur looks for other choices.

He can liquidate the business or he can go public, but either of these choices defeats the purpose of having his family business and also involves a number of other hazards and costs.

He can enter into a number of sophisticated insurance or legal schemes involving trusts or personal holding companies or other devices which may be established with very expensive tax lawyers. However, even these remedies offer only a partial solution as typically they freeze accumulated values in the estates of the older generation, while leaving further earnings to be accumulated in the younger generation.

The path of least resistance and the most frequent recourse is for the family or private business to sell out to a larger national firm. It is here that the focus of the adverse effect of the tax laws shifts from the business to the public interest.

The selling out to large public companies tends to concentrate economic power into fewer hands trending more to monopoly than to a diverse competitive enterprise system. "The big fish eat up the little fish."

Several decades ago, most department stores in this country were independently owned; today, there's hardly a department store in the country not affiliated with a national chain. We see the same trend in the textile industry. Barely thirty percent of the cotton mills operating in Georgia and Alabama thirty years ago still exist under independent ownership. This experience is repeated in many other industries.

By far, the most serious of these trends is in the newspapers which, one after another, have sold out to national chains. Excessive concentration and insufficient independence of the media carry far-reaching implications, far more dangerous than economic considerations.

Secondly, the selling out of businesses to larger national firms has a destructive effect on local charitable institutions, be they health care or welfare agency, schools or museums. Traditionally, it has been local business which has supported local independent institutions. When a local business sells out to a national chain, its support usually becomes as remote as the national headquarters may be from that locality.

The problem of local support becomes more poignant as Congress cuts back the Federal budget and turns back the responsibility of support to private philanthropy. It is indispensable to the well being of our broader national community that local corporate bases of support be preserved.

Why should the ownership in a privately owned corporation be treated any differently from a public corporation for estate tax purposes? Because at death, the executor of an estate can sell stock in a public company in the market without impairing any of the company's capital. In fact, during his lifetime, the owner of the majority of the stock of a public corporation can sell any portion of his stock at any time at long-term capital gains rates to raise money to pay gift tax or for any other purposes.

The incidence of the tax where a redemption is necessary, on the other hand, places the burden not on the individual or on the estate, but on the business entity itself. A loss of capital in the business results in less business volume and fewer jobs, and it becomes a capital tax on the business itself.

Should a privately owned business be penalized? In a free society, the owners of a business have always had the free prerogative to operate privately or publicly according to what best served the laws of economics. In the competitive world of today, it is essential that American enterprise be geared to economics - not taxes.

Finally, let us view the Estate and Gift Tax Laws in their proper perspective. Estate taxes annually raise some six billion dollars, a small percentage of the national budget. Their purpose is not so much to raise revenue as to attack concentrations of wealth.

If this is their purpose, the estate taxes have their shoes on backward. They tax the deceased in whose hands the wealth is powerless. They ignore the power of the surviving beneficiary.

Let's take a simple example. John is the sole beneficiary of his father's estate which is taxable at $500,000.00. He is also the sole beneficiary of the estate of his spinster aunt, also worth $500,000.00. Between the two of them, after taxes, John inherits $688,400.00.

On the other hand, George and Henry are brothers and beneficiaries of half each of their father's estate which is taxable at one million dollars. After taxes, each of them inherits $327,100.00.

George's and Henry's estates each are worth less than half of John's, but yet the tax on the estate of which they were beneficiaries was $34,200.00 more than the combined estates of which John was beneficiary.

Whatever their purpose, it was never meant that the Estate and Gift Tax should deplete capital resources of American businesses.

Therefore, it is our recommendation that the passage of ownership in a closely held corporation by bequest or gift should be exempt from any Estate and Gift Tax. Sale of stock in any closely held ownership should be taxed the same as the sale of stock of any publicly held company, except that any such stock acquired through gift or bequest would be subject first to recapture of the tax which would have been paid on such a transfer by bequest or gift, any gain to take the basis of such bequest or gift value; provided, however, that the aggregate of the recaptured taxes plus the capital gains tax shall not exceed the current ordinary income tax which would have been applicable at the time of sale.

In this way, the company's resources will remain unimpaired, the same with a privately owned company, and it may continue normal growth, normal employment, and normal security for all concerned. Would this provision not encourage hoarding of resources in the company? Not so. There is an accumulated earnings tax which answers that situation. The company would be forced to utilize its resources in normal growth and expansion or else to distribute its earnings as dividends which would be subject to income taxes.

Mr. Chairman and members of the Committee, we hope you will take sure and certain action to exempt the passage of ownership in privately held companies from Estate and Gift taxation, and thus assure the innate growing strength of American privately held companies to prosper from one generation to another. Thank you for your attentiveness to this urgent appeal.

TESTIMONY OF
H. STEWART DUNN, JR.
IVINS, PHILLIPS & BARKER
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
SENATE FINANCE COMMITTEE
JUNE 5, 1981

My name is Stewart Dunn. I am a partner in the law firm of Ivins, Phillips & Barker in Washington, D.C. For approximately 25 years, I have been involved in estate planning for owners of closely held businesses. At no time during these years have the problems of our economy and estate tax structure had a greater adverse impact on family business owners than today.

The estate tax has been affected by inflation in the same way as the income tax. Due to "bracket creep," the effective tax rate increases as the nominal value of the gross estate increases. Valuation problems and illiquidity of closely held business interests make the effect of inflation and bracket creep particularly severe on owners of family businesses.

Based upon inflation alone, if the value of a closely held business interest was $1,000,000 in 1956 when I entered practice, it would have a value of $3,300,000 today. Assuming this business interest in 1956 constituted the entire value of a decedent's taxable estate, the estate tax would have been $326,000, with a 37% marginal estate tax and a 33% average rate. Assuming the owner of this same business interest died at the end of this year and his business increased in value only by the general rate of inflation, his estate tax on a taxable estate of $3,300,000 would increase to $1.5 million, with a 53% marginal estate tax and a 45% average rate. In twenty-five years, inflation and progressive estate taxes will have quintupled the estate tax owed by this family business owner even though his business interest will have only tripled in value and no greater amount of liquid assets will be available to pay the estate tax. If a business increases in value due to factors other than inflation -- for example, its success -- the estate tax dilemma will be even more acute.

The estate tax law with respect to valuation of closely held businesses is stated in very simple terms. As defined in the Treasury Regulations, value is "the price at which. . . property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Though the language of the law may be simple, valuation of closely held businesses is probably the source of more controversy than any other single issue arising under the estate tax law. For many estates, the only issues to be raised on audit are issues concerning the valuation of a family business. The reason for controversy is that there is no established market for such an interest. In the absence of an actual sale between a willing and informed seller and buyer, the definition poses a highly conjectural factual question. What a hypothetical buyer would pay and a hypothetical seller take is a question on which reasonable and expert opinions vary widely. Furthermore, it is a question to which a large number of factors -- all the things that might seem important to any potential buyer or seller -- are relevant. For a decedent's estate containing a minority interest in a closely held business, the key estate tax issue is the impact of this theoretical "fair market value" standard in the absence of any actual market for such interest.

The critical factor to note today is that the law which has determined how much discount should be accorded a minority interest in a closely held corporation developed over a period when interest rates were low. During such times, a willing buyer would compare a return of say 6% on certificates of deposit with the return he could expect by purchasing a minority interest in a company. If the present value of the dividend stream and the expected value of the business when ultimately sold significantly exceeded the 6% income stream he could obtain on a safe, marketable bond or comparable security, the buyer would probably purchase the closely held corporation's stock. A discount for these interests in closely held businesses developed to reflect the fact that investment alternatives yielding 6% per year were available.

Today, alternative investments such as Treasury Bills are available with yields of 16% and more. Since alternative investments offer substantially greater returns, the value of minority positions in closely held businesses are correspondingly reduced. For a willing buyer to purchase a minority interest in a closely held business, the price today would have to be discounted by a substantially higher percentage to reflect the fact that alternative, guaranteed returns of 16% and more are available. The law concerning valuation of closely held business interests has not kept pace with changing economic conditions to reflect the existence of such alternative investments yielding substantially greater returns.

Indeed, the law on valuation of closely held business interests does not even fully take into account the fact that the "willing buyer/willing seller" standard is simply a legal fiction. In reality, there is no market for most minority interests in closely held family businesses. The only way an unrelated buyer would purchase an interest in a family corporation is if the price were substantially depressed.

Thus, I conclude that if "death and taxes at death" are to remain with us, there is a compelling need to revise the standards applicable under present law for valuing closely held businesses. To identify this problem, however, is not to solve it. We have examined many alternatives to the "willing buyer/willing seller" standard. For simplicity, an arbitrary, bright-line approach would be ideal. This would reduce conflict, uncertainty and expense, including legal expenses. Unfortunately, no such bright-line solution is practical when applied to the broad range of American businesses. A need exists for a standard such as the "willing buyer/willing seller" standard to adjust for the enormous diversification of American business. Therefore, we believe that the preferred solution is to leave the present rules intact and allow an additional discount for estates which are composed in part of closely held business interests. We believe that an additional discount of 50% from the value those interests would be assigned if the businesses did not meet the test of being closely held would be reasonable.

In order for an estate to qualify for this special valuation, I recommend that the value of the closely held business interest in a decedent's gross estate constitute at least 25% of the value of the gross estate or 35% of the taxable estate. A closely held business should be defined as one (1) where 50% of the outstanding stock is owned, directly or indirectly, by or for not more than five individuals as required in Section 542(c)(2) of the personal holding company provisions, (2) involved in an active trade or business, and (3) whose stock is non-readily-tradable stock within the meaning of Section 6166(b)(7)(B).

Since the purpose of this family business valuation provision is to permit family transfers, and the estate tax rates rise with increases in value, we recommend that there be no limit on the absolute size of the business or the interests which may qualify under the provision. The policy of permitting intra-family transfers of family businesses should apply no matter how large the business.

In 1976 Congress recognized that inflation was pushing farmers into increasingly higher estate tax brackets. To avoid forced liquidations of family farms and real property used by family businesses, Congress in that year enacted Section 2032A, the special farm use valuation provision. A similar provision such as the one described above for closely held businesses whose value is not based on real and tangible personal property within the narrow meaning of Section 2032A should now be enacted to acknowledge that inflation has produced bracket creep for all taxpayers owning family businesses and to recognize that the valuation techniques presently applied to determine the value of family businesses do not adequately take into account the economic conditions of our time.

84-582 O—81——4

STATEMENT OF WILLIAM M. SCHULER

VALID REASONS FOR THE ELIMINATION OF

ESTATE AND GIFT TAXES - Bill #404

I. Present Inheritance tax law.

   A. Confiscatory.

   B. Examples of the effects on $30,000,000 estate.

      1. Taxes plus interest on ten year redemption exceed total value of estate.

   C. Destroy Incentive.

II. Present Law causes forced sale to "Fortune 500" Company.

   A. Concentration of wealth in the hands of a few companies detrimental to the Country's best interest.

III. 303 Redemption for ten years draws all the expansion money out of the company for taxes.

IV. Bills before the Senate.

   A. Bill #404 will solve all the estate problems listed above.

   B. All other bills increase estate tax deductions or increase credits.

      1. These adjust inheritance taxes to the rate of inflation.

      2. Skirt the issue of capital retention in the companies.

      3. Fail to attack the core of the problem.

WILLIAM M. SCHULER

June 5, 1981

VALID REASONS FOR THE ELIMINATION
OF ESTATE AND GIFT TAXES - Bill #404

I enthusiastically support the elimination of all gift and inheritance taxes as proposed in Bill#404 which is under consideration by the Senate at this time. My primary concern is the effect of the inheritance tax laws on closely held corporations. These existing statutes are confiscatory, work an economic hardship on the employees of the closely held corporation and cause problems in the economy that aren't apparent on the surface. With the tax at seventy (70%) percent on that portion of the net estate in excess of five million dollars ($5,000,000) and the Internal Revenue Service rates of interest prevailing on the unpaid portion, it is impossible for my estate to make these payments without liquidating the assets of the corporation. In the back portion of this statement I have attached exhibit #1, Estate and Interest Calculations under sections 6166A and section 6166. Interest rates have been calculated for this exhibit at ninety (90%) percent of prime or eighteen (18%) percent. This is close to the rate which I figure will prevail in September, 1981 which will determine the Internal Revenue Service rate for the next year.

Assuming a net estate of thirty million dollars ($30,000,000), the taxes are twenty million dollars

($20,000,000). Using a section 303 redemption under the deferred payment provision of ten (10) years (6166A), the taxes plus interest at the prevailing Internal Revenue Service rate exceed the total value of the estate by over four million dollars ($4,000,000). Using the fifteen (15) year deferred payment provision (section 6166) under the same prevailing interest rates and taxes, these payments exceed the total value of the estate by over twenty million dollars ($20,000,000). The taxes and the annual interest payments should be looked at as one and the same because they require annual cash payments from the executor. The interest rates may vary but there is no cap on these rates and they may easily exceed the figures used in exhibit #1. Section 531 of the Internal Revenue Code prevents any accmulation of cash in anticipation of death. Any estate of a large value in closely held companies will have about eighty (80) to ninety (90) percent in shares of closely held companies which would be subject to the section 303 provisions for redemption unless these shares are sold in less than nine (9) months after death. The provisions of 6166 and 6166A make the estate subject to annual payments of principal and interst for a ten (10) or fifteen (15) year period.

Most of the listed corporations on the New York Stock Exchange rarely exceed a fifteen (15%) percent return on equity based on historical cost. Is it reasonable to expect a privately held corporation to be able to pay the prevailing Internal Revenue Service rate (18%), plus annual installments of the inheritance taxes? All the earnings generated must be turned into cash in order to make these annual payments. All evaluations of privately held corporations are based on market value and the historical costs are considerably below these current values. <u>The high tax rates and prevailing Internal Revenue Service interest rates destroy incentive and in many cases make it impossible for the corporation to survive.</u>

An estate which is composed of listed securities is only subject to the prevailing tax in its particular bracket and these shares can easily be sold to pay these taxes. In the privately held corporate sector you have the prevailing tax rate, the interest rate on the unpaid principal in a 303 redemption and the question of the evaluation of the privately held corporation which is subject to a wide range of interpretation. Regardless of the underlying assets, you can take the quoted values of a New York Stock Exchange company but the privately held company's assets are carefully evaluated on the formula of what a knowledgable buyer would be willing to pay. Many New York Stock Exchange companies receive twice the current market value for their stock in a merger because the purchaser is recognizing the value of these assets. All privately held companies are marked up to current market value for estate purposes. You can't sell part of a family business for cash very easily and the best value is achieved by selling the entire company. With the example shown above where the taxes and interest exceed the net value of the estate and we aren't able to generate funds to make these payments it leads to only one solution - Sell.

There would probably be more 303 redemptions if you find executors willing to be personally liable for the payment of these taxes. No bank or lawyer is willing to assume this responsibility for ten (10) or fifteen (15) years. These executors advise the heirs not to attempt these risks of annual payments in cash and advise them to seek a market for the entire company.

You cannot destroy the capital base of the most productive segment of each generation and expect the economy to be strong and vibrant. During the ten (10) year period when the closely held corporation is redeeming this stock, the emphasis is on generating earnings to pay these taxes and no money is available for new machinery and equipment. The liquidity rates of corporations has been declining over the last ten (10) years and the depreciation allowances are inadequate due to inflation.

These corporations can't take ten (10) years of cash drainage through a 303 redemption and remain competitive in the market place. It is my personal observation that the inheritance tax is nothing more than a final success penalty.

As the owner enters the latter stages of his life the further expansion of the corporation is stymied because of the looming inheritance taxes and the necessity to have assets that are readily convertible into cash. These taxes are due in cash and cannot be paid in bricks and mortar. After weighing all the facts the owner may decide to sell the company to a listed New York Stock Exchange corporation, which will simply divert the otherwise productive capital to salvaging the owner's tax situation. Not only are we dealing with high tax rates and high interest rates but the problem of the values of these closely held companies is subject to a wide range of interpretation. The higher the value the greater the tax liability. These large corporations are only interested in a well run company with a continuity of management. These mergers are detrimental to the best interest of the employees and the economy, but are dictated by the existing inheritance tax structure.

The Fortune "500" Companies fully realize that the most successful companies will be available for sale at some state of their growth because of the confiscatory inheritance taxes. Their interest lies in those companies with sales from twenty million dollars ($20,000,000) and up; these happen to be the companies that would experience the highest tax rates upon the death of the principal stockholder.

Companies of this size which employ a large number of people desparately need all of their cash flow for expansion. These high inheritance tax rates will destroy this growth and adversely affect the economy. The inheritance tax laws skillfully herd these companies into the arms of the large multinational corporation because it is the only way you can effectively guarantee the payment of the inheritance taxes. On one hand you are concerned about the concentration of wealth in the hands of a few corporations and with the other hand you are passing inheritance tax laws that force this concentration. <u>These punitive inheritance tax laws must be eliminated in order for the private sector to function.</u>

Realize that when an individual or a corporation makes any money he immediately has to pay income taxes on these profits. If he invests this money in a business and it is successful you tax upon death the full market value. If the individual spends the money on his personal pleasure there is no tax. These inheritance taxes certainly don't encourage investment. Most successful people work because of pride in sense of accomplishment and a desire to leave the fruits of their efforts to their respective heirs. If these assets are taxed away at death to achieve some doubtful social objective this becomes ridiculous. All people are not created equal, they don't have the same amount of intelligence, the same amount of drive and willingness to make personal sacrifices to achieve success. It doesn't make sense to try to fashion laws that will destroy these characteristics that are so important to the success of our Country.

I started my companies with well conceived ideas and products, poured all my energy and efforts into making these a success. At fifty-eight (58) years of age I hate to think that the present existing inheritance tax structure will destroy my life's work. After you have read this statement you may think that the problem outlined is merely an isolated incident and doesn't merit too much consideration. This is an incorrect analysis. There are thousands of inheritance tax problems identical to this one. Most people that have these problems have not spent the energy, time and effort to analyze their estate, figure the tax liability, and determine how to pay these confiscatory taxes.

The only bill before the Senate Committee that will correct this problem is Bill #404 to abolish gift and inheritance taxes. Most of the other bills merely skirt the problem by raising the estate tax deductions or credits. By raising the estate tax exclusions to five or six hundred thousand dollars the revenue produced by the inheritance tax is reduced by approximately fifty percent (50%) and the majority of the tax load would be carried by those gross estates in excess of three million. There is a definite need to completely eliminate the inheritance tax on these companies or they will be sold out to one of the Fortune "500" to solve their cash problems. In summary, the smaller estate will be exempt and the larger ones will have to sell out to the listed companies and this is certainly not the best solution.

WILLIAM M. SCHULER

EXHIBIT #1
ESTATE TAX AND INTEREST CALCULATIONS UNDER SECTIONS 6166A AND 6166

Assumptions:

1. An unmarried individual with a date of death of March 31, 1981.
2. A gross estate of $31,000,000 including value of $27,000,000 of stock interests in closely held companies which qualify for deferred payment provisions.
3. Allowable deductions of $1,000,000.
4. An assumed interest rate of 18%.
5. No prior taxable gifts.

Tax Computations:

Total Gross Estate	$31,000,000
Total Allowable Deductions	1,000,000
Taxable Estate	$30,000,000
Tentative Tax	$20,050,800
Allowable Unified Credit	47,000
Estate Taxes Due	$20,003,800

Note: State death tax requirements are the same as federal requirements. These have not been separately shown since the economic impact is the same as federal.

EXHIBIT #1 - Continued
ESTATE TAX AND INTEREST CALCULATIONS
UNDER SECTIONS 6166A AND 6166

Computation of tax qualifying under Section 6166A:

Total Estate Taxes			$20,003,800
Percentage Qualified Under Section 6166A:			
Value of closely held business / Gross Estate	$27,000,000 / $31,000,000	X	87.1%
Taxes Qualifying for Deferred Payment			17,423,310
Taxes not Qualifying for Deferred Payment			$ 2,580,490

Computation of Tax Qualifying under Section 6166:

Total Estate Taxes			$20,003,800
Percentage Qualified under Section 6166:			
Value of closely held business / Adjusted Gross Estate	$27,000,000 / $30,000,000	X	90%
Taxes Qualifying for Deferred Payment			$18,003,420
Taxes not Qualifying for Deferred Payment			$ 2,000,380

EXHIBIT #1 - Continued
ESTATE TAX AND INTEREST CALCULATIONS
UNDER SECTIONS 6166A and 6166

	Section 6166A 10 Year Installemnts			Section 6166 15 Year Installments		
	Tax	Interest	Total	Tax	Interest	Total
1/1/82	$ 4,322,821	$	$ 4,322,821	$ 2,000,380	$	$ 2,000,380
1/1/83	1,742,331	2,822,576	4,564,907		3,240,616	3,240,616
1/1/84	1,742,331	2,508,957	4,251,288		3,240,616	3,240,616
1/1/85	1,742,331	2,195,337	3,937,668		3,240,616	3,240,616
1/1/86	1,742,331	1,881,717	3,624,048		3,240,616	3,240,616
1/1/87	1,742,331	1,568,098	3,310,429	1,800,342	3,240,616	5,040,958
1/1/88	1,742,331	1,254,478	2,996,809	1,800,342	2,916,554	4,716,896
1/1/89	1,742,331	940,859	2,683,190	1,800,342	2,592,492	4,392,834
1/1/90	1,742,331	627,239	2,369,570	1,800,342	2,268,431	4,068,773
1/1/91	1,742,331	313,620	2,055,951	1,800,342	1,944,369	3,744,711
1/1/92				1,800,342	1,620,308	3,420,650
1/1/93				1,800,342	1,296,246	3,096,588
1/1/94				1,800,342	972,185	2,772,527
1/1/95				1,800,342	648,123	2,448,465
1/1/96				1,800,342	324,062	2,124,404
Totals	$20,003,800	$14,112,881	$34,116,681	$20,003,800	$30,785,850	$50,789,650

Note: For purposes of simplification, the special 4% interest provision has not been utilized in the Section 6166 calculations since it would make only a slight difference in the interest payments due.

6/2/81

Statement of
Louis J. Appell, Jr., President
Susquehanna Broadcasting Co.
before the
Subcommittee on Estate and Gift Taxation
June 5, 1981

My name is Louis Appell, Jr. I am President of Susquehanna Broadcasting Co. located in York, Pennsylvania. Thank you for giving me the opportunity to present my thoughts.

For several generations, my family on both sides has been actively involved in the creation and development of family businesses. We began in the early 1800's as a small pottery manufacturer and have over the years expanded into several other fields which are concentrated in four closely-held corporations.

The largest company, Susquehanna Broadcasting Co. comprises two divisions. As our name indicates, one is involved in the broadcasting industry. It currently operates 14 radio stations in seven states, one UHF television station and 3 cable T.V. systems. Susquehanna's broadcasting facilities are, in the main, located in medium size markets and often serve specialized interests. For example, WQBA radio, our station in Miami, Florida, programs entirely in the Spanish language and has frequently worked closely with elements of the Federal government in connection with the Cuban situation.

Susquehanna's second division is a manufacturer of ceramic table and serving ware, and gifts, under the name of Pfaltzgraff, my mother's family name. This division comprises 5 manufacturing plants and its products are distributed in all 50 states. We are a significant factor in virtually every major department store in the country. Recently we, ourselves, have entered the retail field and now operate 7 stores, two in metropolitan Washington.

In total, Susquehanna provides employment for over 1800 persons.

A second family company, though much smaller, is engaged in the outdoor advertising business in Pennsylvania and currently does business in 29 counties there.

We also have a company which owns and operates a dairy farm and one engaged in real estate. These were started or acquired by my father in the 1930's.

When my father died 30 years ago this month, the businesses just described were very much smaller than they are now. This fact, combined with appropriate tax planning, enabled us to meet his estate tax obligations without excessive hardship. Liquidation of assets was, of course, necessary, but our business interests survived virtually intact. The situation that faces us today is incomparably different.

In the intervening 30 years, our business interests have flourished thanks to some good luck and, I hope, to some capable management. My brother, sister and I have had the marvelous opportunity to take advantage of the relatively small amount of capital left to us and cause it to grow in ways which not only have been profitable for us, but also, I believe, in a very small way beneficial to our national economy. The small companies which 30 years ago employed perhaps 200 people, now provide jobs for nearly 2000 persons. We have been dedicated to seeing our companies grow in a healthy, controlled fashion. Earnings to a very substantial degree have been maintained in the businesses to support that growth. <u>However, under present laws, our very success will likely be our undoing</u>.

Because of punitive estate and gift tax rates, our children and their children will be faced with almost insurmountable problems in raising liquid funds to pay death taxes. The sale of substantial portions of our interests, if not all, will be forced upon them, perhaps during unfavorable times and certainly under uncomfortable circumstances. Alternatively, during my lifetime, some arrangements must be made. Since our family assets are almost entirely comprised of our closely-held companies, significant progress toward solving our estate tax problems can only involve the disposal of family business interests, some of which have been in the family for generations.

I know that you are all intimately familiar with estate tax rates, but I would like to cite a specific example from our own family. My mother is 81 years old and in all these years she has managed to accumulate a net estate of approximately 1 million dollars, largely made up of her residence and personal property. The very small interest she had in family companies has largely been disposed of through gifts. Upon her death, taxes and other settlement costs will consume 33¢ of every dollar. The marginal tax rate will be 39%. What is a relatively modest estate in these inflationary times will shrink from 1 million dollars to approximately $670,000. Certainly a harsh penalty, but manageable and not yet confiscatory.

Let us now proceed from a real example to a somewhat hypothetical one. Let us assume that our companies have a worth of 20 million dollars and that ownership is equally divided among my brother, my sister and me. Assuming it is possible to use the marital deduction in each case, the total cumulative federal estate taxes payable upon our deaths and that of our spouses will be 8 million dollars with a marginal rate of approximately 57%. Remember, this assumes no other significant assets and the use of the marital deduction in each case, a possibility that may or may not exist. Remember too, that the 8 million dollars is for Federal taxes only. State taxes and settlement expenses will deplete the estate an additional 1½ to 2 million dollars.

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Thus, even under the best possible circumstances, virtually 1/2 of that 20 million dollars will have been consumed in a few short years.

As mentioned, the foregoing example is a hypothetical one. The actual situation is far too complex to describe in short testimony. But the example accurately portrays in general terms the degree of the problem our family will ultimately face.

It is obvious that our family cannot maintain our business interests under such circumstances, and yet we would like to be able to. We would like our children, and their children in turn, to have the same opportunities we, and previous generations, have had. In the past 5 years, as a family we have spent untold hours - not to mention money - in attempting to deal with this problem - time and money which could otherwise have been employed in far more constructive pursuits. But for all of that, we have been unable to lessen the confiscatory, punitive impact that Federal estate taxes will ultimately have on our family.

Of course for a family that wishes to maintain a certain unity and which is proud of its achievements, the implications are not only financially momentous, but emotionally traumatic as well. We are just one small family unit, but there are thousands of families like us throughout the country who are faced with similar problems.

As a country, we seem determined to penalize at every turn those who are innovative, creative, motivated and, above all, successful. Those, in short, who provide investment capital and who provide jobs. This national policy, largely begun in the 30's has gained momentum over the years and we are now seeing the results.

Your committee is well aware of the statistics showing the decline in our nation's competitive position compared to the rest of the world. We all know the vast overall economic problems in this country. I suggest that our tax policies are, to a large extent, responsible.

Of the large industrialized countries, only England has shown a poorer economic performance than we have. Peter Grace, in his testimony before the Senate Finance Committee, produced statistics indicating that the United Kingdom and the United States have the highest percentage of gift taxes compared to Gross Domestic Product of the industrialized nations, the U.S. being somewhat higher than the U.K. For ten years our company owned a small manufacturing company in England. I had the opportunity to observe first-hand how unwise tax policies have played a substantial part in reducing a once prosperous, productive nation into one that is now fighting for its economic life.

And yet we seem not to learn from that example and other evidence right here at home. Ironically, for a nation which was built on the inventiveness, productivity and entrepreneurial spirit of its citizens, we seem determined to penalize these qualities.

We discourage those who are willing to risk their fortunes to add to our economy and to provide new jobs. We sit idle as small, creative and flexible family firms are forced to sell out to large, slow-moving and frequently bureaucratic, public companies, thus diminishing incentives and changing the complexion of our communities and our country. Is it possible that anyone can really believe that such tax policies benefit our nation? Gift and Estate taxes represent a mere one and one half % of Treasury Revenue. In order to raise this comparatively miniscule amount, does it make sense for the wealthiest nation on earth to eat its seed corn?

May I ask your indulgence for a short while longer to recount some personal experience. I have lived all my life in the small city of York, Pennsylvania, just 90 miles to the North. Those of you who are historically inclined will recall it as a capital of the United States during the Revolution. It has always been, and still is, a prosperous area combining a strong industrial base with a productive farming community. It is very much like many towns, larger and smaller, throughout the country.

But I have seen York undergo a very considerable change over the years. It has gone from a community which was the home of many relatively small, successful family businesses, the owners of which were proud of their heritage and their town, to one essentially dominated by the branch plants of large national companies. Many of these companies are public spirited, but unfortunately, many are not.

I well recall a luncheon which took place about 20 years ago. It was convened by two of our elder industrial statesmen and comprised the business leadership of the community. These two fine gentlemen had become enthusiastic about the success of the Junior Achievement program in other cities and felt York should have a chapter. During lunch, the concept was explained, enthusiastically welcomed, organized and funded. In less than two hours, one of the most significant programs in our community for young people was launched. I do not believe this experience could be repeated today.

There is a significant postscript to this story. A short time after the luncheon, one of the organizers sold his company. It had been a successful family firm for generations and many family members were community leaders and generous benefactors. The large national paper company which was the purchaser has provided neither volunteer leadership nor significant financial support for local projects.

Today, York, despite its changed business complexion, is still a prosperous community. But those of us who for decades have provided leadership are dwindling in number, and our successors in the person of younger people with business roots in the community are becoming difficult to identify. We wonder who will provide the dedicated, caring leadership as well as charitable support in the years to come. Again, there are undoubtedly hundreds of Yorks throughout the country whose leaders are wondering the same thing. And I ask, can such a circumstance be a healthy one for the future of our country?

It is my hope that the experiences that have been related to you today of one small family unit and the community in which we live will result in tax laws which create and increase, rather than reduce, incentives. I hope that I may have at least caused you to question tax policies which discourage the most productive, innovative and highly motivated individuals in our society. The imposition of excessive penalties on those persons who are willing to risk their capital to create wealth and thus provide jobs can only work to the detriment of our nation in the long run.

Accordingly, I recommend that estate and gift taxes be entirely abolished. If this is not possible, I urge that taxes imposed on family businesses be at much lower rates than currently, and significantly lower than taxes on investment assets.

Thank you very much for giving me this opportunity.

LJA, JR.
6/2/81

STATEMENT
on
MAJOR ESTATE AND GIFT TAX ISSUES
before the
SENATE FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
for the
NATIONAL FAMILY BUSINESS COUNCIL
by
STEVAN A. WOLF
June 5, 1981

My name is Stevan A. Wolf. I am General Manager of our family business, the Letty Lane Company of Westville, New Jersey, and I am Chairman of the Governmental Affairs Committee of the National Family Business Council.

Mr. Chairman, the National Family Business Council appreciates this opportunity to present its views on needed revisions in the federal estate and gift tax laws.

The National Family Business Council is a nonprofit membership association that is dedicated to the survival and well-being of family-owned enterprise. Membership in the National Family Business Council is composed of individuals, firms and corporations engaged in family businesses and those interested in the well being and perpetuation of family-owned enterprise. The Council provides an organization through which common business interests of family-owned commercial enterprises can be promoted and improved. Its current primary legislative objective is the elimination of unreasonable estate and gift tax burdens on family-owned businesses.

History of Estate Tax

The federal estate tax was enacted in 1916. The purpose of the tax was to prevent unreasonable accumulations of wealth in the hands of a very few persons. The tax was never intended to discourage or prevent the perpetuation of family-owned businesses nor was the tax intended to be a revenue producer.

The estate and gift tax is among the smallest of federal taxes collected. It produces only 1.23 percent of the total revenues of the federal government. Eliminating it entirely would probably produce a greater increase in federal income taxes by encouraging profitability among those burdened by the tax.

Today's estate tax is a far different tax from what was intended in 1916. It is what we refer to as the "family business tax." It preys on the widows and children of those whose lifetime efforts have gone into the building of family enterprises. It is no longer just a tax on the wealthy. It taxes many in the middle-income brackets.

Problems With Present Estate Tax

The Tax Reform Act of 1976 provided for a marital deduction for property passing from a decedent to a surviving spouse of the greater of $250,000 or one half of the decedent's adjusted gross estate. The Act also provided an unlimited marital gift tax deduction for transfers between spouses for the first $100,000 in gifts, and thereafter the deduction allowed is 50 percent of the interspousal lifetime transfers in excess of $200,000.

Although the 1976 Act made improvements in the law, we are of the opinion that transfers of property between spouses before or after death should not be taxed. This so-called "widow's tax" should be eliminated. This would be a first step in allowing some consideration to be given to the working heirs who would ultimately take over the family business on the death of the second parent. We would favor making such an unlimited martial deduction optional.

The estate and gift tax as it now operates discourages savings, investment and productivity. In effect, it penalizes the widows and children of those decedents who took the risks of being in business for themselves and working throughout their lives to become profitable. This disincentive to success results in fewer jobs, reduced productivity, and adds to economic decline.

Need for Action

We are in a period of history when this country is suffering from a dramatic reduction in producitivity. While the average American worker produced between 2 and 3 percent more each year after World War II, in the past decade that growth in productivity has declined and then stagnated.

We are in an era of historically high rates of inflation and unprecedented interest rates. The rate of unemployment is running over 7 percent. We are encountering difficulties competing with other countries in auto sales. Our housing industry is in deep trouble. Many businesses are suffering from economic decline. Add to this that government has overtaxed the American taxpayer, and it all adds up to the need for action.

The Congress has before it major legislation to encourage capital formation. An added reason for our current economic and productivity problems is the way we discourage profitability by taxing the lifetime efforts of businessmen and women. President

Reagan has pledged to seek changes in the federal estate tax to alleviate its unfairness to family-owned businesses and farms.

The present estate and gift taxes are a destructive force. While not their purpose, they can destroy the family unit. What has been built as a lifetime income and pension for the husband and wife of a family-owned business can be broken apart by the estate tax and destroyed forever.

Effects of Inflation

Double-digit inflation has pushed the estates of small business into higher and higher estate and gift tax brackets. While the real value of assets in many instances has remained the same, the inflationary spiral has demanded higher taxes through bracket creep. As in the case of the income tax, the movement into higher brackets has resulted from the unfair impact of inflation.

We favor an increase in the tax credit and a reduction in the rates of the estate and gift tax. We are of the opinion that the estate and gift tax credit should be increased to allow up to $1,000,000 to pass to heirs and beneficiaries tax free instead of the present $175,625. We also advocate a reduction in the estate and gift tax rates from the present maximum of 70 percent, to a maximum of 30 percent. Both of these changes would serve to help correct the inflationary injustices of the present law.

Need for Liquidity

Today's estate and gift tax is unnecessarily complex. The result is that the super wealthy have access to tax experts who can assist them in avoidance schemes, while those of moderate means are paying a very high portion of what is an unfair and burdensome tax.

If the law is to remain on the books, the law should be simplified and those in the lower brackets eliminated from the tax entirely.

Marriage is not just a bond between a man and a woman. In a family business it usually results in a partnership. When a member of that partnership dies, it often presents unique problems. The loss of the family member places great burdens on those remaining family members who must carry on the business. It is often difficult to muster the needed courage and strength to carry on the family business in the aftermath of the tragic loss of the father or mother.

A major problem facing heirs of family-owned businesses today is the lack of funds to pay the estate tax. Not only must the heirs face the problems and stress caused by the loss of the principal owner of a family business, but they must almost immediately face the problem of accumulating sufficient funds to pay the estate tax.

Installment Payment

The Tax Reform Act of 1976 provided a 15-year period for the payment of the estate tax attributable to the decedent's interest in a closely-held business. Under the Act, the executor may elect to defer the estate tax, but not the interest on the tax, for a period of up to five years and thereafter pay the tax in equal annual installments over the next ten years. To qualify for this treatment, the value of the closely-held business in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by expenses, indebtedness and losses.

This strict 65 percent rule poses problems for family-owned businesses. The principal owner of a family business must always keep in mind the 65 percent rule when making any transfers of ownership in the business. He may wish to give some of the stock to a son or daughter, but if it will reduce his ownership below the 65 percent margin, he will be reluctant to do so. The result can be that the present law discourages adding family members as participants in the family business.

The rule also can have the opposite effect. If the principal owner is slightly below 65 percent, great sacrifices may have to be made by the owner to meet this percentage requirement. In an effort to meet the 65 percent, he may be forced to sell valuable assets at sacrifice prices.

We believe the provisions in the present law for extension of time to pay the tax should be relaxed in the case of closely-held businesses.

We are of the opinion that the installment provisions for closely-held businesses should be broadened so that where the value of an interest in a closely-held business is 25 percent of the value of the gross estate or 35 percent of the taxable estate, payment can be made under the 15-year installment provision.

Special Use Valuation Rules

While the 15-year installment provision assists those families that cannot muster adequate funds to pay the tax without resorting to selling a part or all of the family business, it is frequently insufficient. Family-owned businesses are being sold prior to death in anticipation of estate taxes and after death to meet the tax costs. Under such circumstances, small businesses are being forced to sell out to larger businesses, and the estate tax is thereby encouraging the concentration of American business enterprise in the hands of fewer persons.

The special use valuation in the present law has been helpful for estates composed largely of farmland, but the provision has generally not aided those estates of closely-held businesses. We favor a special valuation rule for closely-held businesses that would allow an executor to value a closely-held business for estate tax purposes at 50 percent of market value.

Annual Exclusion

Under present law there is an annual exclusion of $3,000, $6,000 where the nondonor spouse consents to split the gift, for transfers of present interests in property for each donee. The Revenue Act of 1942 modified the annual gift tax exclusion by reducing it from $5,000 to $3,000.

Unfortunately the gift tax is often today honored in the breech. The $3,000 annual exclusion is too low and frequently taxpayers are not even aware of the requirement to pay the tax. The annual exclusion should have been increased years ago. We favor increasing the annual gift tax exclusion to $10,000.

Conclusion

Mr. Chairman, I appreciate this opportunity to be here today to express the views of the National Family Business Council on the need for changes in the estate and gift tax. May I offer you the services and cooperation of our organization to assist you in any way possible in your efforts with regard to estate and gift taxation.

Senator SYMMS. Now we will hear from a distinguished former member of this committee, Senator Carl T. Curtis, from Nebraska, who is now a practicing attorney here in the city of Washington, D.C.

Senator Curtis, you were not here when I made the opening announcement, but I might just say that I suggested to the President and to the Secretary of the Treasury, that what we should do on this estate tax right now while the tax package is before the Congress is to compute how much revenue loss the Treasury can take on the estate tax now in the overall computation, and just put that in the program and start phasing this out so that in 4 or 5 years there is no estate and gift tax left and stop all of the complicated ideas.

So, you might give us your viewpoint on that suggestion, also.

STATEMENT OF SENATOR CARL T. CURTIS, NELSON & HARDING, WASHINGTON, D.C.

Senator CURTIS. Thank you, Mr. Chairman.

Fifty-one years ago, I stood before the Supreme Court of Nebraska and was sworn in as a lawyer.

The distinguished chief justice made a speech. I have forgotten everything he said, but two points. One of them was, "Gentlemen, always be in court on time."

I remember what he said. I disobeyed this morning. I bow humbly and extend the committee my apologies.

Mr. Chairman, it is a real pleasure to return to the Committee on Finance and have the opportunity of making this statement.

I commend the committee and its distinguished chairman for holding these hearings. Relief from the present burdens which are imposed by estate and gift taxes is very necessary. It is in the interest of fairness to the taxpayers and in the best interest of our overall economy.

My statement will be brief. The case will be well-developed by the distinguished panel and other witnesses you have already heard and who will follow.

My remarks are not directed toward any particular bill but rather for the need for legislative relief. By their very nature estate and gift taxes must be considered together.

These burdens at the present time are not only unfair to the individuals and families who pay the taxes but they are unsound from the standpoint of our entire economy.

Whenever an owner of a small- or a medium-size business dies, his widow and the members of the family are faced with the task of raising sizable sums of money to pay the estate taxes.

Too often the business has to be sold. In most cases, the buyer of a business is not another small businessman, but the only potential buyers are the large chain-type corporations.

I am not using this forum to complain about or criticize big business. We need businesses of all sizes. I do contend, however, that the Federal Government's tax policy should not be designed to promote mergers and monopolies by forcing business property out of the hands of the survivors of the owners of small- and medium-size enterprises.

There are other cases where to pay the taxes, the business is completely liquidated and the jobs of faithful and oftentimes long-standing employees are destroyed.

The estate and gift taxes were never intended to be a tax on all successful people, who by hard work and saving accumulate a modest amount of property.

Unless the Congress makes some substantial changes in the law, the estate and gift taxes will be a burden upon a high percentage of our people who do not fall into the category which was intended to be taxed when the estate and gift taxes was first introduced into our Federal tax system.

The Federal estate and gift tax were originally intended to be levied on a few families in America who were tremendously wealthy and whose wealth was so great that the passing on of that wealth to their families was regarded as antisocial in nature and not in the interest of—the best interest of our overall economy.

Today, by reason of inflation and the economic growth of the country, the burden falls upon millions of individuals who are not the possessors of huge amounts of wealth.

The burden of estate and gift taxes is now borne by individuals who have accumulated what they have through hard work, saving, and self-denial, and who by comparison are not individuals of great wealth at all.

Many of these hard-working citizens who have through their toil, accumulated some property, are not aware of the impact that the estate taxes will have upon their death.

There are others who cannot afford to pay for the best and most sophisticated estate planning.

The total revenue from the estate taxes is a very small percentage of the total revenue of the U.S. Government. It is costly to administer. It is very costly to the taxpayers. It is very destructive to our economy.

I would urge the committee to grant real and substantial relief from these taxes.

The present provisions of the law which were enacted a few years ago, which deal with the valuation and lower interest rates raising the credit and extended time for paying estate taxes are commendable, but they are not enough.

Relief should be granted to everyone. The credit against the tax should be greatly increased and the rates of tax should be substantially reduced for all taxpayers.

In the case of husbands and wives, the estate taxes should not be imposed until the death of the surviving spouse.

The relief granted should not be limited to the owners of a particular type of property, but should include everyone.

A client of mine was recently asked, "Mr. Johnson, how can I become a millionaire?" To which he replied, "That is easy. Buy a house now for $50,000 and wait 20 years."

This committee should deal with the inflation factor by indexing or otherwise, so that the relief that you grant will have some permanent value.

I thank you for the opportunity to make this statement.

Senator Dole. Where do you get that house for $50,000? [Laughter.]

Senator CURTIS. Mr. Chairman, I still think like a Nebraskan. [Laughter.]

We don't gouge out there. [Laughter.]

We have better values.

Senator SYMMS. Thank you very much, Senator Curtis, for your excellent statement.

Are there any members of the panel who wish to ask any questions?

Senator GRASSLEY. I would like to ask him a question, Mr. Chairman.

Senator SYMMS. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

You were a former member of this body, and I believe of this committee. I don't know what you thought about indexing tax rates at that particular time, but it can apply both to income tax and there has even been a suggestion of indexing estate taxes so that they would keep up with appreciation and costs—appreciation and inflation.

I would like to have your view on that, not just on the principle of indexing per se, but as it would apply to estate taxes.

Senator CURTIS. I am not sure of what position is correct with respect to taxes generally. I am not critical of those who do advocate indexing across-the-board.

It is a problem that runs from year to year.

In the estate taxes, I think it is very important that something be done to protect against inflation because it has such accumulating effect.

The toil and sacrifice and self-denial that goes into an estate, all of the inflation is accumulated over a period of years and applied on the one bite.

So, while I would reserve opinion as across-the-board, I am not critical of it, but I am just not sure what it should be.

I do think that indexing is a necessary element of the estate taxes.

Senator SYMMS. Thank you very much.

Senator Dole.

Senator DOLE. I have no questions. I just want to welcome Senator Curtis before the committee. I am occupying the chair formerly occupied by Senator Curtis.

We now have moved over to the other side, but we are not used to it yet. By habit we always end up on this side, I guess. We are in good company, I might add. [Laughter.]

Senator CURTIS. With due respect to our distinguished chairman of the past, I would say that you are occupying that chair very well and we are proud of you.

Senator SYMMS. Senator Byrd.

Senator BYRD. I just wanted to join in welcoming Senator Curtis and say I think he presented an excellent statement to the committee this morning.

Senator SYMMS. Senator Boren.

Senator BOREN. Thank you very much, Senator. We appreciate having you with us.

Senator SYMMS. Thank you very much. You are forgiven for not being here at 9 o'clock. So, don't worry a minute about it.

Senator CURTIS. I hope the judge who gave that advice doesn't read this transcript.

Senator SYMMS. After your 40 years of service in the Congress of the United States, I think you deserve to get here at 10. So, that's fine.

[Statement follows:]

STATEMENT OF SENATOR CARL T. CURTIS

Mr. Chairman, it is a real pleasure to return to the Committee on Finance and have the opportunity of making this statement. I commend the Committee for holding these hearings. Relief from the present burdens which are imposed by the estate and gift taxes is very necessary. It is in the interest of fairness to the taxpayers and in the best interest of our overall economy. My statement will be brief. The case will be well developed by the distinguished panel and the other witnesses who will follow. My remarks are not directed toward any particular bill but rather for the need for legislative relief. By their very nature estate and gift taxes must be considered together.

These burdens at the present time are not only unfair to the individuals and families who pay the taxes, but they are unsound from the standpoint of our entire economy. Whenever an owner of a small or medium size business dies, his widow and the members of his family are faced with the task of raising sizeable sums of money to pay the estate taxes. Too often the business has to be sold. In most cases the buyer of the business is not another small businessman, but the only potential buyers are the large chain-type corporations. I am not using this forum to complain about or criticize big business. We need businesses of all sizes. I do contend, however, that the federal government's tax policy should not be designed to promote mergers and monopolies by forcing business properties out of the hands of the survivors of the owners of small and medium size enterprises. There are other cases where to pay the taxes the business is completely liquidated and the jobs of faithful and often long standing employees are destroyed.

The estate and gift taxes were never intended to be a tax on all successful people who, by hard work and saving, accumulate a modest amount of property. Unless the Congress makes some substantial changes in the law, the estate and gift taxes will be a burden upon a high percentage of our people who do not fall into the category which was intended to be taxed when the estate and gift taxes were first introduced into our federal tax system. The federal estate tax and the gift tax were originally intended to be levied on a few families in America who where tremendously wealthy and whose wealth was so great that the passing on of that wealth to their families was regarded as anti-social in nature, and not in the best interest of our overall economy.

Today, by reason of inflation and the economic growth of the country, the burden falls upon millions of individuals who are not the possessors of huge amounts of wealth. The burden of estate and gift taxes now is borne by individuals who have accumulated what they have through hard work, saving and self-denial, and who by comparison are not individuals of great wealth at all.

Many of these hard working citizens who have, through their toil, accumulated some property are not aware of the impact that the estate taxes will have upon their death. There are others who cannot afford to pay for the best and most sophisticated estate planning. The total revenue from the estate taxes is a very small percentage of the total revenue of the United States Government. It is costly to administer and it very costly to the taxpayers.

I would urge the Committee to grant real and substantial relief from these taxes. The present provisions of the law which were enacted a few years ago and which deal with the valuation and lower interest rates and an extended time for the paying of the estate taxes, are commendable but they are not enough. Relief should be granted to everyone. The credit against the tax should be greatly increased and the rates of tax should be substantially reduced for all taxpayers. In the case of husband and wives, the estate taxes should not be imposed until the death of the surviving spouse. The relief granted should not be limited to the owners of a particular type of property, but should include everyone.

A client was recently asked, "Mr. Johnson, how can I become a millionaire?" To which he replied, "that is easy, buy a house now or $50,000 and wait 20 years." This Committee should deal with the inflation factor by indexing or otherwise so that the relief that you grant will have some permanent value.

I thank you for the opportunity to present this statement.

Senator SYMMS. Now, we will be very happy to hear from a panel consisting of a former neighbor of mine, the former chairman of the House Ways and Means Committee, the Honorable Al Ullman, whose district bordered mine for 8 years. We enjoyed working together in the House.

Mike McKevitt, of the National Federation of Independent Business; Dr. Peter Nelson, president, Agricultural Trade Council; Robert L. Spence, chairman, National Committee To Preserve the Family Business; and Herbert Lieberson, National Small Business Association.

So, gentlemen, please come up and be seated.

STATEMENT OF HON. AL ULLMAN, ULLMAN CONSULTANTS, WASHINGTON, D.C.

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

First, on behalf of all of us, I want to express our appreciation for your great interest in this estate tax matter.

Second, I apologize also for missing the 9 o'clock deadline this morning. But, I also am exceedingly pleased to have the chairman of the full committee here, Senator Dole.

This is the first time I have testified before the Congress on this side of the table. I am indeed pleased and honored that you are here, Mr. Chairman, also Senator Byrd, Senator Boren, whom I have talked with about this matter, Senator Grassley, to congratulate him and to commend you all for your interest in this estate tax matter.

Mr. Chairman, I do appreciate the opportunity to testify. I am serving as legislative counsel to the National Committee To Preserve the Family Business.

Mr. Chairman, we formed this national committee because we felt the need for an umbrella organization to focus on estate and gift tax reform for the owners of farms, ranches, timber lots, and small businesses.

As you know, the burden of estate and gift taxation today falls most heavily on that group. I think all of you here remember the 1976 efforts on estate taxes. We made some progress. But inflation has totally eroded the gains we made.

The galloping concentration of businesses is today in a state of crisis. Small businesses are being forced to consolidate. A lot of this is due to estate taxes.

The time has come to act. Therefore, I appreciate the fact that not only all of you are interested, but that the President has indicated direct interest in this matter.

The Democrats in the House in their tax reduction proposal have indicated a priority interest in this matter and that makes us feel very good.

I think all of the people who testified on the previous panel, and on this panel, know that small businesses in America are vitally concerned about this matter of closely held business, and how you define them, and how they are treated in estate tax provisions of the law.

We do have a draft proposal that encompasses many—if not all—of the concerns of small business.

I would hope, Mr. Chairman, that we could incorporate the small business provisions that we recommend in the testimony today.

Our proposal would substantially reduce rates, increase the exemption and liberalize the gift tax provisions.

Senator SYMMS. Without objection, your proposal will be made part of the record.

[Material to be inserted.]

STATEMENT OF HON. AL ULLMAN

Mr. Chairman, I appreciate the opportunity to testify before the subcommittee today. I am serving as the legislative counsel to the National Committee to Preserve the Family Business, and the members of this panel all serve on the Advisory Board.

We formed the National Committee to Preserve the Family Business because we felt the need for an umbrella organization to focus on estate and gift tax reform for the owners of farms, ranches, timber lots, and small businesses. As you know the burden of estate and gift taxation today falls most heavily on this group.

As Chairman of the Ways and Means Committee in 1976, I recognized the necessity of addressing these problems, and as a result we worked hard to modify the harsh impact of the estate tax burden on our farmers, businessmen and citizens. Members of the Senate Finance Committee were very helpful in that effort. Now, however inflation has eaten away the gains we made, and there is an urgent need to again make major changes in these provisions of the tax code.

Small businessmen, ranchers, and farmers are especially hard-hit since their holdings are often very illiquid; when this is combined with the fact that the paper value of their estates has skyrocketed, they are often forced to sell to large corporations or the wealthy in order to meet estate tax liability. This is destroying the family business in America, which has always been the bedrock of our economy.

It is also contributing to the restructuring of our economy, in that large corporations and the wealthy are able to gain the property and assets of small and medium sized estates, while often avoiding the tax themselves. This is precisely what the estate tax was designed to avoid.

Our proposal would substantially reduce rates, increase the exemption, provide a special reduced rate for closely held businesses and simplify the procedures for payment of the tax. Other members of the panel will address these solutions in more detail.

I am proud to appear here with a distinguished panel that includes Robert Spence, the Chairman of our National Committee to Preserve the Family Business, Herbert Liebenson, the President of the National Small Business Association, Mike McKevitt, the Director of Federal Legislation for National Federation of Independent Business, and Dr. Pete Nelson, President of the Agriculture Trade Council.

All the members of this subcommittee have taken leadership positions on this issue, and I look forward to working closely with you to achieve our goals. We now have a golden opportunity to make the most far-reaching reforms ever in gift and estate taxation.

Thank you again, Mr. Chairman.

Mr. ULLMAN. Thank you, Mr. Chairman.

But, more than that, we define closely held business in a way that we think simplifies the law and is very workable. Witnesses will be dealing more specifically with that on this panel.

We also do provide specially reduced rates for closely held businesses. Under a formula that we think is workable. It is a 50-percent formula with a cap of $50 million. We think it realistically faces up to the problems of small business in this country.

I am proud to appear here with a most distinguished panel which includes Robert Spence, the chairman of our National Committee To Preserve the Family Business; Herbert Lieberson, president of the National Small Business Association; Mike McKevitt, the director of Federal legislation for the National Federation of Independent Business; Dr. Peter Nelson, president, Agricultural Trade Council; and Dan Goldy, who is our economic adviser for the national committee.

All the members of this subcommittee have taken leadership positions on this issue. I look forward to working closely with all of you to achieve our goals.

We now have a golden opportunity to make the most far reaching reforms ever in gift and estate taxation. I want to assure you that we will fully support and coordinate our efforts with yours in order to achieve that objective.

Thank you, Mr. Chairman.

Senator SYMMS. We thank you very much. We look forward to working with your group to formulate what will be a solution to this.

Senator Dole.

Senator DOLE. Mr. Ullman, I appreciate very much your comments. I have to go over to an Agriculture Committee meeting. I will be back in about 25 minutes. This panel may have finished by then.

As you indicated, there is a recognition now that something is going to be done. We are also right now in the process of drafting what that will be.

So, I think this hearing is particularly timely. I would hope that members of this panel and other panels here will be available not only today for testimony but for some actual input into what we hope will be a satisfactory proposal.

As I view it, we are not constrained by anything except maybe dollar amounts on how we fashion the package. That hasn't been dictated by the President or anyone else for that matter.

So, we would be pleased to have as much—input as possible a lot of us have different ideas on how it should be done. We will need some help, I guess.

Mr. ULLMAN. Senator Dole, let me say that this does have the priority attention of every member of this panel. I can guarantee you that each and every one of us will be fully available to work with you and help in any way possible.

Senator DOLE. Thank you.

Senator SYMMS. Thank you.

Mike, did you have a statement that you wanted to make this morning?

STATEMENT OF JAMES D. "MIKE" McKEVITT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. McKEVITT. Yes, Mr. Chairman, and distinguished members of the committee. I will just make it very brief.

My name is James D. "Mike" McKevitt, director of Federal Legislation of the National Federation of the Independent Business.

I also serve as a member of the advisory board of the national committee to preserve the family business.

I would like to say that business owners' concern for estate taxes that might burden family members or business associates results in business decisions which are not economically based.

Very often substantial resources are wasted on legal and accounting fees and life insurance premiums with the goal of minimizing estate taxes and providing the needed cash to pay the estate tax bill.

As you may recall, I testified before your subcommittee several weeks ago, Mr. Chairman. One of our members, Mr. Wilbur Doyle, here, from Martinsville, Va., who gave a graphic example of his lumberyard operation where he spent 20 percent of his net profits paying for life insurance to cover his prospective death taxes that he faces down the road.

I would reiterate also or to elaborate even further, two surveys we have done. One is a national survey, a random survey of our members where we gave them 12 different options for tax cuts for small business.

The one that came in a very close second was the abolishment or modifications of death taxes.

We did a special survey of major cities of our members in the core cities areas as to what their needs were to keep some of these troubled areas alive. They mentioned three primary solutions and one of them was the abolishment or modification of death taxes.

Our ultimate goal is to support your legislation as to the abolishment of, and I call it "death tax" because I do think the estate and inheritance taxes are terms we ought to begin to get out of our vocabulary, because of the misleading nature of them and the fact it stands in the way of trying to bring this legislation about.

We also strongly support the proposal of the national committee to preserve the family business which entails amending Senator Wallop's proposal, S. 395.

Senator Wallop's bill provides an excellent framework for substantial relief of estate tax rules by small business. The proposed amendments provide more fundamental assistance to small business in the area of valuation of liquidity than S. 395.

The proposal outlined by Chairman Ullman is necessary to preserve small business continuity and deserves serious consideration in the short term by this subcommittee.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you very much for your excellent statement.

Dr. Nelson.

STATEMENT OF PETER NELSON, PRESIDENT, AGRICULTURAL TRADE COUNCIL

Dr. NELSON. Thank you, Mr. Chairman.

We appreciate the opportunity to be here. With your permission, if we could have our statement entered into the record, I will just summarize.

Senator SYMMS. Without objection, it shall be. All of your statements will be inserted in the record.

Dr. NELSON. Thank you.

The present law has an intent of avoiding concentration of wealth. But as it turns out, it is contrary to that intent in that each time a small business is eliminated it creates fewer and larger corporations to take over, and the creation of oligopolies is against the interest of the public.

In the rural environment it is very detrimental to the local economies. Eventually small business which create local employment are sold to companies far away in cities and a substantial reduction in employment exists both in the commercial sector, the agribusiness sector, and the family sector.

With due respect, I would like to take exception to Senator Long's statement which is not typical where someone finds oil and sits and watches the oil pumps go. That is not typical of the average business.

I might mention the farm, where you have a family enterprise and the children start at a very early age helping on the farm and they may up to the age 40 or 50 when the father dies, really be part of that corporation. All of a sudden they lose everything.

The purpose of the legislation was to eliminate these oligopolies and as a result the farmer has very little incentive to continue farming.

In most cases, the farmer can sell his land, put his money in a money market fund and get some $200 and $300 per acre per year in interest.

He cannot farm and make $200 and $300 per acre, even working for $100 a week as many of them do.

So the only incentive for continuing farming in many cases is to have something to pass on to the children, to the family.

If that incentive is eliminated we end up reducing farmland. We reduce our major source of export funds which is agricultural commodities and end up with a bad situation.

Reduction of competition is also contrary to the consumer interests. Each time a small business is eliminated you have less competition in the marketplace. You have less competition in our foreign trade business where we are competing against foreign corporations.

If our prices go up we reduce our potential market overseas. The rest of my statement is in the paper. I thank you.

Senator SYMMS. Thank you very much, Dr. Nelson.

Robert Spence.

STATEMENT OF ROBERT S. SPENCE, CHAIRMAN, NATIONAL COMMITTEE TO PRESERVE THE FAMILY BUSINESS

Mr. SPENCE. Mr. Chairman, I appreciate the opportunity to be able to testify this morning.

In the interest of time, I have a more detailed statement I would like to submit for the record. But I will read this brief summary.

Mr. Chairman, my name is Robert L. Spence. I am the chairman of the National Committee To Preserve the Family Business.

I am also chairman of the tax committee of Western Forest Industries Association, as well as vice president of a closely held business, Pacific Lumber & Shipping Co., of Seattle, Wash.

I am also speaking on behalf of the Southern Lumber & Manufacturers' Association.

As a small businessman, I have seen firsthand how current estate and gift tax laws impose almost impossible burdens on the most productive sector of our economy.

My own corporation has four generations involved in it. My grandmother died in 1980, and we incurred a tax liability of $2 million.

Her estate passes to my father and if he passes away we will incur another liability of $8 million.

If the tax is not changed, I don't think that Pacific Lumber & Shipping Co., will see 1990.

As Congressman Al Ullman has already suggested, inflation has raised the paper value of our assets. However, because small businesses, farms, and ranches are not liquid, the value of these assets is not readily available to meet the estate tax liability.

This creates a situation where the property or assets must be sold, often to a large corporation or to wealthy individuals, almost entirely removing the incentive to build up a business or farm so that it can be passed on to their heirs.

This has ramifications beyond the immediate estate. Many small businesses operate as the only major industry in small towns across the country. These businesses must be liquidated to pay estate taxes, large corporations may buy the assets and then shutdown the operation or move it, thus creating severe economic dislocation.

In the timber industry of the Pacific Northwest, for instance, a large company may buy a smaller illiquid lumber mill, simply to gain its timber base, and then shut the mill down.

A small businessman can buy insurance to cover his expected estate tax liability, but the costs are enormous, up to one fifth of the profits of the company may have to be invested in a policy to cover the owner or majority stockholder.

Additionally, current provisions in the tax code to ease the burden on farms and ranches and to permit small businesses to redeem stock and extend the estate tax payments are unnecessarily restrictive.

Much of the debate has properly focused on the problems with section 203(2)(a), the special use valuation provision for farms, ranches, and wood lots.

However, attention must also be given to the payment and qualification problems of closely held business.

We believe the extended payment provisions of section 6166 should be liberalized to allow a closely held business to qualify more easily for installment payments of estate taxes.

Section 303 should also be amended to provide for a closely held business to accumulate funds within the business for estate tax liability without the funds being subjected to a tax penalty.

The accumulation of funds is the most pressing problem facing a small business. Perhaps most important, we believe that those individuals with interest in a closely held business should pay estate taxes based on 50 percent of fair market value, after taking into account the non marketability of this interest.

This will go a long way toward reducing the crushing burden of estate taxes on small businesses.

In applying these provisions, we also believe a modified definition of closely held business is necessary. The current definition is becoming more and more restrictive as closely held businesses participate more widely in employee stock ownership plan.

As the number of stockholders goes up, they are excluded from taking advantage of those sections of the code that cushion the estate tax burden.

We do not believe that small businesses should be penalized because they are encouraged by the Congress to offer ESOP's or because they permit key employees to share in stock ownership.

For that reason, we would like to see a definition used in both the extended payment provisions and the small business valuation provision that makes a closely held business eligible if 50 percent or more of the company is owned by 20 or fewer stockholders, while excluding all corporations whose stock is publicly listed.

We hope the subcommittee will give serious consideration to these proposals.

Again, I thank you for giving me the opportunity to appear this morning.

Senator SYMMS. Thank you very much.

Before we hear from Mr. Lieberson, I just want to ask you one question. You made reference to your own family company. Who would be a likely buyer of Pacific Lumber & Supply Co., if you were out looking for a big company to buy up.

Would it be in the lumber or oil?

Mr. SPENCE. That is a good question, Mr. Chairman. We participate in the National Forest Service System. And, because of certain limitations, large companies do not have the same access to the timber that we do.

So there is somewhat of a liability for them to buy a corporation such as ours. More than likely we would have to auction the corporation. What concerns me vitally is that that means we would jeopardize three communities with a substantial employee base, under those circumstances.

Senator SYMMS. How many people do you employ?

Mr. SPENCE. It is 450.

Senator SYMMS. I see, 450.

Mr. SPENCE. Yes, sir.

Senator SYMMS. Thank you very much.

Herbert Liebenson.

STATEMENT OF HERBERT LIEBERSON, PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION

Mr. LIEBENSON. Yes, Mr. Chairman. I am Herbert Liebenson, president of the National Small Business Association, a 44-year-old national organization with approximately 50,000 members.

I am also executive director of the Small Business Legislative Council with over 80 national organizations representing 4 million small businesses.

And 57 of those organizations have supported a position for changes in the estate and gift tax. I ask they be made a part of the record.

We are pleased to join with all concerned here today, including the Committee To Preserve the Family Business and the National Family Business Council in advancing the cause at this time.

Our own country is now at a juncture of tax policy which will shape the contours of the American economy, economic and social structure for many years to come.

We have been brought to this decision by historic surge of inflation which sent the general price level up close to 100 percent in the past 10 years.

Approximately 50 percent since the Federal estate tax limitations were most recently adjusted in 1976.

The Tax Reform Act of that year raised the Federal estate exclusion from $60,000 to $175,000, approximately in accordance with the price indices between 42 and 70, in 1976.

During this same period, owners of farms and small businesses have witnessed a climb in the values of land and capital equipment of well over 100 percent. That is even steeper than the averages as shown in the following tables. I won't read it all, but capital equipment has gone up over 105 percent and so on.

Accordingly, what justifies the fixed dollar limitations increase in the estate and gift tax at this time, merely in order to restore the original congressional intent of the 1976 reform legislation.

Otherwise, the Federal Government will enjoy a windfall of increased taxes at the expense of citizens who have already experienced personal loss and who are likely to be struggling to attain financial security.

We are gratified that both Congress and the President now have recognized the seriousness of the problem and are now committed to appropriate remedy.

Allowance for inflation is a very minimal adjustment that should be contemplated at this time. Such a response is minimal and we believe inadequate to because experience has shown that we do not alter these limitations every year or even in every Congress.

It is now 5 years since the last major amendments in the estate tax.

The 1976 law established a new inflation adjusted exclusion of $175,000. Its effect was also phased in over 5 years so that the 1942–76 adjustment became fully effective only in 1981.

If the same procedures are followed this year, we will assure multiyear time lag in estate tax policy. Instead, if we do not wish to fall further behind, let us at least project the price levels to 1986 and phase the exclusions up to the benchmarks over the next 5 years.

We must also ask whether the positions from which we start are sound or whether we need new points departure in view of the increasing financial scale of personal and especially of commercial activity.

For the owners of a farm or business the aggravated inflation of business assets over a long period of time, makes the need for estate tax revisions absolutely essential.

In our testimony we show an example and it shows that the present $175,000–$625,000 limitation does not make sense.

The book value of the company we show is $175,000. The market value is something like $1 million at this time. The family, there is no one in the family that can take over the business. The firm would have to be sold to outside purchasers, and it is improbable that the five key employees together have enough personal net worth to buy the owner out.

But, under—using relatively conventional assumptions the smallest business estate may be liable for approximately $140,000 in Federal estate tax, plus State inheritance taxes. That means in all likelihood the company will have to be sold or merged into a larger business.

The Senate Finance Committee has done a great deal of work in the past Congress and in this Congress to produce far-reaching revision proposal, S. 395.

The extensive public hearings by Senator Byrd, Senator Nelson, and Senator Symms established a solid record on which to base meaningful legislation.

As a result, we have seen wide bipartisan support in the Congress for these measures. We believe this is backed by broad support among the business community and the public.

Thank you.

Senator SYMMS. Thank you very much, gentlemen, for your testimony.

Senator Byrd, do you have any questions?

Senator BYRD. Thank you, Mr. Chairman.

I think there is general agreement that because of inflation something needs to be done with regard to the estate taxes.

It seems to me what we need to do is to focus on the details of legislation. With due respect to all of us involved in the 1976 tax bill, and I was one of those, I think we did not pay enough attention to some of the details.

Now, let me ask this. Under the administration proposal the tax credit will be increased to a degree which will equal to roughly $600,000 exemption.

But at that point, estate tax rates began at, as under the present law, at 35 percent.

Now, it seems to me if we are going to change the estate tax law and we are, that after the figure in this case, $600,000 is reached, then anything above that should not start at that top figure of 35 percent, but should go back and begin at the first figure, namely, 20 percent and then build up.

Second, it seems to me that that 70-percent bracket is much too high and should be reduced to 50 percent.

Now, unless we draw the legislation in a way to accomplish those two purposes, it seems to me we will accomplish very little. There are many houses today, and not palaces by any means, many houses alone are worth $600,000, and will be taxed on that basis.

I had some business in California recently, and went into some private homes there, that were not palacial homes at all, but they were valued at $600,000.

In Fairfax County, they are.

So, in using the $600,000 figure, we are not using really a large figure in this day of increasingly high inflation.

So, I guess my question to whoever would want to comment on it is, do you think we should be careful about the details of this legislation to see that those two purposes are accomplished; namely, that after the $600,000 figure is reached, that anything above that start not at 35 percent but at the original rate of 20 percent.

Second, whether or not it is important to reduce the 70 percent top bracket to 50 percent.

Mr. ULLMAN. Mr. Chairman, Mr. McKevitt has an appointment with Secretary Regan and must leave within 5 minutes, and hopefully he can be excused.

Second, I think I can speak for all the members of the panel, in saying they all concur in the overall legislation that we proposed. We have gone to the $600,000 figure on the unified credit exemption equivalent. We have gone to a $10,000 annual gift tax exclusion.

We do provide a reduction the first year to 50 percent. Subsequently, we favor phasing it down even below that as a maximum and adjusting those rates all the way down. You are absolutely right, it is not right to start at 35 percent. You must start at a much lower figure.

I think we would fully concur in that.

Mr. SPENCE. I might add, we gave great consideration in discussion in the budget considerations as far as funding and the impact on the budget to this proposal, and the phasing down that we are proposing in the rate takes that into consideration.

We are suggesting we phase down by 1985, to 30 percent on the tax rate. That would allow an adjustment in the economy to absorb whatever short-term shortfall in funds might exist.

We think that by doing this we will incur productivity increases in the society that will more than overcome any loss of revenue from a tax reduction.

Senator BYRD. At what point do you get from the 70 to 50?

Mr. SPENCE. We suggest that we start in 1981, at the 50-percent level and from 1981, in 1982, we go to 40 percent. In 1983 we go to 30 percent.

Senator BYRD. You envision this would be made retroactive or made effective the latter part of this year or at what point?

Mr. SPENCE. December 30, 1980.

Senator BYRD. 1980.

Mr. SPENCE. That we would start and impose the qualifications.

Senator BYRD. Thank you.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you very much, Senator Byrd.

Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman.

Most of you connected with the panel are obviously, represent nonagricultural interests and so you might not have as much of an interest in special use valuation, because I understand about 95 percent of that is made use of by the States, heirs of estates who are involved in agriculture.

But we have a particular problem in that program or that aspect of the bill that you may be familiar with of what constitutes material participation.

Quite frankly, we get into the problem of a definition of material participation, and in a sense, who is the operating farmer or has a real interest in farming as opposed to someone who is a passive investor.

Now, some of the legislation tries to take care of some of the specific problems that have been brought up since 1976 with that bill. But I don't think any of the legislation really tries to cure the problem once and for all by changing or using some definition other than material participation.

Do any of you have any suggestions what we could do in that area?

Dr. NELSON. Mr. Chairman, the Agriculture Department has a definition of a commercial farm. It is one that produces at least $2,500 worth of salable products per year. That is a very low figure.

If that or something in that area were imposed, then those people who are buying farms just for the fun of it or to keep a couple of horses might be excluded.

I might mention that good farmland now is worth $2,000 to $3,000 an acre. So the $600,000 would include about a 300-acre farm.

Most productive farms are from 300 acres up to 2,000 acres. Those are the large family farms that give us the majority of our product. They have economies of scale to be efficient and effective.

Now it is in the interests of the administration to induce investments and increase productivity and the present bill is totally contrary to that.

Now, you should have a limit so the family farm can compete effectively with the large corporate farming operations with thousands and thousands of acres.

This is a very important thing. The number of working farms have been reduced each year for—since World War II at a drastic level.

At the same time, we are losing farmland because there is so little incentive for people to continue farming. They can make more money by just putting their money in the bank and collecting the interest.

We would suggest that you consider farming as a special category and where the sons of the family are willing to continue to farm for 10 years, that there would be a waiver of this tax altogether. Because those children of the deceased very likely have been working at the farm for the majority of their life.

They have a vested interest in it. They should have a de facto, if not a de jure—they have a de jure, but they should have—I am sorry, they have a de facto, they should have a de jure interest in their labor over the years.

Senator SYMMS. Dan Goldy, do you want to comment on that?

Mr. GOLDY. Yes, Mr. Chairman. I haven't participated up until now because as you know, Mr. Chairman, I testified before this subcommittee a couple of weeks ago, on behalf of the national committee.

But, in answer to Senator Grassley's question, we represent on this committee, not only agriculture and farmers, and Dr. Nelson represents the agricultural trade council with many agricultural organizations in it, but also the lumber-timber owners, people engaged in forest products.

We do have a very special problem in the timber industry with respect to the material participation provisions that are in the present bill.

If you own a timber tract the individual who owns it doesn't get out there necessarily and plot the trees that have to be cut or engage in material participation in the way it seems the present provisions of law contemplated.

Basically, an owner of a timber tract will be materially participating but would probably never leave his office. The material participation in that sense would mean making the substantive decisions that some professional forester or some trained person would go out and plan on the timber tract.

The present provisions of law are totally inadequate in that regard. We would suggest that material participation be redefined so that it in effect relates to the person who makes the substantive decisions, whether or not they are out there actually shoveling the stuff around on the farm or marking the trees for cutting.

Senator GRASSLEY. We would welcome such a suggestion of redefinition and help on redefining, but to this point the only people I have had much contact with who have come forward have been to take care of the special problems like maybe in your interest the special problem with timber, another instance where maybe somebody had been disabled over a long period of time and that maybe would prohibit material participation under the present law.

So, correct that problem and on down the line, where maybe you are going to take care of a few problems or you may take care of all of them.

I don't know, but it seems to me like a patchwork approach. We recognize after 5 years there is something basically wrong with the 1976 law. I think it ought to be corrected and if it isn't corrected now, it may not be corrected for another 5 years until another estate tax bill comes along.

So, I would invite all of you who have any interest in this to please help us.

Mr. GOLDY. Senator, we will submit—language has been developed. We will see to it that it is submitted.

Senator GRASSLEY. Thank you.

Mr. SPENCE. Senator, the purpose of the committee was to attack this problem in a broad way that dealt with the problems of citizens across the United States and dealt with it fair and equitably for all interests, not just the timber industry.

We have substantial support. We have received applause for the efforts we have made. We have gone to very technical help in drafting up our proposals. We hope that when we submit the detailed suggestions we have, they could be implemented.

Senator GRASSLEY. Could I ask you, in regard to, specifically, material participation—have you been careful it does not provide just a tax loophole for people who have no interest whatsoever in family farming, family businesses, and can be used as a loophole for people who want to avoid taxes?

Mr. SPENCE. We have tried to do our best. I think we have come up with a proposal that does that. We are asking for a 50-percent valuation of fair market value on small closely held businesses or entities in the estate tax appraisal system.

So, we believe that will, coupled with the reduction in the overall estate tax rates, serve to do that.

Senator SYMMS. Thank you very much.

We will be hoping to work with you, particularly here in the next ensuing days ahead. We hope to accomplish something on the road toward the direction of the adverse impact on our society that the death tax does have.

I thank all of you for being here this morning.

Mr. SPENCE. Thank you, Mr. Chairman.

[Statements follow:]

STATEMENT OF JAMES D. "MIKE" MCKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, my name is James D. "Mike" McKevitt, Director of Federal Legislation for the National Federation of Independent Business and a member of the Advisory Board of the National Committee to Preserve the Family Business.

Estate taxes continue to have a severe detrimental impact on small business ownership patterns and on the free flow of capital within the small business community.

A business owner's concern for estate taxes that might burden family members or business associates results in business decisions which are not economically based. Very often substantial resources are wasted on legal and accounting fees and life insurance premiums, with the goal of minimizing estate taxes and providing the needed cash to pay the estate tax bill.

A recent NFIB survey of urban areas provides additional evidence on the potential damage that current estate tax law may create for small business. Preliminary results show that a large percentage of business owners situated in northeast urban areas inherited their business from family members. If estate tax law is disrupting these patterns of business transfers, we may be seriously endangering an important economic base.

Our membership's ultimate goal with respect to estate taxes would be abolition of the estate tax. Statistical evidence leads one to the conclusion that the estate tax does not raise sufficient revenue in a matter that would be considered efficient. Additionally the severe cost of life insurance premiums drains off profits that would otherwise be used for inventory or business expansion.

Senator Symms' proposal for abolition of estate tax law is one our members would support if this committee decides to commit to that goal.

However, abolition of estate taxes will require intensive study because of the legal and technical difficulties that may be encountered. The revenue loss would have to be picked up from other taxes, a major problem given the current tax debate.

We also strongly support the proposals of the National Committee to Preserve the Family Business, which entails amending Senator Wallop's proposal, S. 395. Senator Wallop's bill provides an excellent framework for substantial relief from estate tax rules by small business. The proposed amendments provide more fundamental assistance to small business in the areas of valuation and liquidity than S. 395.

The proposal outlined by Mr. Ullman is necessary to preserve small business continuity and deserves serious consideration in the short term by this subcommittee.

Statement of Dr. Peter Nelsen

Good Morning, Gentlemen. My name is Dr. Peter Nelsen. I am an economist and President of the Agricultural Trade Council, a non-profit trade association representing exporters of agricultural commodities, food products, forest products, farm implements, food machinery and related products and services industries. ATF is a sponsor of the Agricultural Research and Development Institute of which I am the Chairman. I also serve on the Advisory Board of the National Committee to Preserve the Family Business. On behalf of all three of these organizations, I thank you for the opportunity to present testimony before this Committee.

I am here today to testify in favor of reform in the area of federal estate and gift tax rules; specifically to support efforts and proposals of the National Committee to Preserve the Family Business.

To open my remarks, I would like to express my support of the views indicated by my colleagues before me, and to commend the efforts of those Senators sponsoring related bills providing for substantive relief in this area. We are all in agreement here today that such relief is an absolute necessity and sorely overdue if we may anticipate for the future the continuing presence of a most vital segment of our economy, that of the small closely held business, and the family farm.

My area of particular concern is in providing relief to farmers desiring the continued viability of their farms beyond mere "lives in being" and beyond the inevitable roadblocks provided by a transfer tax. As they currently function, the estate and gift tax laws have the inevitable effect of forcing many family owned farms and small enterprises out of business.

Since the productivity of agriculture is an important facet of our overall economic stability and growth, the negative impact of their continuing demise at such an alarming rate, is substantial.

In theory, the intended purpose of such transfer taxes as the estate and gift tax is three-fold: First and primarily, it is designed to prevent centralized accumulations of great wealth disproportionate to the bulk of the remaining population. The tax forces money to change hands and thus creating the illusion of a leveling effect. In practice, the tax has the opposite effect by letting the most affluent farmers buy out the smaller ones as the owners die and the farms are auctioned off. This trend leads us toward an oligopoly which is not in the public interest. Secondly, and more predictably, these (as do all taxes) generate some revenue. This, however, is not a primary objective of these particular taxes, and cannot justify maintaining them, as they are currently applied. Thirdly, they function to mechanically monitor the transition of property from one generation to the next in an alledgedly harmonious, perpetual movement. Perhaps this last consideration is where the greatest misconception lies:

Far from facilitating harmonious transition, the estate and gift tax destroy in far too many cases, the ability of the succeeding generation to invest in, improve or even carry on the overly burdened family operation in the face of these transitional taxes. Where the succeeding generation can afford to at least maintain the enterprise, after taxes, production may be limited and growth non-existent. Where it still exists, the enterprise's ability to bring forth a competitive product is severly handicapped by the diversion of monies for taxes. The integrity of the family farm in America must be preserved; and in so doing our current tax structure must not preclude our farmers from maintaining an ability to compete with foreign markets. In the same vein, our family farms, for the role they play in the overall economy of this nation, must be afforded the same benefits as those enjoyed by larger corporations who are not subject to these same estate tax complications.

It must also be noted that the latter are usually the beneficiaries of the demise of small businesses and farms due to our overly burdensome tax structure. Simply, big fish have always swallowed little fish.

The time has come to give these "little fish" sufficient teeth and stamina to withstand—and compete in the same pond with their larger counterparts. We would like to see across the board rate reductions starting in 1981, and progressing downward in coming years. Further, phase-in of an increased unified credit over a period of 4 years such that ultimately, estates valued upwards to $600,000 may pass to the successor free of federal estate and gift taxes.

We would also like to see the $500,000 cap on the special use valuation provision repealed. This is of peculiar significance relative to farms because the inflated value of land today renders a poor farmer a millionaire at his death, and his equally impecunious heirs incapable of affording their new-found burden of wealth. Based on traditionally low returns per acre, those whose livelihood is in tilling the soil need added assistance in neutralizing rampant inflation in land value which bears no reasonable relation to yield and after tax dollars.

Another beneficial provision would be an unlimited marital deduction which reduces the inequity suffered by a surviving spouse who contributed to the enterprise prior to decedent's death. In essence, the rules as they currently function fail to recognize the singular most compelling facet of such small enterprises; that they are owned and operated by the family as a working unit, not by any single individual whose estate declares that he alone owned and worked. That his family is taxed for a capital gain after his death which their labor supported during his lifetime is untenable and cannot be perpetuated. We would like to remedy this, and other patent inequities which have heretofore been perpetuated not by design, but through gradual changes in our economic structure.

Gentlemen, our proposals offer an opportunity to rectify these inadvertent wrongs. I urge you to respect the fairness, sincerity and wisdom of those experts and concerned sponsors who have brought it before you. My sincere hope is that this legislation be enacted into law as a matter of first priority and absolute necessity, a status it truly merits beyond merely being advisable.

Thank you, Gentlemen, this concludes my remarks.

Statement of Robert L. Spence, Chairman of the National Committee to Preserve the Family Business

Mr. Chairman, my name is Robert L. Spence. I am chairman of the National Committee to Preserve the Family Business. I am chairman of the Estate Tax Committee for the Western Forest Industries Association, and I am Vice President and chief operating officer for Pacific Lumber & Shipping Co. of Seattle, Washington, a small to medium sized timber company with operations on the West Coast. Pacific Lumber & Shipping Co. was started by my grandfather in 1932.

Mr. Chairman, the reason that I am here today with my distinguished colleagues is to sound a clear warning in regard to estate tax laws. As the law exists today, it threatens not only the basic fundamental principles that this country was founded on, but its resource base and the ingenuity and creativity that have in the past brought to the United States the envy and respect of every nation on this earth. I have observed over the last twenty years the slow but sure breakup of our farmland base into ever smaller tracts of land. I have watched the timberland base held by small entreprenueurs, tree farmers, and small to medium sized timber companies disappear at an alarming rate, especially with the burden of these abhorrent tax rates, coupled with the inflation rate that we have experienced in the last twenty years. I have watched the small to medium sized manufacturers, the entrepreneurs of America, who have set the pace for productive, creative competition in this country, slowly but with ever increasing frequency shrink under the weight of this cruel burden. Mr. Chairman, the estate tax is confiscating the heart of America. Contrary to its original intent of keeping the wealth of this country dispersed, it is forcing the concentration of wealth into the hands of either large corporations or government agencies. Is it any wonder, Mr. Chairman, that the productivity of this country has declined to its existing depths when you consider how vital a role the small to medium sized entrepreneur, The Family Business, has played in our society. He is the stimulus, the catalyst, the creator of ideas, the source of never ending energy that has in the past, and does today, provide the mirror for large organizations and corporations to gauge their performance by and serves to help keep those organizations within reasonable cost performances. Unfortunately with the concentration of industry and the decline of asset based family enterprises to provide the competition level to keep our larger industries finely turned we can no longer claim to be the highly productive nation we were.

Mr. Chairman, I can think of no better example of how this tax brings devastation to business rather than promoting it than in the timber industry of which I am a part. It was not until I experienced the harshness of this tax first-hand that I began to realize the process that was occurring in this country. Very simply a combination of need to invest in a capital intensive business to stay competitive, coupled with inflation, have created paper assets that are incurring 70 percent tax rates. This creates a scenario that sets off a remarkable set of events that at best amount to frantic efforts to hedge a slow death due to a cash flow drain from gift tax hedges, ~~life~~ insurance hedges, transfer of ownership schemes, etc., all which are very expensive because they usually involve double taxation due to income taxes. When a family involved in the timber business today incurs a death the resultant cash drain saps the business of precious cash needed for reinvestment in order to stay competitive. A new competitive sawmill today costs approximately fifteen to twenty million dollars. To pay the existing tax on investments like that is impossible. It usually leaves an heir with two options: sell the business piecemeal by auctioning off the assets, or find another corporation to absorb the entity in tact which normally means a large timber company in our business. In the case of piecemealing out the assets, this usually means dislocating a labor force which brings a great deal of hardship to small communities where sawmills exist. Because of the high paper dollar value of timberlands, the same characteristics prevail. I would point out here though that once timberland is taken out of the productive land base and broken into smaller tracts, it will never be used for growing commercial forests again. That is why the productive private timberland base is shrinking. The same phenomenon is occurring in the farming industry. I might add that both of these phenomena have drastic implications for the world economy, especially when you consider the fact that the world population is projected to double by the year 2000 and wood is still the number one energy source, and the United States has played such a vital role in providing the world's food supply.

Therefore, Mr. Chairman, my colleagues and I have proposed a bill that will return common sense to the tax code. This is a proposal that has garnered wide support from owners of wheat ranches, cattlemen, newspaper owners, owners of T.V. and radio stations, retail businesses, distribution businesses, small manufacturers of all sorts, dairy farmers, truck farmers, people in all types of occupations.

The bill would reduce the estate and gift tax rates substantially over a three year period from a maximum rate of 50 percent in 1981 to a maximum rate of 30 percent in 1983. The existing maximum rate is 70 percent. The bill also increases the unified credit over a four year period beginning in 1982 from $41,000 to $61,875 in 1985. The bill would make a substantial change in the marital deduction.

The bill would make a number of changes in the provisions allowing special use valuation of real property used in farming or other closely-held businesses—the most significant being that an executor of an estate could elect to value an interest in a closely-held business at 50 percent of its fair market value. There are also changes being recommended to improve stock redemption provisions and payment provisions. We are recommending the annual gift tax exclusion be raised from $3,000 to $10,000.

Mr. Chairman, these are some of the highlights in our recommendations, but I will include a detailed summary with my testimony in the interest of time. Our recommendations are the product of detailed and intensive scrutiny by many knowledgeable people. It is imperative that these concepts be acknowledged and effective relief be established for small closely-held businesses and farms. Mr. Chairman, I appreciate the opportunity to testify before this important committee.

STATEMENT OF HERBERT LIEBENSON ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Good Morning. I am Herbert Liebenson, President of the National Small Business Association (NSB), a 44 year old national organization with approximately 50,000 members. We have been in the forefront of efforts to revise and reform the estate tax since 1973,[1] and are pleased to join with all concerned—including the Committee to Preserve the Family Business and the National Family Business Council—in advancing this cause at this time.

Several years ago, an economist observed that if an airplane passed over the country-side of any nation, the passengers could tell what the estate tax laws were. In France, he said, small plots of ground were tightly bound by fences and hedgerows. There, all heirs inherited equally. In England, there were larger farms and occasional estates, a consequence of centuries of primogeniture.

Our own country is now at a juncture of tax policy which will shape the contours of the American economic and social structures for many years to come. We have been brought to this decision by a historic surge of inflation, which has sent the general price level up close to 100 percent in the past 10 years, and approximately 50 percent since the federal estate tax limitation were most recently adjusted in 1976. The Tax Reform Act of that year raised the federal estate exclusion from $60,000 to $175,000, approximately in accordance with price changes between 1942 and 1976, when it had been last enacted.

During this same period, owners of farms and small businesses have witnessed a climb in the values of land and capital equipment of well over 100 percent, that is even steeper than the averages, as shown in the following table:

CHANGES IN PRICE LEVELS

	1971	1976	1980	10-yr. increase (percent)
Inflation (GNP deflator) [1]	96.01	132.11	177.36	+84.73
Capital equipment [2]	116.6	173.4	239.8	+105.66
Farmland [3] (billions)	$223.2	$416.9	$671.2	+200.72
Producer prices [2]	113.7	170.6	247.0	+117.24

[1] Expressed in terms price level in 1972 (e.g. 1972=100).
[2] 1967=100.
[3] Nominal dollars.
Source: Economic Indicators, JEC-CEA, 1979-81.

Accordingly, inflation alone justifies a sizable increase in the fixed dollar limitations of the estate and gift tax at this time, merely in order to restore the original Congressional intent of the 1976 reform legislation.

Otherwise the federal government will enjoy a windfall of increased taxes at the expense of citizens who will have already experienced personal loss, and who are likely to be struggling to attain financial security.

We are gratified that both the Congress and the President have recognized the seriousness of the problem, and are now discussing appropriate remedies.

A humane policy can avoid a progressive increase of this tax, because to do so would make the achievement of security more uncertain with every passing year.

Allowance for inflation is the very minimal adjustment that should be contemplated at this time.

Such a response is minimal, and we believe inadequate, because experience has shown that we do not alter these limitations every year, or even in every Congress. It is now 5 years since the last major amendments of the estate tax. The 1976 law established the new inflation-adjusted exclusion at $175,000. Its effect was also phased in over 5 years, so that the 1942-1976 adjustment became fully effective only in 1981.

If the same procedure is followed this year, we will assure a multi-year time lag in estate tax policy. Instead, if we do not wish to fall further behind, let us at least

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[1] See Statement of Hon. Frank Carlson on behalf of National Commission for Small Business Tax Reform and National Small Business Association before Ways and Means Committee, Mar. 6, 1973.

project the price levels to 1986, and phase the exclusions up to those bench-marks over the next 5 years.

We must also ask whether the positions from which we start are sound, or whether we need new points of departure in view of the increasing financial scale of personal, and especially of commercial life.

SPECIAL PROBLEMS OF FAMILY AND CLOSELY HELD ENTERPRISES

For the owner of a farm or business, the aggravated inflation of business assets over long periods of time makes the need for estate tax revision absolutely essential.

Let us look at an actual example. One of our members is a small manufacturer of industrial machinery here in the East.

Begun by his grandfather, the firm is over 100 years old. It employs 30 workers, some of whom are second generation employees. It owns an 80 foot by 250 foot building, constructed in 1955, sitting on 3½ acreas of land, and containing the appropriate machine tools. The balance sheet looks approximately as follows:

BALANCE SHEET OF SMALL MANUFACTURER

	Cost	Book value	Approximate market value
Building	$225,000	$100,000	$500,000
Land	5,000	5,000	150,000
Machinery		70,000	350,000
Total		175,000	1,000,000

The family circumstances—a wife who is not a businesswoman, a daughter in the computer field, and a son studying for the ministry—indicate that this firm must be sold either to employees or an outside purchaser.

At present, it is improbable that the 5 key employees would, even together, have enough personal net worth to buy the owner out, or under existing estate tax limitations, to continue the business after his death. Using relatively conventional assumptions, this small business estate might be liable for approximately $140,000 in federal estate taxes, plus state inheritance taxes. That means, in all likelihood, that this company will have to be sold or merged into a larger business.

Traditionally, a primary purpose of the estate tax is to discourage the concentration of wealth. These kinds of pressures are now promoting the concentration of wealth. Other members have informed the association that an owner may be paying 25 percent of his income in insurance premiums in order to provide for estate tax payments so a business may be continued.

Everyone who has studied this area has commented on the complexity of arrangements needed to have any chance of continuing a family or closely-held firm after an owner's death. The uncertainty of the valuation of a non-public firm—which can literally take years of negotiation and/or litigation—is a major deterrent to even attempting to run the gauntlet of the tax collectors.

A member of this Committee (Senator Bentsen) has written: "In my view it is not the government's place to tax away a lifetime of hard work and thrift when a family member dies."

Unfortunately, that is exactly where the estate tax policy—under the impact of inflation—is headed. We deeply believe that we need estate tax standards that encourage continuity rather than discourage small business ownership. Small enterprise is the dynamic mainspring of the U.S. economy. Government statistics show that:

Small firms sustain 55 percent of existing private sector jobs, and create a striking percentage of net new employement—President Reagan says 80 percent;

They are an equal partner in generating our traditional Yankee ingenuity, accounting for half of all innovation in heavy industry, light industry, trade and commerce. Examples of recent small business innovations that have sparked impressive advances in employment, exports and tax revenues include the Xerox process, air conditioning, the instant camera and miniature electronics.

They make major financial contributions to all levels of government. For example, a 1978 survey showed that $100 invested in the electronic industry yielded $35 per year in federal, state, and local taxes.

Small business owners are major factors in the stability of their towns and cities. They know their employees and customers. They are the last to fire people when the economy turns down and the first to hire employees as it revives. The owners have a stake in their hometowns, so they and their families often work to support churches, charities and other neighborhood and community institutions.

Small business has always been the doorway of opportunity into the mainstream of our economy, and the means for self-reliance and independence for millions of our citizens.

In our view, we must have a convincing statement of the rationale for an estate tax law that facilitates small business continuity. This must be accompanied by a thorough revision of the estate tax to renew the climate for creation, development, and continuity of small enterprise, if small busines is to survive.

With the prospect of a tax bill that will dominate the tax system for the better part of this decade, we believe this action should be taken at once, since it appears unlikely that tax reductions of the scope and magnitude contemplated in 1981 will re-occur in the near future.

The Senate Finance Committee has done a great deal of work in the past Congress and in this Congress to produce a far-reaching revision proposal (S. 395).[2] The extensive public hearings by Senator Byrd of Virginia, Senator Nelson and Senator Symms establish a solid record on which to base meaningful legislation. As a result we have seen wide bi-partisan support in the Congress for these measures, and we believe this is backed up by broad support among the business community and the public.

When Senator Wallop introduced S. 395, he remarked to the Senate:

"The legislation focuses on relieving the harsh consequences of inflation, especially as it interacts with the estate tax laws to force many family-owned firms and small enterprises out of business."[3]

We commend the Finance Committee for these initiatives, and strongly support enactment of this bill. It would be an excellent beginning for comprehensive estate tax revision in behalf of modest-sized estates and smaller businesses. In the short-run, and even more over the long-run, we believe that such a policy will have the most desirable effects on the country's business, economic and social landscape.

Senator SYMMS. Next we call up the panel of Prof. Gerald P. Moran, David Raboy, Ray Stroupe, and David Keating.

Professor Moran, whenever you are ready, you can go right ahead and start.

STATEMENT OF PROF. GERALD P. MORAN, MARSHALL-WYTHE SCHOOL OF LAW, COLLEGE OF WILLIAM AND MARY, WILLIAMSBURG, VA.

Dr. MORAN. Thank you, Mr. Chairman.

My name is Gerald Moran. I am a visiting professor of law at the College of William and Mary and a professor of law at the University of Toledo.

I am happy to have the opportunity to address the estate tax proposals that are before the committee.

My background includes 7 years with the Internal Revenue Service, 4 years in private practice, before I entered teaching.

My approach to tax law is from the viewpoint of tax policy with equal concern for both tax theory and its application.

I submit the tax laws should be judged under approximately the following criteria. We should be concerned about the revenue produced, the allocation of the tax burden, simplicity, its role on the

[2] Original co-sponsors of S. 395 with Senator Wallop were Senators Boren, Harry F. Byrd, Jr., Percy, Helms, Domenici, Symms, Baucus, Tower, Heflin, Bentsen, Hayakawa, Pryor, Lugar, Andrews, Durenberger, Thurmond, Zorinsky, Mathias, Nickles, Burdick, Abdnor, and Matsunaga.

[3] Congressional Record, Feb. 5, 1981, p. S1023-1030.

Federal budget, its impact on the economy and its cost, not simply in terms of government costs, but total public and private cost incurred in complying with the particular tax law. In connection with estate taxes, we might add that most of the private costs are incurred, of course, in avoiding estate taxes.

There is another aspect of cost which is qualitative. To what extent should Federal tax laws impinge on the right of a person's testamentary choices. This is a very subtle aspect and it creates, in effect, a regulatory impact on American citizens.

A final item I would suggest be included is political support. Now the greater a tax law comports with these elements, the more it reaches a level of acceptance. This is not a test of either absolutes; that is, it either qualifies or it does not, but rather of degrees. I submit the present estate and gift tax laws do not even register on this scale.

Now I reach this particular position not in 1981, I had reached the same position in 1976. I requested the Ways and Means Committee at that time—1976—not to amend the estate and gift tax system until you decide what its purposes are. At that time the committee thought the issue of purposes was an academic curve. How can you amend or reform until you have a criteria by which the tax laws are to be judged.

Now let's take a look at the present estate taxes. It produces minimal revenue while creating tremendous complexity. The total cost of compliance, I submit, and I have no direct empirical evidence, probably exceeds the yield that Uncle Sam receives.

The cost of the estate planning industry includes: Attorneys' fees, accounting fees, insurance costs, trust costs, appraisers, the cost of legislation, the cost of the IRS in administrating as well as the cost in curred in preparing proposals for its reform. If these total costs are taken into consideration they likely exceed the yield to the Federal Government.

The second aspect that I would like to submit in favor of its repeal is that there is no constituency in favor of its continuation.

The House Democrats on the Ways and Means Committee have included revision for estate tax in their tax package.

In the Rose Garden, yesterday, we heard from President Reagan. He is committed to a minimum $600,000 increase in exemption. And, this committee is strongly in favor of a significant reduction if not outright repeal.

Neither political party is committed to an estate tax which is going to yield significant revenues. Can't we get beyond the usual bipartisan interplay? The Republicans need not be called the Party of Protecting the Wealth, when the Democratic controlled Congress of last sessions reduced significantly estate and gift tax in 1976, and repealed carryover basis in 1980.

This is a bipartisan position. Neither party is committed to an effective estate tax system. We can undo the complexities that the committee is now dealing with by adopting the chairman's position of total repeal of the Federal estate and gift tax.

Now, some members of the bar, you will recall sought repeal of carryover basis on the basis of its complexity. The record is replete with how complex carryover basis was. Carryover basis was one section in the Internal Revenue Code.

The estate and gift taxes may be 25 to 45 provisions.

Section 2032(a) alone, which is taking up time of your staff, particularly as to issues raised by the regulations, is so complicated that it creates 2032(a) experts and appraisers across the country.

Have we not reached a level where it is time to admit the obvious. We are not a country that is politically committed to an effective estate and gift tax system. I think this committee will acknowledge that and recommend its repeal.

Now I realize the financial limitations of the budget and the difficulties in phasing its repeal in over the next few years. The problem created is discrimination on those people who die, let's say, after the Rose Garden announcement yesterday and its eventual repeal by 1986.

I would suggest that the committee adopt a proposal calling for its repeal with respect to decedents who die after June 4, 1981.

The loss of revenue we are talking about is minimal. S. 395, which I think there is bipartisan support, would reduce the estate taxes in 1985 to what they would be or were in 1971, less than $4 billion.

It would represent 0.6 percent of total Federal revenues. Alcohol and tobacco taxes produce more than the estate taxes. Custom taxes produce more than the estate taxes.

Do we have a subsection of taxation for alcohol and tobacco attorneys? The answer is obviously we don't. Attorneys may enjoy the cost of creating revenue from alcohol and tobacco, but we don't have that kind of complexity creating a demand for legal service. We can raise revenue without the necessity of continuing the estate and gift taxes.

We don't have to continue this attempted definition of closely held business for special use purposes or devise a new 50-percent reduction. We don't have a commitment to an effective system. Repeal it. Let's be honest with the public. The middle class may have the illusion that there is an effective estate and gift tax. Nobody wants to tell them that one does not exist.

We can phase in S. 395, but I don't think we are being honest with the country. We are continuing a massive misallocation of legal services by continuation of estate tax system.

So, I seriously and strongly support its repeal, but I would admit the concept of an estate tax is appealing in theory, but if we reduce the tax burden to only 0.3 or 0.2 of those dying, can that indeed be called a tax?

I thank the committee for the opportunity to testify. I would like to reiterate the concept of the tax law should be considered from the viewpoint of policy. It is not sufficient in my opinion, to rely or make the judgment on the basis of those people who find paying the estate tax burdensome.

I have never found a taxpayer who is going to come forward in favor of a tax. The problems of the farm community and closely held businesses will continue even if there is a repeal of the estate and gift taxes.

Bob Bergland's outgoing report from the Agriculture Department of the last administration pointed out the serious problems that the small farmer has in continuing to operate with the large farmers.

Those are national policy issues which transcend many of the arguments you are hearing today.

I think it is time to repeal it. If at some time in the future and if there is political support for effective estate and gift tax, I would be here to support that.

Senator SYMMS. Thank you very much for a very excellent statement.

Senator GRASSLEY. Mr. Chairman, before you go on to the last or rest of the panel, I think the professor asked a legitimate question about what the policy ought to be and whether or not we have a policy if it is only 2 or 3 percent of the total revenue.

The policy I would like to have, even though I can support repeal. I don't think it is going to happen. So I put my energies where I think they can do the most good. But we did have a pretty consistent policy under the 1916 estate tax law, the 1934 estate tax law and the 1942, and then it wasn't changed again until 1976.

From that period of from 1916 up to 1969, we had a policy that we were going to tax the most wealthy estates that amount to about 1 percent of the total estates in this country.

Then inflation and appreciation came in to bear upon the exemption and they were of little value. They reached a point in 1976 where we were taxing about 12 percent of the estates.

Then we passed the 1976 law and I think we get it down to about 5 or 6, and then in 5 years now, it is probably back to where it was.

I think with the effect of the program we are talking about, coupled with indexing, which isn't part of it, that we could maintain a policy of taxing 1 or 2 percent of the estates in the country.

Whether you could justify the work for the revenue is an entirely different question and a legitimate one on your part.

But I think we would have a consistent estate tax policy that we have had since 1916.

Mr. MORAN. In 1926, Congress almost repealed the estate and gift tax as part of the massive reduction under former Secretary Andrew Mellon.

The progressives at that time retained a skeletal form of estate and gift taxes. It produced virtually no revenues and the maximum rate was 20 percent. They created State death tax credit of 80 percent of that.

So most of the funds went to the State, but then when we hit the depression, the economy and the social views of wealth changed and the new administration gave it a new definition.

What is surprising, there really hasn't been any significant change, except increases during the depression, and also during the war, why hasn't it increased in revenue with the tremendous inflation from 1945 to 1976.

I submit we lawyers have adopted the skills of the medieval philosopher to defeat through estate planning the yield. It is a practiced profession. It is a specialized subindustry.

There is a law school that gives a master's in estate planning.

You are giving us direct employment. I have benefited from that, and perhaps I shouldn't be testifying in favor of repeal.

But I think there is a point where we have to be public about these tremendous costs. The yield has not increased in terms of percentages. The amounts are relatively insignificant. We could increase the cigarette taxes and get more. You can increase the alcohol taxes and get more.

If we are not getting significant revenues, at tremendous cost and complexity, Senator you are going to be hearing again from the farm community in 5 years. They are going to have problems with inflation again.

Senator GRASSLEY. Hence, that is why I support indexing.

Mr. MORAN. Well, that is one approach. But when you are down to the minimal number of people that are going to pay it, let's be honest and repeal it.

That is my opinion and judgment and people can differ.

Senator GRASSLEY. All I was responding to is, did we have a policy. I thought we had a fairly consistent policy between 1916 and the time inflation set in and about 1969.

Mr. MORAN. Well, I take the view in my paper that your purpose is either the redistribution of wealth or revenue.

It is a colossal failure in terms of redistribution of wealth.

Professor Smith of the University of Pennsylvania found the super 0.5 percent of the richest people in America have maintained their wealth from 1945 through 1973 or 1974.

There is little empirical study on redistribution. Income taxes perhaps affect more of a redistribution than the estate and gift tax.

What we have in process is a piecemeal repeal of the estate and gift tax because of the problems agitated by inflation.

The problems of the people before the committee are obviously real. It is like talking about capital punishment. We can debate that in a law school, but for the person who is in jail, he is going to be killed, it is not so theoretical.

So, you do have real farmers, a closely held business, who do suffer the hanging. But I do think tax laws have to be judged in terms of policy and not necessarily on isolated cases.

Senator SYMMS. I thank you very much.

I thank you very much, Senator Grassley, also for those comments.

I think that what is really causing a great deal of problem here in this town and in this country is the damn printing presses down here that keep running 24 hours a day printing money and destroying the value of everything and completely disrupting the financial markets and the institutions, the banking system, the value of people's property and the general price levels keep going up as long as they run the printing presses down there.

We will have that to contend with. But that is another matter. I really agree with you that the death tax is certainly an inequitable tax. It is a very inefficient way to raise revenue. It is not good for long-term capital formation and capital planning and jobs and a strong economy in this country, because it destroys incentives. It really should be the real answer to abolition. Anything else is just another way to have people go out and hire another bunch of lawyers and CPA's to plan their estates so they can avoid it.

Now, Dave, after that little sermon, we would like to hear from Dave Raboy.

Mr. RABOY. Thank you, Mr. Chairman.

STATEMENT OF DAVID RABOY, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

My name is David Raboy. I am pleased to testify on the subject of the economic effects of the estate and gift taxes.

I am director of research for the Institute for Research on the Economics of Taxation, a nonprofit research group, founded in 1977, by Dr. Norman B. Ture.

It is hard to pin down the rationale for estate and gift taxes. To some these taxes are mere revenue raisers. To others, the purpose of taxes on wealth transfers is to retard an unacceptable accumulation of wealth.

A further justification is the belief that these taxes enhance the equity of our tax system.

These taxes, however, are hardly powerful revenue raisers producing Federal revenues of only $6 billion a year. Rather than being taxes on only the very rich, even the most modest estates are subject to taxation.

In 1916, when the estate tax was introduced, the exemption was $50,000. Projecting that forward and considering inflation, there would have to be a current exemption of approximately $400,000 to equal the original exemption in value.

Today's unified credit produces an equivalent exemption of approximately $175,000, less than half of what was intended according to the law, in 1916.

I would characterize this tax in economic terms as a tax on small business, and I can't put this in my statement, but if you would like to ask me a question as to why I feel that way, I will be happy to tell you.

Finally, as is discussed in my written statement, existing estate and gift taxes violate reasonable standards of tax equity.

Although these taxes do not accomplish what they were apparently intended for, convention wisdom holds that estate and gift taxes do little damage to the economy.

An on-going IRET research project which considers matters of economic efficiency, as well as equity, suggests the opposite.

Our preliminary suspicions are that these taxes cause widespread distortions in the economy due to the fact that in the words of the late former Secretary of Treasury, Andrew Mellon, "These taxes are a levy upon capital."

The first efficiency loss due to these taxes is a decrease in the overall level of saving in the economy. It was previously thought that the desire to leave a bequest for one's heirs was an insignificant component of the savings motive.

Recent research however, has turned this notion on its head. A study conducted by Laurence Kutlikoff and Lawrence Summers of the National Bureau of Economic Research suggests that a majority of saving in the economy takes the form of wealth transferred from one generation to another.

Other recent research has shown that taxes on the income from savings, in general, and on bequests in particular, decrease the after tax return to savings and since saving is responsive to its after tax return, these taxes decrease the aggregate amount of saving in the economy.

The result of estate and gift taxes is an unequivical drop in the rate at which society saves and accumulates wealth.

The second major efficiency loss has to do with the fact that taxes on wealth transfers force savings into uneconomic uses.

For example, estate taxes are levied on the estate itself and become due a short time after the transfer. This clearly biases savings away from those investments that are less liquid such as a closely held manufacturing or construction firm.

Illiquid estates risk the hazard of having to sell off assets at distress prices. As a result, under present law, an estate comprised primarily of physical assets is a poorly planned estate.

Unfortunately, it is just such estates that are the most valuable to society from an economic prospective.

Estate and gift taxes encourage what economists refer to as trustification. That is, the establishment of trusts to minimize tax liability.

Since trust administrators tend to be less willing to take risks than the average entrepreneur, this blunts innovation.

Again, this is unfortunate because a dynamic economy depends on venture capital and the entrepreneurial drive.

In the weeks to come, IRET will be looking further to some of the issues in this testimony. We will be curious to see the extent to which saving is decreased by estate and gift taxes and the extent to which saving is directed into unproductive uses.

We will also take a second look at the equity argument in an attempt to see just who bears the burden of estate and gift taxes.

As a first step, we are currently simulating the effects of a complete repeal of all estate and gift taxes on such variables as employment, investment, Federal revenues and GNP growth.

The simulation is being performed on the analysis of tax impacts model at the firm of Coopers & Librin. This model was developed by Dr. Norman B. Ture and when the results are complete they will be made available to this committee.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you very much, David.

Now, Ray Stroupe.

STATEMENT OF ROY M. STROUPE, PRESIDENT, NATIONAL TAX EQUALITY ASSOCIATION

Mr. STROUPE. Yes, thank you, Mr. Chairman and Senator Grassley.

I am Ray M. Stroupe, president of the National Tax Equality Association or NTEA. I am accompanied by Christopher Frenze, our director of research.

The National Tax Equality Association appreciates this opportunity to support S. 404, a bill to repeal estate and gift taxation.

NTEA consists of over 1,900 firms, mainly small enterprises, which oppose excessive and discriminatory taxation of business and capital.

In recent years more attention has been focused on the pressing need to encourage increased savings, capital formation and productivity growth required for the effective operation of our capitalist system.

Recognition of the detrimental effects of high marginal income tax rates has rightly assumed a central role in discussions of tax policy.

In our opinion, Federal estate and gift taxation represents another extremely counterproductive feature of our Tax Code.

Disincentives to investment and entrepreneurial activity are very great relative to the tax revenues derived from this source.

Less than 1 percent of total Federal revenues.

Effective estate planning can minimize the impact of inheritance taxation on the very wealthy, but the incidence of the tax is regressive, falling heaviest on relatively modest estates, especially small family businesses and farms.

These closely held estates are often forced into liquidation on relatively unfavorable terms to meet tax payments.

The existence of the tax provides an incentive for older businessmen to sell out to publicly held corporations and use the proceeds to purchase liquid investment vehicles such as Government securities.

Estate taxation imposes a heavy burden on aggressive entrepreneurship, successful business judgment, and capital formation in closely held enterprises.

Yet, these qualities are essential to the dynamic and efficient operation of our competitive enterprise system.

The tax rates imposed by law are harsh enough, but inflation induced bracket creep has pushed the tax take to virtually confiscatory levels.

As a result, the tax really disrupts business planning and forces the liquidation or truncation of many of the most successful and productive business units.

Estate taxation destroys capital, discourages savings and capital accumulation, and produces little revenue.

Government policy condemns economic concentration and strongly enforces many antitrust laws. Yet, when concentration or market power actually appear, it is most often as a result of some Government regulation or action.

Estate taxation, for instance, promotes unnecessary economic concentration, while making many small businesses and farms sell out to large corporations.

Tax considerations introduce a significant bias in decisionmaking in favor of larger business units.

In addition, by hindering the growth of successful small businesses by the confiscation of capital, the tax can insulate big, established corporations from competitive forces that would otherwise exist.

Particularly where economies of scale play an important role, the effects of the tax may constitute a barrier to entry or expansion, preventing a small firm from accumulating enough capital to aggressively challenge established businesses.

Because estate taxation is inapplicable to publicly held corporations, it discriminates against small private businesses and farms.

The competitive disadvantage imposed is considerable and should be removed. The repeal of the tax can achieve this objective and facilitate more neutral taxation of business enterprises.

Thank you.

Senator SYMMS. Thank you very much.

Now we will hear from David Keating.

STATEMENT OF DAVID KEATING, DIRECTOR OF LEGISLATIVE POLICY, NATIONAL TAXPAYERS UNION

Mr. KEATING. Thank you, Mr. Chairman.

I would like to thank the committee for the opportunity to appear today to discuss major estate tax issues on behalf of our members and in all 50 States.

Mr. Chairman, in 1789, Ben Franklin wrote, "Nothing is certain in life but death and taxes." He was right, of course. Unfortunately, for Mr. Franklin, he passed away in the following year.

Seven years later the Federal Government decided to impose additional suffering by taxing death for the first time. It has been with us off and on ever since, mostly on, in the past 70 years.

The National Taxpayers Union favors the bills before this committee which would reduce Federal estate and gift taxes.

In particular, we support S. 404, introduced by the chairman, which would repeal the Federal estate and gift tax.

Although repeal is preferable and most equitable, we also support S. 395 which reduces estate and gift taxes.

One of the original purposes of the estate tax was to discourage the concentration of wealth. It is ironic that it has often had the opposite effect.

Small farms and family businesses are often forced to close or merge with larger companies because of the necessity of paying a tax, not because of consideration of efficiency.

Due to inflation, the estate and gift tax will increase over the coming years. The rates of the estate and gift tax are steeply progressive. This produces a bracket creep effect.

As inflation and other factors pushes estate values up, an estate becomes subject to higher rates of tax, even though its real value has remained the same.

S. 395 attempts to alleviate this problem with a 10-percent rate cut and increase in the estate and gift exemption.

While we believe it is a good start, we feel rates could and should be cut further. It is not a permanent solution, as well.

A better solution would be to establish a permanent indexing system for the estate and gift taxes. Both the exclusion amounts and the bracket amounts could be adjusted according to the CPI or other appropriate index, so that the bracket amounts' values will remain the same.

One problem which has always plagued the estate tax is that of valuation. We feel that several changes should be made to allow fuller use of the special use valuation provision.

We support the changes proposed in S. 395 which I have listed in my statement.

We also support a full marital deduction. We don't think there is any valid reason that husband-wife transfers should be taxed. Not only has the husband and wife not gained anything by the death, they have suffered a loss, both emotionally and economically.

It makes little sense to impose another burden.

The estate and gift taxes are to be maintained, there are certain changes which I have listed in my statement which we feel must be made. They closely follow S. 395, except we would recommend adding a provision for indexing the brackets.

The best possible solution is repeal. We fully support S. 404, by the chairman. Even if all the other faults of this tax were to be removed, and the bias against small business somehow lessened, the effects of inflation counteracted and the problems in valuation resolved, which are very significant problems, there would still be a major flaw in the tax.

It is, as it was meant to be, a device to discourage inheritance and the accumulation of wealth within the family.

It should be noted that this has popular support, I believe. Our members, in concert with other members of other tax groups in the State of California, have placed on the ballot two initiatives to repeal that State's inheritance taxes.

I believe well over half a million signatures were collected.

The current system, with the high rates of taxation is simply punitive. People are benefited by the drive to acquire wealth. We should not punish the accumulation of justly acquired property.

It is in everyone's interest that one institution, including the Government, not acquire a monopoly over most cultural, educational, and scientific activities. We should not prevent the development of private funds necessary to pay for these activities.

Finally, the bias of the estate tax against accumulating wealth acts to discourage savings by individuals, as Mr. Raboy has indicated in his statement.

There is no reason to continue to discourage savings in this way.

In conclusion, it is impossible to calculate how many small but vital small businesses and farms have had to close because of the effects of the death tax.

Many businesses, had they not been crippled by the tax or sold at estate sales, would have grown and continued to make valuable contributions to all Americans.

There is no reason to let this tax continue.

Thank you.

Senator SYMMS. Thank you very much for a very excellent statement.

We have one witness here that is not on the listed panel?

Mr. STROUPE. Mr. Friends, who is with me, sir.

Senator SYMMS. Very well.

I did have one question or two that I wanted to ask. Mr. Raboy, you made the reference about the effect on small business, but just what is the economic difference and the impact, do you think, between outright repeal and simply raising the credit to a higher level?

Mr. RABOY. I suppose that is a quantitative matter. It depends upon how high you raise the credit. I took a look at the statistics of income for the latest year available and I came up with some startling evidence on capital accumulation and small-type businesses, noncorporate businesses.

Virtually 76 percent of the taxable returns in that year were from estates within the $100,000 to $1 million range. This accounted for 65 percent of the gross taxable estate.

Now there was another variable that I took a look at in coordination with this, and this was noncorporate business assets.

It turns out that this group accounts for about 60 percent of the noncorporate business assets that are included in gross estates.

Couple that with the fact that this group also paid 55 percent of the total amount of the estate tax after credits, and you can see it is probably correct to characterize this tax as a tax on small business.

With respect to immediate repeal, a couple of weeks ago Senator Heinz, in front of the full committee, asked me if I would support immediate repeal of the corporate income tax. I responded to Senator Heinz saying that I was an economist and not a politician.

I will respond in kind, to you. I see no economic justification whatsoever for taxes on estates and gifts. The political matters are beyond me.

Again, if the exemption was raised to a very, very, very high level, probably you would have basically the same net economic effects as outright appeal. But, that is an empirical matter at this point, and I would prefer not to play around with it and say that probably repeal would be the best way to go.

Senator SYMMS. Thank you very much.

What would be wrong with—in view of the present bill the President is now talking about, that there seems to be somewhat of a bipartisan coalition supporting what the President wants to do, to just simply computing the portion of that tax bill that is dealing with the death tax, and the gift tax and simply say that 1981 is the base year and that for each year that in the phase out, if you died in 1981, your heirs would have to pay this much tax, but in 1982, your heirs would be paying 75 percent of what it was in 1981, and if you died in 1983, your heirs would be paying 50 percent and so on or whatever they could do until it is gone.

And get it on the books now, because the clock keeps running and sooner or later, if we could ever pass the law that abolished it, they would have to change things.

It seems to me like that is a very simple, easy-to-understand system. You don't have to write a new Tax Code. You just have one simple formula that the rates are going down to zero and then it disappears, at the end of a time certain, 5 years, 10 years, 6 years, whatever it takes.

Mr. RABOY. I would agree with that. I think the problem with the President's proposal, as it stands now, if I am correct, there is a $600,000 exemption and then the rates start exactly as they are under present law.

Senator SYMMS. That has certain humanitarian aspects, because look at the encouragement that would be for people who are in their later years to stay alive for another 10 years.

Mr. RABOY. Well, actually, there is a correlation between life expectancy and the amount of taxes raised from estate and gift taxes, but I wouldn't want to establish a causal relationship between the two.

But the point is, above $600,000 the rates can get very steep. Looking at the statistics of income, there is an enormous amount of capital accumulation that goes on of estates of $1 million, $2 million, that sort of a thing.

That would greatly discourage savings, still.

So, I would agree that the phaseout of——

Senator SYMMS. I would just say that I have suggested this to Treasury Secretary Regan and to President Reagan. So, any of you that have any influence there, if you agree with that, within the next 2 or 3 days, I think is the time to get the message down there to them.

Mr. MORAN. I think it should be noted that table 4 in the joint committee staff report discloses an average tax rate of almost, since 1945 through 1977, of about 25 or 26 percent.

As a result of the Tax Reform Act of 1976, it dropped by 7 percent to about 19 percent. When we talk about phase in of the exemption and decrease in the rate brackets, what are we really talking about in terms of average effective tax rate? Is it going to be under 10 percent?

I think the effective tax rate gets so small, when you combine the increase exemption with the reduction in tax rates, if they start at 20 percent over $600,000. It is just another way of pointing how minimal the tax burden will be, and I hope, subject to limitations of budget, that other Members of Congress can support your bill to repeal it.

This is another way of looking at what we are really talking about, such a minimum amount of revenue for such a maximum amount of complexity.

It can't be justified to continue in the fashion that it is.

Senator SYMMS. Thank you very much.

I certainly want to thank all members of the panel for being with us. Your entire statements will be a part of the record.

[Statements follow:]

Statement of Gerald P. Moran
Visiting Professor of Law
Marshall-Wythe School of Law
College of William and Mary

Summary of Statement

1. The estate tax system as it presently exist fails to meet any minimal standard by which tax laws should be tested:

   (a) It produces minimal revenue while creating immense complexity;
   (b) The total cost of compliance, public and private, probably exceed the current federal yield of revenue;
   (c) There is no constituency in favor of its continuation; neither political party is committed to an estate tax which produces significant revenues;
   (d) It plays a marginal role in terms of total federal receipts — 1 percent;
   (e) Clearly, the estate tax system fails as a viable tax system under any rational standard which is applied to actual results.

2. Whether its purposes are revenue raising or redistribution of wealth, the present system fails in meeting either objective.

3. It creates enormous cost for the public in attempting to avoid or reduce its impact.

4. The estate tax system is far more complex than carryover basis and has created a sub-industry of taxation-estate planning. Certainly, tax laws are not enacted to justify employment for the professional classes.

5. The farm community found bipartisan support to reduce its yield in 1976 and finds even more today.

6. The enactment of S. 395 or some modified compromise is tantamount to repeal.

   (a) It would reduce estate tax revenues in 1985 to what they were in 1971 (approximately $4 billion).
   (b) It would impose the tax burden on only .3 percent of those dying.
   (c) It would reduce estate taxes to less than .5 percent of total federal receipts.
   (d) And, the problems of the farm community transcend even outright repeal.

Conclusion:

Its time to admit the obvious and give the estate tax system an honorable death. While the idea of an effective estate tax system remains appealing, it presently does not exist. I expect this Committee to end the charade by recommending repeal of the estate tax system.

Statement

of

Gerald P. Moran

Visiting Professor of Law

Marshall-Wythe School of Law

College of William and Mary

I appreciate the opportunity of sharing my views with respect to the estate and gift tax system and, more particularly, the proposal for repeal pending before this Committee.

It should be noted that I appear solely as an individual and my views are not to be attributed to any institution with whom I am or was associated. This past academic year of 1980-81 I was a visiting professor of law at the Marshall-Wythe School of Law of the College of William and Mary. I am a professor of law at the College of Law, University of Toledo and, apart from my primary academic responsibilities, engage in some limited consultation. Prior to entering an academic career, I was engaged in private practice and was employed for seven years in various capacities by the Internal Revenue Service. These collective experiences, private practice, university teaching, and government service interact to shape an approach to tax legislation which has as its basis an equal concern for tax theory and application.

It is my hope that tax laws are shaped by some standard other than political expediency or economic theology. I submit a standard by which tax laws should be tested includes adequate concern for:

1. Revenue Produced
2. Allocation of the Tax Burden

3. Simplification

4. Role in Federal Budget

5. Impact on the Economy

6. Cos*s in terms of Public and Private Expenditures (Quantitative) and in terms Personal ~~and Professional Description (Quantitative)~~ Testamentary Disposition (Qualitative)

7. Political Support

The greater a tax law comports with the above elements, the more it can be stated Congress has attained a level of political perfection. The elements are neither exclusive nor are they to be applied in terms of absoluties — either yes or no — but rather tax laws should be measured by the degree to which they comport with the above standards. The present estate and gift tax structure hardly registers on this scale.

We can agree:

1. The present estate tax system produces minimal revenues ($7.2 billion 1981).

2. The tax burden rests on the richest 2.3 percent of those dying.

3. It creates a tremendous amount of complexity and requires the skill of a medieval philosopher to understand its application.

4. The estate tax system plays only a marginal role in the federal budget — 1 percent and falling.

5. With respect to impact on the economy, most believe that estate taxe' have a negative impact on small farms and closely held trades or business.

6. In view of its complexities, the estate tax system has generated a sub-industry of taxation, estate planners. Included are lawyers, academicians, accountants, insurance representatives, trust officers, appraisers and others. These services are costly and the federal

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government may reap more on income taxes from this industry than from the estate tax system itself.

7. There is almost no constituency in favor of estate tax and the present mood of both political parties appears to be in favor of a substantial increase in the exemption as well as further relief to family farmers.

Clearly, the estate tax system fails as a viable tax system under my criteria on any other rational standards which are applied to actual results.

I suspect the Republicans are afraid of being charged with removing the estate tax on the wealthy - but it should be noted the Democratic controlled Congress (96th) reduced estate and gift taxes dramatically in 1976 and permanently repealed carryover basis in 1980. Moreover, the tax package of both the Reagan Administration and the Democratic alternative in the House both include proposals to reduce the burdens of estate tax; cannot this Congress get beyond the usual bland of partisan politics and admit that neither political party is committed to an estate and gift tax system which will yield significant revenues.

I would like to review briefly certain aspects of the current structure which necessitates repeal, viz., failure to achieve stated purposes, failure to raise revenues, cost, complexity, and erosion of political support.

Purposes of Estate and Gift Tax:

In the Spring of 1976, I asked the Ways and Means Committee to address the objectives of the estate and gift tax system before it proceeded to recommend major reforms which would increase complexity while further reducing the revenue harvest from the system. The former chairman of the Committee, Representative Ullman, whose views on this matter have been presented to the Committee this morning, was somewhat irritated by the question of purposes and stated in part in 1976:

> If we have to decide that issue (purposes) we will spend all of our time debating the issue and never get a bill out of the committee so perhaps you are trying to confound us, Professor, by throwing us a curve, but there is no way we can make this judgment and get language that would satisfy the members of this committee or the Congress, or that we could get through Congress.[1]

I am pleased to see that this Committee does not consider the question of purposes of the estate and gift tax irrelevant or an academic curve. There is no way the issue of repeal or amendment can be analyzed without first establishing the functional objections of the system.

Until the 1930s, the sole function for the estate and gift taxes was to raise revenue to meet the cost of wars -- the Civil War, Spanish American and World War I. Except for the last war, the estate taxes (inheritance in 1800s) were repealed after the hostilities concluded. The estate tax would have been repealed in 1926 as a result of the efforts of Andrew Mellon, Secretary of the Treasury. However, a skeletal version of the estate tax structure was preserved by the skillful legislative maneuvers of progressives in the House who reduced the maximum rates to 20 percent, increased the state death credit to 80 percent and increased the exemption to 100,000. They also, repealed outright the gift taxes. While the estate tax evidenced some modest degree of hostility towards wealth, its principal if not exclusive purpose at the time of its initial enactment and in 1916 in particular was to raise revenue.

The rampant tax reductions of the 1920s were followed by the Great Depression. Estate taxation found favor with the new Roosevelt Administration which stressed the anti-wealth aspect of the tax and, in so doing, gave it a new definition. A number of specific changes were effected: exemptions were decreased, gift taxes reenacted, and tax rates increased. The apex of anti-wealth attitude was suddenly reached on June 19, 1935 when President Roosevelt sent an unexpected message to Congress. President Roosevelt decried the evils of the transmission of wealth from one generation to another and asserted "inherited economic power is an inconsistent with the ideals of this generation as inherited political power was inconsistent with the ideals of the generation which established our government." He then proposed an inheritance tax in addition to the estate tax to preserve a measure of equality of opportunity for all. Congress responded by greatly increasing the estate tax burdens but did not adopt the recommended inheritance tax.

As the country moved out of the depression, it was confronted with the necessity of raising revenues to finance World War II. The estate and gift taxes, like all other sources of revenue, were used to meet the new emergency. As soon as the war ended, Congress, in a manner comparable to the twenties, began to reduce taxes. President Truman vetoed the Revenue Act of 1948; in his message explaining the veto, he was particularly critical of the enactment of the marital deduction which would reduce estate tax burdens for the 12,000 richest families in America.

While it is evident that the anti-dynastic mood of the thirties is concealed in the roots of the system, few have focused on the empirical results in terms of redistribution. Professor G. P. Verbit of Boston University Law School in a two part article in 1978 found that there was little or no data to support the proposition that the estate taxes effected redistribution. He cited one major economic study of Professor James D. Smith who found little shift of wealth among the super rich (i.e., the richest .5 percent) for the period of 1955-1972. Hence, the sparse data disclose, assuming some believe that the primary or even secondary objective of the federal transfer tax is to effect redistribution, a colossal failure in that respect. As will be seen in the discussion of revenue below, the other traditional objective of estate taxation, viz., that of raising revenue, has also not been achieved.

Revenue:

It has been a constant source of surprise and concern that the media tends to concentrate on abstract ideological debates and personalities rather than focusing on the results of our complicated alternative sources of federal revenue. President Reagan's revised budget (March 1981) discloses the federal transfer tax will generate a mere $7.6 billion or 1.1 percent of revenues for fiscal 1982. Assuming the legislation before this Committee is not enacted, this amount will increase to $11.3 billion by fiscal 1986, but the percentage of federal revenues will remain approximately constant at 1.2 percent. We realize more revenue from alcohol and tobacco taxes than we do from estate and gift taxes! Alcohol and tobacco taxes generated $8 billion in fiscal 1980 — as compared to $6.4 billion from estate and gift taxes. The results for later fiscal periods are estimated to continue; e.g. estimated $8.3 billion as compared to $6.9 billion for fiscial 1981.[2] To say that the estate and gift revenues are a marginal aspect of federal revenues is somewhat of an overstatement. This is not a recent development. The revenues from estate and gift tax have been less than 2 percent of total federal revenue for the last thirty-five years. The high point was reached in the thirties (4.2 percent in 1935) because of a significant drop in income tax revenues and increases in the estate tax rates. Hence, accepting that revenue is the purpose of the federal transfer tax, we see less than significant revenues and a process of constant deterioration. In fact, Congress will not have to face the actual decision to repeal if it simply continues making ad hoc modifications further devitalizing its reach.

However tenuous the effectiveness of the present system, it will be further exacerbated by the enactment of S. 395 calling for an increase in the exemption (in the form of an increase in the unified credit) to $600,000. This change alone, if applicable now, would reduce revenues from $7,263 billion to $3,518 billion (revenue loss $3,745 billion) for fiscal 1981. This constitutes cutting the total federal revenue from the federal transfer tax by more than 50 percent and, as a result, the estate tax revenue would constitute only .6 percent of total federal revenues. It also would place the entire burden of the tax on only .3 percent of those dying whereas the present burden is shared by 2.8 percent. Can such a discriminatory allocation of the burden be described as tax? If phased in over the next four fiscal periods on a graduated basis as proposed, the new exemption alone, would reduce revenues in 1985 by $5.9 billion - almost what is yielded in fiscal 1980 ($6.4 billion).

In terms of absolute dollars, the $4 billion in estate taxes to be collected in 1985 would represent turning the clock back to 1971, where only $3.7 billion in estate tax revenues was yielded. Estate tax revenues would be reduced to an all time low as a percentage of federal revenues, viz., .5 percent.

Cost:

Any evaluation of revenues must be analyzed from the perspective of cost. I doubt the Internal Revenue Service's costs in collection are any greater than those involved in collection of income taxes. However, it is a mistake to consider only the public cost. Some consideration must be given to private costs.

There are significant questions involved in estate planning, valuation, incidence of ownership of insurance policies, problems about post-mortem elections, qualification of marital deductions, qualification of annual exclusions, and litigation involving these and other issues. These problems have created an estate planning industry. Numbered among the group are lawyers, accountants, insurance representatives, academicians, and trust officers. We have estate tax seminars, law courses and at least one law school grants a masters degree in estate planning. We have made the technical rules a way of life; a business. Lewis Eisenstein the late tax realist said it over twenty years ago and it's even more true today:

> While it — estate and gift tax law — helps to support many lawyers, it does relatively little to support the government.

I suspect the federal government may realize more in the income tax paid by estate planners than it receives from the federal transfer tax itself. That is not an amusing circumstance. It becomes even more paradoxical when one realizes that the tax laws authorize an income tax deduction for a good portion of estate planning fees paid to avoid or lessen the tax burden. There are in short enormous costs incurred by the public in dealing with the estate tax laws which provide minimal yield for the federal government.

Complexity:

My fellow members of the Bar made a successful attack to repeal carryover basis. It was repealed on the finding it increased cost of administration and was unduly complicated. The complexity of carryover basis is simplicity itself when compared to the range of complexity generated by the estate and gift tax structure.

With the recent successful attack on the carryover basis still warm, have my fellow members of the Bar informed this Subcommittee on Estate and Gift Taxation of the greater complexities associated with the federal estate tax system? Have they asked for repeal of the estate tax system or do they ask for further simplification in form of increased exemption while retaining the system? If so, why? The answer is obvious, they have a vested legal technology having significant economic value and wish to retain the benefits accruing therefrom. There are others in the estate planning industry who will also likely posture gainst its repeal — included are academics and the banking, accounting, and insurance industries. I assume that tax systems are created to raise revenue and not to create jobs for the professional classes.

Political Erosion:

The farm community whose elected representatives in 1926 saved a skeletal term of the estate tax system from repeal are in the ironic position of pressing for significant reduction which are tantamount to repeal in my opinion. At the public hearings before the Ways and Means Committee in 1976, all elements of the farm community were in attendance to support an increase in the exemption and the enactment of special use valuation. Their argument then and now is that estate and gift taxes are among the major forces causing termination of the family farms in America. I am not an economist nor do I suggest any specific knowledge of the problems in agri-business. However, the problems facing the family farmer with 400 to 600 acres transcend those arising because of the application of estate and gift taxes. These problems are not unlike the neighborhood grocery stores of the 1940s which fell victim to large national grocery stores. Indeed, there has been a farm boom during the late seventies and the increases in farm land values have exceeded the inflation rate; i.e., real increases in value.[3] Yet, it is this community which found congressional support in 1976 and finds bipartesan support today.

If you believe that increases in the exemption will be the answer to their problems, you're simply passing the same problem forward. The capital intensive aspects of farming will increase as will the value of farm land in this decade. You can expect they will be back again to discuss their "estate tax" problems with you or your staff in the near future.

In 1976, I opposed the concept of taxing people owning different kinds of property on the basis it created unequal treatment and broke the integrity of the estate tax concept of taxing property on the basis of its fair market value. Congress did not agree and enacted section 2032A to provide special relief for the farming constituency. Section 2032A epitomizes how well intentioned legislation that sounds good in theory, can create a nightmare in application. The first problem is definitional - how can you describe what types of property qualify and how will its special value will be determined? One of my friends in agri-business at Ohio State University tells me there are section 2032A valuation experts and that he spends over ten percent of his time clarifying the meaning of the law and regulations. If you create a flat reduction from fair market for farm land, then the disparity of treatment will be highlighted. It's a road down which there is no answer expect to admit that further significant increases in the exemption to provide relief for the farm community also constitutes in reality repeal of the system.

Conclusion:

The present estate tax system produces a marginal yield of $7.2 billion for the federal budget. This constitutes only 1 percent of total receipts. It is proposed that the yield should be cut to $4 billion by 1985 in which event this would constitute less than .5 percent of total revenues. The burden of the tax would be shifted to only .3 percent of those dying; down from 7.3 percent in fiscal 1977 and 2.8 percent for fiscal 1981. Obviously, the system is filled with complexity which creates an expensive spin-off industry of estate planners. It is more likely the government realizes more in income taxes paid by the spin-off industry than it does from the estate tax system; this is particularly true if S. 395 or some modified compromise is enacted. The estate tax role in the federal receipts as a percentage of total revenues is presently 1 percent and expected to fall drastically. There are many claims about its negative economic impact on farming and closely held businesses. In additon to the enormous private costs incurred in avoiding the tax, there are significant limitations imposed on a person's testamentary choices. Finally, there is little support in favor of the estate tax and the claims of the farm community are finding bipartisan support. There is in short increasing political erosion in favor of an estate tax.

Adoption of S. 395 constitutes a sub silento repeal under any measurement. It's time to admit the obvious - let this Congress give the estate tax an honorable death. The idea of an effective estate tax remains appealing but it is not one that presently exists. At this poinit, we — this Committee — should not continue the charade of an estate tax system, particularly if further reductions of its already minimal revenues are recommended.

I am glad Chairman Symms has placed the important issue of repeal before the Committee. I believe that this Committee should be forthright in acknowledging to the American people that neither political party is committed to an estate tax system which produces significant revenues and that the form of this acknowledgement will be a recommendation in favor of its repeal.

Footnotes:

1. Public Hearings on Federal Estate and Gift Taxes before the Ways and Means Committe, 94th Cong., 2nd Sess., Part 1, at 762 (1976).

2. The recent Joint Committee report on S. 395, et al indicates the estate and gift tax revenues for fiscal 1981 are $7,263 billion; see Background and Description of Bills (S. 395, S. 404, S. 574 and S. 858) Relating to Estate and Gift Tax, Joint Committee on Taxation, JCS-16-81, at 23 (1981). President Reagan's revised budget discloses a return of $6.9 billion for fiscal 1981 as does former President Carter's economic report for 1981; see President Reagan's Budget Revisions for Fiscal 1982, at 122; and Economic Report of the President, at 315 (1981).

3. See extensive discussion of the agri-business in the Economic Report of the President, at 115 through 123, inclusive (1981).

THE ECONOMICS OF ESTATE AND GIFT TAXES

Statement by
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SUMMARY

This testimony considers the economic effects of estate and gift taxes. The rationale for these taxes includes the raising of revenue, the retardation of excessive wealth accumulation, and the enhancement of equity in the tax system. The tax is not a powerful revenue raiser; it has been levied on large sections of the middle class, and has violated reasonable standards of tax equity.

Most economic analysis has focused on equity and has ignored the effects of estate and gift taxes on the efficiency of the economy. Our preliminary suspicions are that these taxes cause widespread distortions in the economy due to the fact that they are taxes on wealth. Recent research has shown that the majority of saving takes the form of bequests from one generation to another. Thus, estate and gift taxes are one additional layer of tax on saving. Recent research has also established that taxes on the return to saving inhibit the motive to save. Therefore, taxes on bequests decrease the aggregate amount of saving in the economy.

A second economic loss occurs because estate and gift taxes force people to channel savings into uneconomic uses. Because these taxes are levied on the estate and become due shortly after the transfer, they bias investment away from illiquid investments; that is, investments in physical capital as would be the case with a closely held business. This is unfortunate because the greatest job-producing potential comes from such businesses. Further, these taxes inhibit risk taking by causing "trustification"--the establishment of trusts for tax avoidance purposes. It is well known that the administrators of trusts are generally far less willing to take risks than other economic actors. Again, this is unfortunate because a dynamic economy depends on innovation.

IRET is conducting an ongoing research project on the efficiency effects of estate and gift taxes. As a first step, the effects of a complete repeal of estate and gift taxes are being simulated by the Analysis of Tax Impacts Model, developed by Dr. Norman B. Ture, and now being run by the firm of Coopers and Lybrand. As soon as these numbers are ready, they will be made available to the sub-committee.

Introduction

In an earlier part of the history of our tax system, little emphasis was put on the economic effects of taxes. The primary criterion for judging a tax change was equity and little attention was paid to the effects that a tax might have on the efficiency of the economy.

The parallel growth and intrusion of the income tax into our day to day lives has rekindled an interest in "supply-side" economics and has spawned a widespread and active inquiry into the nature of the income tax and how it affects our society. As a result of this examination, it is now widely accepted that the existing high marginal tax rates on income tend to limit productivity and real economic growth by penalizing work, savings, and investment.

Unfortunately, far less economic analysis has gone into examining the effects of the existing high rate of estate and gift taxes. The purpose of this testimony is to provide the outlines of an ongoing research project at IRET, and to offer some preliminary findings. Essentially, our aim is to apply the same principles of neo-classical or "supply-side" economics to the effects of the estate and gift taxes as have already been applied to the income tax.

Our preliminary findings indicate that there are significant and widespread distortions that result from the estate and gift taxes. Some of these distortions flow from the peculiar design of the taxes as part of the Internal Revenue Code, and consequently some may be remedied by legislative reform. But more importantly, the fundamental problems with the estate and gift taxes flows from their essential nature as taxes on wealth.

Recent research has indicated that a primary motive behind the decision to save is to leave bequests to one's heirs. Further, an enormous amount of wealth is transferred from generation to generation. Thus any tax which is levied on such an important pool of savings ought to be examined very carefully. To the extent that such a tax influences the decision to save, it could produce serious impediments to economic growth.

It was once believed that estate and gift taxes could not have serious economic effects because they only effected a few individuals. In many ways the experience of the estate tax parallels that of the income tax. At its introduction the estate tax was assessed at relatively low rates with exemptions sufficiently large to subject only a very limited number of persons to the tax. As time passed, however, the rates skyrocketed and the exemptions were eroded by both legislation and inflation. Now the tax affects a great many savers indeed.

In the analysis that follows, the "efficiency" effects of estate and gift taxes will be considered. The point of departure is that these taxes are viewed as an additional level of taxation on income from saving. In section I a history of these taxes is provided. In section II the economic effects are explored. Section III explains the ongoing IRET research project.

I. Overview

The estate tax has been a feature of U.S. law since 1916. Its sister tax, the gift tax on lifetime transfers, has been with us since 1932. Generally speaking, the existing unified estate and gift transfer tax is a levy which applies to the total value of the estate of a decedent plus the value of taxable gifts made after 1976. The tax is a tax on transfers, rather than a tax on inheritances. As a result, the estate, not the heir, is the tax payer.

Estate taxes differ from inheritance taxes (frequently imposed by the states) in that estate taxes (1) are imposed on the estates, (2) do not provide a tax saving opportunity for splitting bequests among a number of beneficiaries thereby lowering the marginal rate of tax, and (3) do not provide seperate rate schedules depending on the relationship of the decedent to the beneficiaries. The estate and gift transfer taxes differ from an accessions tax in that amounts received by beneficiaries by lifetime gifts or testamentary bequests are not treated as income for the purposes of the income tax.

The History of Modern Estate and Gift Taxes

Although the United States experimented with a number of death taxes before this century, the modern estate tax must trace its origin from 1916. Earlier attempts at imposing some kind of inheritance tax were short-lived and were generally in response to some pressing, but transitory, need for revenues.

While the need to raise revenue is always the cornerstone of any undertaking to enact any tax, estate tax advocates always put forth additional justifications. One of the earliest calls for an estate tax on grounds other than mere revenue raising came from the trust busting rhetoric of President Theodore Roosevelt in 1906. President Roosevelt called for "a progressive tax on all fortunes beyond a certain amount . . . a tax so formed as to put it out of the power of the owner to hand on more than a certain amount to any one individual." Even though Roosevelt paid lip service to the tax as a revenue raiser, in a later reference to the tax he said; "As an incident to its function of revenue raising, such a tax would help provide a measurable equality of opportunity for the people of the generations growing to manhood."

Despite his popularity and his rhetoric, Roosevelt never got his tax. When the Congress got around to enacting an estate tax, the lawmakers did so under special circumstances and for different reasons. Up until 1913, the United States relied almost exlusively on customs taxes and various internal duties as sources of federal revenue. An attempt to impose an income tax in 1894 failed when the Supreme Court struck down the tax as unconstitutional. Nevertherless, continuing pressure for revenues resulted in the adoption in 1913 of the 16th amendment to the Constitution which expressly allows taxes on income.

For a number of reasons, the income tax of 1913 was not a major revenue producer, and the United States continued to depend heavily on various customs duties for the increasing demands of government. At the same time, however, the widening war in Europe threatened these essential customs duties by disrupting international trade. Despite Wilson's campaign slogan, "He kept us out of war," war also precipitated the need for significantly greater federal spending for military preparedness.

The Revenue Act of 1916 introduced the estate tax to America. In addition, the act substantially furthered the concept of "ability to pay" as a basic tenet of U.S. tax philosophy. While the stated purpose of the legislation was to fund "the extraordinary increase in the appropriations for the Army and Navy and the fortification of our country," the House Ways and Means Committee report accompanying the act states:

> No civilized nation collects so large a part of its revenues through consumption taxes as does the United States, and it is conceded by all that such taxes bear most heavily upon those least able to pay them.

The report goes on to state:

> . . . our revenue system should be more evenly balanced and a larger portion of our necessary revenues collected from the incomes and inheritances of those deriving the most benefit and protection from the government.

The estate tax enacted by the Revenue Act of 1916 is by contemporary standards very moderate indeed. At a time when $50,000 was no mean fortune, that amount was exempt from the federal estate tax. Above the $50,000 exemption, the rates were quite low. The result was to subject only a very small number of relatively wealthy persons to a tax of relatively low marginal rates. Consider the following comparison of the estate tax rates of 1916 and 1981:

Size of Taxable Estate			1916	1981
$ 0	to	$ 10,000	1%	18%
$ 10,000	to	$ 20,000	1%	20%
$ 20,000	to	$ 50,000	1%	22%
$ 50,000	to	$ 60,000	2%	24%
$ 60,000	to	$ 80,000	2%	26%
$ 80,000	to	$ 100,000	2%	28%
$ 100,000	to	$ 150,000	2%	30%
$ 150,000	to	$ 250,000	3%	32%
$ 250,000	to	$ 450,000	4%	34%
$ 450,000	to	$ 500,000	5%	34%
$ 500,000	to	$ 750,000	5%	34%
$ 750,000	to	$ 1,000,000	5%	39%
$ 1,000,000	to	$ 1,250,000	6%	41%
$ 1,250,000	to	$ 1,500,000	6%	43%
$ 1,500,000	to	$ 2,000,000	6%	45%
$ 2,000,000	to	$ 2,500,000	7%	49%
$ 2,500,000	to	$ 3,000,000	7%	53%
$ 3,000,000	to	$ 3,500,000	8%	57%
$ 3,500,000	to	$ 4,000,000	8%	61%
$ 4,000,000	to	$ 4,500,000	9%	65%
$ 4,500,000	to	$ 5,000,000	9%	69%
$ 5,000,000	and up		10%	70%

While the above comparison does illustrate a dramatic difference in rates, even this difference is greatly understated. First, the present law has far broader coverage than the 1916 act. Many types of transfers which are presently taxable were not taxable under the original act. But far more important, while there has been some increase in the nominal amount effectively exempt from the estate tax the rate brackets have not been adjusted for inflation. As a consequence, the marginal rate on real income is grossly understated.

With only one significant exception, the history of the estate tax shows a gradual increase in rates over the past 65 years. "Supply-siders" will not be surprised to learn that the exception came in the mid 1920's, with Coolidge as President and Andrew Mellon as Secretary of Treasury.

The end of World War I, the rapid expansion of the U.S. economy in the 1920's, and the continuation of some wartime revenue raising measures (including the "War Estate Tax" of 1918) all contributed to a problem unheard of today--Treasury surplus. In this historical context, Secretary Mellon raised precisely the question which will be the subject of the IRET project. In testimony to the Senate Finance committee he said:

> The far-reaching economic effect of high inheritance taxes is not properly understood. These taxes are a levy upon capital.

Of course, the prosperity and growth of the 20's did not last and the political pendulum was to swing back. In response to the economic, social, and political crises precipitated by the Great Depression, Congress enacted an estate and gift tax of unprecedented magnitude. During this period, even former Secretary Mellon supported estate tax increases to deal with the spectre of rising and uncontrollable federal deficits.

Touching a responsive chord in Depression America, President Franklin D. Roosevelt said:

> . . . the desire to provide security is natural, but is adequately served by a "reasonable" inheritance.

and:

> Accumulation of wealth perpetuates . . . great and undeniable. concentration of control in a relatively few individuals over the employment of many, many others.

The Senate Finance Committee report on the Revenue Act of 1934 picked up these new themes and stated that the act would do more than merely raise revenue, it "moreover will tend to prevent undue accumulation of wealth." Since the 1930's the estate tax has been the object of a general trend of statutory and inflation induced rate increases.

Federal Gift Tax

Since a death tax could be avoided by gifts made on the death bed, the 1916 estate tax also applied to transfers "in contemplation of death." Further, the act provided a rebuttable presumption that any transfer made within two years of death should be deemed in contemplation of death. These contemplation of death provisions were not intended to attach a tax to purely "intervivos" or lifetime gifts. Rather, they were intended to plug this perceived "death-bed loophole" in the estate tax. However, contemplation of death provisions did not solve the problems of the complex interrelationship between intervivos and testamentary transfers. Consequently, a federal tax on gifts made a two-year appearance in 1924, and became part of the law in 1932. The purpose of the gift tax was to foreclose tax planning opportunities which were raised by the existing estate and income taxes. These new concerns were reflected in the House Ways and Means Committee report on the Revenue Act of 1932. That report stated:

> To assist in the collection of the income and estate taxes, and to prevent their avoidance through the splitting up of estates during the lifetime of a taxpayer, our committee recommends a gift tax.

<u>Tax Reform Act of 1976</u>

The most important recent change in the estate and gift tax law came in the form of the Tax Reform Act of 1976. Prior to the 1976 act, the estate tax had an exemption of $60,000. In addition to the $3,000 per person per year annual exclusion, the gift tax had a seperate lifetime exemption of $30,000. The top estate tax rate was 77%, and the gift tax rates were so-called "bargains," since their bracket rates were equal to three quarters of the corresponding estate tax rate. These and a host of other far-reaching changes made the Tax Reform Act of 1976 a benchmark in the history of estate and gift taxes. With a few exceptions and a couple of transition rules, the estate and gift taxes are now one unified, integrated tax.

II. The Economics of Taxes on Wealth Transfers

In IRET's Economic Report #1 a basic principle of taxation was stated: taxes ought to be levied in ways that least distort individuals economic decision-making. To distort the decision process is to cause people to make economically inferior choices-- choices that lead to a weaker economy.

Throughout their history, a large variety of rationalizations have been offered for the estate and gift taxes. To some, the taxes are mere revenue raisers. To others, they prevent the perpetuation of accumulations of wealth thought to be threatening to our system of government and commerce. At any rate, it was believed that these taxes did little harm to the economy because they only affected a few people and it was believed that savings behavior would not be influenced by taxes on transfers.

The two benchmarks that are traditionally used to judge a tax system are efficiency and equity. Efficiency embodies the concepts mentioned above; that is, the most desirable tax system is the one that least distorts the economy. Equity concerns the fairness of a tax system. Analysis of estate and gift taxes has mostly centered on equity arguments. Here, both issues will be considered.

Taxes, Bequests, and Saving

Until recently the efficiency loss due to estate and gift taxes was held to be small because of two perceptions that have now been cast into doubt. One of the beliefs concerns why people save. Economic theory postulated that people save mainly to smooth out their consumption patterns over their lives. That is, there are periods when earnings are higher than others but it is desirable to maintain some basic standard of living during all the years of one's life. A common example is that people save to fund their retirement. It is clear that saving for retirement is an important motive, but it was previously believed that it was the motive, and the decision to leave bequests was relatively unimportant; that is, passing wealth on to others was an after-thought. Pursuing this logic, the drop in saving due to taxes on wealth transfers wouldn't be of much concern because that type of saving was supposed to be relatively insignificant.

Recent research, however, has turned this comforting notion on its head. A study conducted by Laurence J. Kotlikoff and Lawrence Summers of the National Bureau of Economic Research and the Masschussets Institute of Technology has concluded that the great majority of accumulated wealth in the United States is transferred from generation to generation. The vast majority of savings are eventually conveyed to others, not used up during one's lifetime. Thus this form of saving is terribly important. Anything that discourages it is of great concern.

Having determined that bequests are a significant proportion of saving, we must consider how taxes affect saving behavior. Economic theory holds that taxes on income from saving in general, and bequests in particular will alter the after-tax rate of return to saving. The second reassuring (to the proponents of transfer taxes) but erroneous belief was that saving was relatively insensitive to its after-tax rate of return; that is, raising the tax on income from saving would have little effect on the amounts that people save. Thus, although the estate and gift tax might reduce the wealth passed on within the private sector, the distortion in savings behavior would be small. But again, saving is quite responsive to its after-tax rate of return and additional taxes on the income from saving can reduce saving dramatically.

In Economic Report 1 the proper mechanism to judge a tax was given. Every tax has the attribute of changing the relative costs facing actors in the economy. As stated above one of the primary motives for saving is to leave a bequest to one's heirs. What estate and gift taxes do, then, is to increase the costs of providing an income stream for a future generation, relative to consuming now. Suppose an individual wants to leave a bequest of $90 to his heirs. In a simple world, absent estate and gift taxes, the cost of transferring $90 is exactly $90; that is, he must give up $90 of consumption in order to leave the bequest.

Now suppose an estate tax of 10% is levied. In order for the poor old man to leave an after-tax bequest of $90, he would have to come up with a bequest of $100. The cost of leaving the desired wealth to his heirs has increased--he must now forego $100 of present consumption to leave the desired bequest. Economic theory tells us that, given this increased cost, he will be discouraged and save less. As a result, he will bequeth less than $90 before tax.

Of course, in the real world the situation is even more serious. The income from saving is taxed many times. An individual earns income which is taxed. He saves some of this after-tax income and the income from this saving is taxed again as interest or dividends or capital gains (if realized in his lifetime). Now, if the purpose of the saving was to leave some wealth to his heirs, this saving is taxed again under the provisions of estate and gift taxes. Further, marginal tax rates on estates rise to extremely high levels, up to 70% for taxable estates of over $10 million. At such marginal rates, one should not be surprised if vigorous efforts are undertaken to avoid the tax and saving for bequests falls. The result is an unequivocal drop in the rate at which society saves and accumulates wealth. Because this will slow growth, it will lower the well-being of society as a whole. The loss will not be confined to only those who directly pay the tax. The first efficiency concern, then, is the decreased rate of saving due to estate and gift taxes.

Estate Planning, Tax Avoidance, and Economic Inefficiency

Besides inhibiting saving, estate and gift taxes contribute to inefficiency by forcing people into less desirable forms of savings solely in order to evade taxation. By effective estate planning, one can avoid high marginal tax rates. The tax system rewards this activity--that is, the making of decisions that would otherwise not be made. Remember that the tax is not part of the natural economic order; it is a government imposed artifact.

A primary example of such inefficiencies concerns the topic of liquidity. As was stated above, estate and gift taxes are levied on the estate and become due in a very short period of time. In order to pay the taxes, a portion of the assets might have to be liquidated.

Clearly, this discriminates against capital intensive types of investment. An entrepreneur would shy away from the purchase of a small foundry because, upon death, part of it might have to be sold just to pay the estate taxes.

Illiquid estates run the hazard of being compelled to sell off assets at distress prices in order to pay the estate taxes that are due within nine months of death.

As a result, under present law, an estate primarily composed of physical assets (such as a family owned manufacturing business) is a poorly planned estate.

Unfortunately, the greatest amount of economic growth and job creation accrues to those assets that are the least desirable from an estate planning perspective. Thus the estate and gift taxes force savings toward less eonomic uses.

Another economic loss is the enormous demand for estate planning created by these taxes. The skills of thousands of lawyers and accountants are now being devoted to work that would be unnecessary except for the tax. This is surely an economic cost of the tax.

Taxation and Equity

The estate and gift tax is frequently defended on grounds of equity. There are two concepts of equity--vertical and horizontal. Vertical equity embodies the "ability to pay" approach and leads to a defense of progressivity. When speaking of vertical equity, however, one must consider the final incidence of a tax--that is, who the tax really affects.

A 90% tax on the income from physical capital would be perceived by most to be progressive in that rich people own more factories than poor people. At such a confiscatory rate, investment in physical capital would lag and individuals would seek investments by which they would avoid the tax. As the capital stock contracts, workers' real wages would fall, unemployment would increase and the economy's growth rate would decline. When all was said and done, it is altogether possible that the rich would bear less of the burden than the poor. When considering vertical equity, one must consider all the economic ramifications.

It is altogether possible that estate and gift taxes weigh more heavily on the middle class and the poor than on the rich who can afford sophisticated planning. At the current rate of inflation even modest family estates will not escape taxation. Further, as stated above, the taxes reduce the level of saving generally, and the level of real wages in the society. It is understood that small, closely held firms have the greatest potential for providing new jobs.

The second concept of equity is horizontal equity. Horizontal equity requires that people of equal means be treated equally. Suppose two individuals are identical in ability, luck, work effort, and most other characteristics. In fact, the only difference is that the first places a high priority on helping his decedants, while the second puts a high priority on his own standard of living. By the principle of horizontal equity, the tax system is far tougher on the first individual. As the funds that will eventually be transferred are saved, their earnings are taxed. When the conveyance finally occurs, the funds are taxed again. The second individual, who emphasized his own consumption and his own standard of living, escapes these two taxes on savings. He has the lighter tax burden solely because of the value he places on current consumption.

III. Future Research

In the weeks to come IRET will be taking a look at some of the issues raised in this testimony. We will be curious to see the extent to which saving is decreased by estate and gift taxes and the extent to which savings are directed into unproductive uses. Simulations will be run on various legislative proposals to see the effects of changes in the estate and gift tax laws on investment, employment, economic growth, and federal revenues. We will also take a second look at the equity arguments in an attempt to see just who bears the burden of estate and gift taxes.

As a first step, we are currently simulating the effects of complete repeal of all estate and gift taxes on such variables as employment, investment, revenues, and GNP growth. The simulation is being performed on the Analysis of Tax Impacts Model at the firm of Coopers and Lybrand. This model was developed by Dr. Norman B. Ture. When the results are complete, they will be made available to the subcommittee.

STATEMENT OF RAY M. STROUPE, PRESIDENT

NATIONAL TAX EQUALITY ASSOCIATION

ON S. 404

BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

<u>SUMMARY</u>

ESTATE TAX RELIEF NEEDED FOR INCREASED SAVINGS AND CAPITAL FORMATION

ESTATE TAX DISCRIMINATES AGAINST SMALL FIRMS AND FARMS

ESTATE TAX PROMOTES UNNECESSARY ECONOMIC CONCENTRATION

June 5, 1981

Mr. Chairman and members of the Subcommittee, I am Ray M. Stroupe, President of the National Tax Equality Association (NTEA), and I am accompanied by Christopher Fienze, our Director of Research. The National Tax Equality Association appreciates this opportunity to support S. 404, a bill to repeal estate and gift taxation. NTEA consists of over 1900 firms, mainly small enterprises, which oppose excessive and discriminatory taxation of business and capital.

TAX RELIEF FOR INCREASED CAPITAL FORMATION

In recent years more attention has been focused on the pressing need to encourage increased savings, capital formation, and productivity growth required for the effective operation of our capitalist system. Recognition of the detrimental effects of high marginal income tax rates has rightly assumed a central role in discussions of tax policy. In our opinion federal estate and gift taxation represents another extremely counterproductive feature of our tax code. Disincentives to investment and entrepreneurial activity are very great relative to the tax revenues derived from this source: less than 1% of total federal revenues.

Effective estate planning can minimize the impact of inheritance taxation on the very wealthy. The incidence of the tax is regressive, falling heaviest on relatively modest estates, especially small family businesses and farms. These closely held estates are often forced into liquidation on relatively unfavorable terms to meet tax payments. The existence of the tax provides an incentive for older businessmen to sell out to publicly held corporations and use the proceeds to purchase liquid investment vehicles such as government securities. Estate taxation imposes a heavy burden on aggressive entrepreneurship, successful business judgement, and capital formation in closely held enterprises. Yet these qualities are essential to the dynamic and efficient operation of our competitive enterprise system.

The tax rates imposed by law are harsh enough, but inflation induced bracket creep has pushed the tax take to virtually confiscatory levels. As a result, the tax severely disrupts business planning and forces the liquidation or truncation of many of the most successful and productive business units. Estate taxation destroys capital, discourages savings and capital accumulation, and produces little revenue.

ESTATE TAXATION AND COMPETITION

Government policy condemns economic concentration and strongly enforces many antitrust laws. Yet when concentration or market power actually appear, they are most often a result of some government regulation or action. Estate taxation, for instance, promotes unnecessary economic concentration by making many small businesses and farms sell out to large corporations. Tax considerations introduce a significant bias in decision making in favor of larger business units. In addition, by hindering the growth of successful small businesses by the confiscation of capital, the tax can insulate big established corporations from competitive forces that would otherwise exist.

Particularly in industries where economies of scale play an important role, the effects of the tax may constitute a barrier to entry or expansion, preventing a small firm from accumulating enough capital to aggressively challenge established businesses.

Because estate taxation is inapplicable to publicly held corporations it discriminates against small private businesses and farms. The competitive disadvantage imposed is considerable, and should be removed. The repeal of the tax can achieve this objective and facilitate more neutral taxation of business enterprises.

Thank you.

STATEMENT OF DAVID KEATING

DIRECTOR OF LEGISLATIVE POLICY

NATIONAL TAXPAYERS UNION

before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

COMMITTEE ON FINANCE

UNITED STATES SENATE

JUNE 5, 1981

SUMMARY

1. The current federal estate and gift taxes do not affect only the rich. Middle income taxpayers, especially those with farms or small businesses, are often hurt.

2. Inflation has been increasing the estate and gift tax each year by eroding the value of exclusion amounts, and by pushing estates into higher brackets.

The exclusion amounts, bracket amounts, and other fixed dollar amounts should be fully indexed with inflation to prevent further increases. Estate and gift exclusions should be increased to $600,000 and rates reduced 10% to provide relief and counteract past inflation.

3. Special use valuation rules should be liberalized. We support the changes proposed in S.858 and S.395.

4. The widow's tax on transfers between husband and wife should be abolished. They represent no real change in ownership and should not be taxed.

5. The best possible solution is repeal. The National Taxpayers Union fully endorses S.404, abolishing the federal estate and gift tax. The current system is punitive and serves to discourage individual saving.

Mr. Chairman and distinguished Members of the Committee, thank you for the opportunity to discuss major estate tax issues.

I appear representing the 450,000 family members of the National Taxpayers Union in all 50 states.

The National Taxpayers Union favors the bills before this committee which would reduce federal estate and gift taxes. In particular, we support S.404, introduced by Senator Symms and Senators Jepsen and Boren, which would repeal the federal estate and gift tax. Although repeal is preferable and most equitable, we also support S.395, introduced by Senator Wallop and others, to reduce the estate and gift taxes by providing an unlimited marital deduction, an increase in the estate and gift tax exclusion to $600,000, a reduction of the tax rate by 10%, and other revisions.

The Tax Hurts Family Businesses & Farms

The federal estate tax, when enacted in 1916, was seen as an easy and politically harmless way to raise revenue. The tax would be levied on the large wealth being transferred from generation to generation. The middle and lower class would not need to pay. In addition, the tax helped to achieve what was seen as a socially desirable goal - the redistribution of wealth. The rich would be prevented from passing on their wealth intact to their heirs.

This tax has never lived up to these intentions, however. Middle and low income taxpayers have often been forced to pay huge amounts due to the "death" tax, and frequently the sale of homes or farms is necessary to raise the money to pay the tax. In recent years inflation has been pushing up the nominal values of property, meaning that many farms and small businesses are now subject to the tax. If current real estate trends continue, many more private homeowners may find themselves subject to the death tax.

Since the one of the original purposes of the estate tax was to discourage

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the concentration of wealth, it is ironic that it has had the opposite effect. Executors of small businesses and farms often find it necessary to sell an estate in order to pay the taxes on it. Often the buyer is a larger firm or even a former competitor. The tax also favors corporations over family-owned businesses. Since a corporation never really dies, it is never subject to an estate tax. The result is a trend toward larger farms, and bigger businesses. In many areas, the family owned enterprise is nearing extinction. Often it does make economic sense for a business or an industry to switch from a small family or individually owned form of organization to a larger corporate form. At times it is more efficient, and better services can be provided. But the estate tax promotes the reduction of such businesses without regard to the economic effects. Small farms and family businesses are forced to close or merge with larger companies because of the necessity of paying a tax, not because of considerations of efficiency. At a time of concern over the reduction in family farms, and over obstacles to small enterprises, it does not make sense that the estate tax should be continued.

The estate tax has significantly affected the middle income tax. There are several reasons for this. First, land values have skyrocketed in recent years. Estates which in the 1930's and 1940's were well under the minimum taxable value, are now taxed heavily. The continuing rise in home values will only increase this trend. If current law is not changed, soon the average homeowner will find himself liable for estate taxes.

Secondly, taxpayers in upper income brackets may have much better access to tax advice. They may be able to plan their estates well in advance, make the most use of potential credits and benefits, make early transfers when necessary. Middle income taxpayers, while potentially eligible for the same benefits, usually do not have regular advisors and often just aren't as aware of potential tax liability. In addition, upper bracket taxpayers can often choose which types of property to own, and have assets which can be sold easily when necessary. Owners of small farms and businesses do not have that option. Their assets are not as liquid. The owner of a small family farm cannot sell or exchange property to suit the IRS.

This is not a matter that can be solved just by closing a few "loopholes". Even if all of the rich were forced to pay more it would not help the middle class - they would still end up paying the same amount. Also, providing more tax information to small estate owners would not solve the basic problem. There would still exist a potential liability, which would force small estate owners to change many of their current practices, or face a heavy tax liability. There is no reason to impose even this burden for an unjustified tax such as this.

Effect of Inflation

Due to inflation, the estate and gift tax has actually been increasing over the years. When the estate tax was first established in 1916, a $50,000 exemption was allowed. In 1942, the exemption was $60,000, and in 1976 it was increased to $175,625. In real dollars, however, the value of this exemption has been shrinking. The original $50,000 exemption provided for in 1916 would be worth over $300,000 in 1980 dollars. In other words, the exemption has lost over 40% of its original value.

The gift tax exclusion has undergone a similar shrinkage. When this tax was first introduced in 1932, it allowed a $5,000 exclusion. In 1942 this figure was decreased to $3,000. In the 39 years since this amount was last changed, it has lost over 75% of its original value.

In addition the rates of the estate and gift tax are steeply progressive. This produces a "bracket creep" effect. As inflation and other factors pushes estate values up, an estate would become subject to a higher rate of tax, even though its real value has remained the same. If land values increased at a rate of 10% per year, prices would double in seven years. For example, an estate worth $250,000 in 1980 would be worth $500,000 in 1987 if inflation continued at 10% per year. If that estate was taxed in 1980, the tax would have been $23,800, but in 1987 the tax would leap to $108,800, an increase of almost 500%. In constant dollars, the tax would have more than doubled with no legislative change.

S.395, by Senator Wallop and others, attempts to alleviate this problem with a 10% rate cut and an increase in the estate and gift exemptions. While we believe this is a good start, and will help counteract the effects of past inflation, it will not be a permanent solution. In the next few years, the exemptions will again start to lose their value, and estates will again become subject to higher rates of taxation.

A better solution would be to establish a permanent indexing system for the estate and gift taxes. The exclusion amounts and the bracket amounts could be adjusted according to the CPI or to another appropriate index, so that their value will remain the same.

Even indexing, however, would not be a perfect solution. Since land values may vary widely, there may be problems in finding the proper index. Therefore, we believe that the best solution would be to abolish the tax entirely, and free estate owners from the fear of inflation.

Valuation Problems

One problem which has always plagued the estate tax is that of valuation. The traditional rule was that a property was assessed at its "highest and best use." Often a farm or business property, while worth little as is, will be worth much more if assessed at for different use. For example, a piece of property might be worth $250,000 as a farm, but, if it were subdivided for new tract homes it could be worth $1 million. Until 1976, the farmer would be liable for estate taxes on a $1,000,000 property. The Tax Reform Act of 1976 altered this so that if property were being put to one of certain "qualified uses," the property would be assessed at that time. Several changes should be made, however, to allow fuller use of the "special use valuation" provisions. We support the changes proposed by Senator Durenberger in S.858 and Senator Wallop in S.395. Among these are:

* Elimination of the $500,000 cap on special use valuation. If a property is legitimately being put to one use, the owner's heirs should not be punished if it is worth over $500,000 more in another use.
* Limit "material participation" requirement to time of decedents disablement or retirement. Retirement or disablement does not show an intent to put the property to a different use - it shouldn't be assessed as such.
* Allow use of "active management" rather than "material participation" in some cases. Often a widow has not physically participated, but has put the land to use just the same.
* Allow rental to an heir to qualify for special use valuation.
* Decrease current 15 year limit for "recapture" of taxes if the use is changed. 15 years is too long a time for an owner to have to worry about IRS restrictions on his land. We would support Senators Kassebaum's plan in S.573 of a phase-out of restrictions after five years, or a straight reduction to 10 years.

Marital Deduction

Until 1948, gifts and inheritances between husband and wife were taxed just like any other transfer of wealth. Under current law, a partial deduction is allowed. The estate tax allows a deduction of $250,000 or one-half of the decedent's estate. The gift tax allows a full deduction up to $100,000 and a 50% deduction for all amounts over $200,000.

There is no valid reason however, that husband-wife transfers should be taxed at all. Husbands and wives usually both contribute to a household, either by actual work or by duties at home, and usually share all the family assets. So when a husband makes a gift to a wife, or a wife to a husband, no real transaction has taken place. There is no effect of the transfer outside the household, and no justification for a tax.

There is even less reason for an inheritance tax at the death of a spouse. Not only has the husband or wife not gained anything by the death, but they have suffered an actual loss, both emotionally and economically. It makes little sense to impose another burden. We feel, therefore, that the "widow's tax" should be abolished by making the marital deduction unlimited.

The National Taxpayers Union believes that due to the numerous problems of the estate and gift taxes, reform is necessary.

If the estate and gift taxes are to be maintained, there are certain changes that must be made:

1. The unified estate and gift exemption should be raised to at least $600,000, and the gift exemption to at least $10,000. This will counteract the effects of past inflation, as well as remove most middle class families from the tax.
2. Rates should be decreased by at least 10%. This will help ease the current burden, and compensate for past inflation.
3. The system should be fully indexed for inflation, including all exemptions, marginal rates, and bracket amounts. This will keep the tax from again silently expanding.
4. Various changes in the determination of the special use assessment

should be made, as outlined above. This will help insure that heirs will not be taxed for theoretically possible, but unintended uses of the land.

5. Eliminate the widow tax. It should be recognized that an inheritance from spouse to spouse really is not a change in ownership, and should not be taxed.

The best possible solution, however, is repeal. We fully support S.404 by Senator Symms, and Senators Jepsen and ~~Boren.~~ Even if all the other faults of this tax were to be removed, if the bias against small business lessened, the effects of inflation counteracted, and the problems in valuation resolved, there would still be a major flaw to the tax. It is, as it was meant to be, a device to discourage inheritance and the accumulation of wealth within a family.

We feel this goal must be reconsidered. The accumulation of wealth is not an evil which society must combat, but often is a good which provides positive benefits for society. The current system, with its high rates of taxation on estates is a punitive system. The economist Richard Wagner has pointed out that in a free enterprise economy, those who have accumulated wealth are, to an extent, those who have been more successful in producing services valued by other people. The more successful one is at providing services, the wealthier one will become. Society then is benefited by the drive to acquire wealth, and should not punish the accumulation of justly acquired property.

Further, inheritance makes it possible for private funds to compete with government in supporting various charitable activities. It is in society's interest that one institution, even if that is the government, not acquire a monopoly over this part of life. Diversity is necessary for most cultural, educational and scientific activities, and we should not prevent the development of the private funds necessary to pay for it.

Contrary to what some supporters of the estate tax say, elimination of the tax, along with its charitable deduction, will not decrease private giving. While elimination of the deduction will eliminate the current advantage of charitable bequests over other bequests, the total amount of wealth available for giving will increase. So, while the artificial advantage to charity now in the tax law will be abolished, individuals will probably respond by leaving larger bequests, resulting in larger charitable bequests.

Finally, the bias of the estate tax against accumulating wealth acts to discourage saving by individuals. One of the reasons that an individual saves rather than spends his wealth is the hope that he will be able to pass it on to future generations. Why would anyone save a great amount of capital, if it will only go to the state at their death? Why should anyone save for their family, if it will go to the IRS, not their heirs? The death tax, then, is also a tax on savings. There is no reason why the Treasury should continue to discourage saving in this way. It only hinders the formation of capital which is needed for the functioning of the economy.

The estate tax, by discouraging the "evils" of wealth accumulation, has curtailed the efforts of many families with small businesses to become successful, and grow, over a period of generations. It is impossible to calculate how many small, but vital, small businesses and farms have had to close because of the effects of the death tax. Many businesses, had they not been crippled by tax, or sold at estate sales, would have grown and continued to make valuable contributions to the economy, as well as to the families who owned them. There is no need to let this waste continue.

Senator SYMMS. Now we will hear from the next panel which consists of Harvie Branscomb, Malcolm Moore, John A. Wallace, and Ben Wallis.

STATEMENT OF HARVIE BRANSCOMB, CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY JOHN NOLAN, ED DELANEY AND DORIS BLAZACK

Mr. BRANSCOMB. Thank you, Mr. Chairman.

My name is Harvie Branscomb. We appreciate your comments, Mr. Chairman. The American Bar Association is on record as strongly in favor of simplifying the Tax Code. We would like to speak to that today.

I am from Corpus Christi, Tex. I am chairman of the 23,000 lawyer tax section of the American Bar Association.

I am accompanied today by John Nolan, our chairman-elect, Mr. Ed Delaney, our vice chairman for government relations, both of whom are in the audience, and on my left by Doris Blazack who is the very capable chairwoman of our committee on estate and gift taxes and who is with me because of her technical expertise in this area.

I would like to try to follow Senator Dole's and Senator Byrd's suggestion of limiting comments to specific ways in which the estate and gift tax laws might be restructured in view of the announcement of policy that reduction of taxes in this area is likely to take place.

I would like to attempt to limit my remarks to matters which have not been presented to you before today.

Let me first comment briefly about the alternative of repeal versus a reduction in the tax which is of interest to the chairman.

Without speaking to the basic policy problem which faces the Congress and on which the tax section has no special expertise, there do appear, and recognizing, let me add, the effect of the estate taxes in distorting family planning and distorting business decisions which they certainly do, there are some problems involved in a complete repeal of the tax which would be in order to, for consideration, in the event that complete repeal were embarked on.

Briefly they are, first, that at present taxpayers get a new basis at death, on the value of their property. This has been regarded by some as an income-tax-free step-up in the value of property and as you know, it was a carryover basis rule that was adopted and then rescinded to deal with this area.

If the estate tax were completely repealed, no doubt new consideration would be directed toward the question of whether it is appropriate to have an income-tax-free increase in value.

Our experience in attempting to deal with that was not a very satisfactory one.

Second, there is a substantial credit to the States in connection with our Federal estate tax. If the Federal estate tax were eliminated, the committee might wish to consider what the response from the States would be, whether they would proceed to increase their taxes, whether there would be competition among the States and their rates.

Third, it has been suggested that, and this is a controversial suggestion, it has been controverted, that the freedom from gift and estate taxes might permit transfers of property within family groups in manners that would result in substantial income tax reductions which might not be justified.

Finally, the estate taxes at present provide a substantial for charitable gifts which would not be present if there were no estate taxes.

I merely mention these as factors for possible consideration in connection with such proposals.

If the tax is to be reduced, obviously there is the matter for consideration not only of increase in the exemption, indexing the exemption, indexing the brackets, all of which would be appropriate items for consideration.

There has been a good deal of discussion of the special use valuation provisions. We would like to relate the areas that create technical problems in the special use area which we would hope would be considered.

We would also like to suggest that the generation skipping provisions of the Federal tax laws contain very serious problems which merit serious consideration of this committee.

Finally, let me state that some of the comments I have made have been on behalf of the American Bar Association. Others reflect the views of officers, counsel, committee members, and others of the section of taxation on which no official position has yet been taken by the American Bar Association.

I would invite the committee to our written statement for the identification of which sets forth each position.

Senator SYMMS. Thank you very much for an excellent statement.

Mr. Moore.

STATEMENT OF MALCOLM A. MOORE, PROBATE AND TRUST DIVISION DIRECTOR, SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, AMERICAN BAR ASSOCIATION

Mr. MOORE. My name is Malcolm A. Moore. I am from Seattle, Wash. In August, I will be chairman-elect of the section of real property, probate and trust law of the American Bar Association. We have about 28,000 members, a number of whom specialize in trusts and estates law.

I am testifying in my individual capacity, not on behalf of the ABA, and not on behalf of the section.

I think that the basic message that I bring to these hearings is that from my own experience as a pracṫing lawyer in this field, on a daily basis, and I think I speak for a lot of lawyers across the country, the present estate and gift tax laws are simply too intrusive in terms of people's personal lives.

There is no reason that they should be. Every day I have clients who come into my office who have a very good simple plan of disposition; a couple with a $500,000 or $600,000 or $700,000 estate and want to leave it all to the surviving spouse, or if there is no surviving spouse, then they want to leave it to their children, perhaps in trust until a child attains age 25.

This is a very simple disposition which should take four or five pages and then we start talking about taxes. What we end up with in that situation is not an outright disposition to the spouse. We end up with a trust to save taxes at the second death. In many cases the surviving spouse loses control of the assets. Records have to be kept. People have to be hired.

When we talk about the trust for the children, we have to start talking about the orphans' deduction and draft for that. We have to consider the generation skipping tax consequences of such a trust; if a child dies before age 25, the trust property may be taxed in his estate, if it doesn't go to his grandchildren in a peculiar fashion which is very impractical to draft for.

So, what we end up with and what our clients end up with is a will 15 pages long and a large fee for having prepared it. It is not what the clients want. They don't understand it. They don't want to pay for it. And, frankly, it doesn't make sense from the point of view of their own disposition of their property.

What would make much more sense is what they wanted to do in the first place; an outright disposition to the surviving spouse, or if he or she predeceases, then on to the children in a simple kind of trust without any tax hangup.

I think that a substantial increase in the unified credit as is contained in S. 395 or one even greater than that, coupled with significant rate reductions which we have heard about today, would certainly remove a lot of the estates from the estate tax system right now that should not be in the system.

There is no reason why a person with the range of assets I described should be in the estate tax system.

I also think a provision for unlimited interspousal transfers whereby one spouse can transfer property tax free, both during life and at death to the other spouse certainly should be a part of our law.

Those of us who practice in this field every day are familiar with the husband and wife who make transfers to each other all the time during life, and it never occurs to them that taxable gifts are being made.

For example, the wife inherits $50,000. She wants to make it the joint property of the husband and wife, and all of a sudden I have to tell her she has to file a gift tax return. She has to use up part of her unified credit on a transfer to her husband.

That is the case if she files a gift tax return. More likely, she is not going to file the return because spouses simply don't feel these are transfers that should be taxed.

The same thing happens when you educate a child. I talk about everyday situations in my office. To educate a child costs perhaps $8,000 a year and frequently more than that.

Most people aren't aware that as far as the Federal gift tax laws are concerned, payment of those expenses for a child to whom no support obligation is owed constitutes a gift. That notion is very offensive to me and to all of my clients.

Certainly in that situation, I can almost guarantee you they are not going to file a gift tax return.

It seems to me that any system that really makes law breakers out of honest, law-abiding citizens which the estate and gift tax laws now do as applied to a great number of situations to which it never should be applied, is simply wrong.

With respect to the interspousal transfer point, one other consideration should be made that hasn't yet been brought up. It seems to me that the Government shouldn't dictate in what form a transfer should be made between spouses to be deductible.

If spouses think that they want to make a disposition in trust to the other spouse for various reasons—perhaps in a second marriage—and they want the property to ultimately pass to the children of the first marriage, why shouldn't that be a deductible transfer? Why should they be forced to do it on an outright basis?

So, it seems to me a qualitative change in the law allowing a life interest passing to a surviving spouse should be permitted.

I might mention that the generation skipping tax as it impacts on that 25-year-old's trust is simply an example of the complexity and overreaching nature of this law which I believe should be repealed just to get the law off the books because it simply applies in hundreds and thousands of situations that it was never intended to apply.

I appreciate the opportunity to be here today. My basic message is that we should get the Government and the Internal Revenue Service off the backs of the majority of our clients with respect to what they want to do. What they want to do in terms of estate planning is, I think better reasoned in most cases than what I tell them they should do in light of what the tax laws force me to tell them to do.

Senator SYMMS. Thank you very much for a very excellent statement. I might make note of the point that S. 404 does repeal the generate skipping section of the Code also.

But, I think what you say about the client that comes in that doesn't want to file the gift transfer, is absolutely correct, not only with the estate and gift tax, the death tax law, but it is true with our entire Tax Code. It has become so complex, there is a massive underground economy out there growing.

If Washington, D.C., doesn't wake up some day, they will find out that more and more people are trying to operate outside of the Tax Code than inside, because our whole taxing system is biased against work and production.

So, people that want to work and produce, they get sick of working for the big spenders in Washington, and watching the money being pumped away for needless, unnecessary endeavors that somebody thinks is a noble cause.

It is certainly encouraging an entire group of Americans. I think this is really implicitly dangerous to our society. It is wrong. We have a disrespect of institutions that we do need.

I think it is essential we have a reduction of rates of all taxing, of every part of our Tax Code, to get away from this so people's incentives to be patriotic and pay their taxes and not go underground.

Mr. MOORE. I think you are absolutely right. The gift tax laws are just simply unenforced in this country. It is because they make no sense in terms of transfers between families.

Senator SYMMS. There is no way the IRS can hire enough revenue-producing agents to go out and do this, unless they want to do like they did in Rome and have every third person be a tax collector. We all know how that ended.

That is the way we are headed right now. I think that is why we need to reduce this.

Mr. MOORE. From the point of view of the practicing lawyer, Senator, I think clients who come to seek competent counsel are at a disadvantage, because we, as lawyers must tell them, yes, they should file a gift tax return.

Clients who don't come to competent lawyers, or who don't come to lawyers at all, simply don't know that they should file gift tax returns and hence are really innocent, yet nonetheless lawbreakers. I don't think my clients should be prejudiced as against a person who seeks no advice because I am giving advice which I am dutybound to give them.

Senator SYMMS. I think your point is very well taken. I certainly am one Senator who appreciates it.

John A. Wallace, from Atlanta, Ga.

Mr. WALLACE. Thank you, Mr. Chairman.

STATEMENT OF JOHN A. WALLACE, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE, AMERICAN COLLEGE OF PROBATE COUNSEL

My name is John Wallace. I am here in my capacity as chairman of the estate and gift tax committee of the American College of Probate Counsel, an organization that consists of more than 2,300 lawyers from every State in the country, who specialize in the law of trusts and estates and related tax laws.

A principal concern of the American College of Probate Counsel, since its inception, has been the simplification of the process of probate in this country, the disposition of property between family members and others.

There is no question that the estate and gift tax laws represent the most complex component in this process by any stretch of the imagination, that is an accurate statement.

With this in mind, we strongly advocate a substantially increased unified credit against the estate and gift tax.

We do so in the hope and expectation that the level will be set at a point that would extract most estates from the transfer tax process.

It has simply become too burdensome, and as Mr. Moore said, too intrusive in the lives of American citizens.

Anyone with a house and a barely adequate insurance policy is hit by the tax and that's not right.

We acknowledge that the purpose of the tax should be an effort to break up undue concentrations of wealth and power.

Should we start at the $175,000, to accomplish that objective? Or at $500,000? Or even $1 million?

We submit, the transfer tax system should be organized to reward industry, to provide for the continuity of ongoing business enterprises and to preserve the economically productive capital in the private sector of our economy.

So, we ask that you set your sights high when you substantially increase the unified credit.

We also urge that a substantially unified credit be coupled with major tax relief in terms of rates.

We submit, as Senator Byrd did earlier this morning, that a bottom rate of over one-third of the estate is too high.

We also submit that a top rate of 70 percent is virtually confiscatory.

If we tax earned income at 50 percent, why do we tax the assets that help produce the earned income at a higher rate. It simply makes no sense.

The college also supports unlimited interspousal transfers without a transfer tax.

Again, as Mr. Moore has alluded to, we ask that that change be accompanied with a change in the qualitative marital deduction rules so that a husband or wife may transfer property to the other, giving the transferee spouse a life estate but allowing the transferor spouse the right to dictate the ultimate distribution of the property.

This simply reflects the wishes of our clients and the need of a society where a multiple marriage is now becoming more frequent.

We urge the repeal of the generation skipping tax which is simply an overly complex answer to a nonproblem.

The revenue implications of the generation skipping tax by any estimate are minimal. That says to us in the converse that there is no problem to begin with. If you are not raising revenue from it, why worry and tax it, particularly when the system of present taxation represented in chapter 13 in the Code, is virtually unworkable.

We also urge an increase in the gift tax annual exclusion to $10,000 or even higher. If it costs $10,000 to send your over 18-year-old son to Princeton, you have made a gift, Senator.

It simply makes no sense to set a level of exclusion that is designed to eliminate routine gifts from the transfer tax system at a level where you are almost sure to find people making gifts in a support, and a moral support obligation context that have to be taxed.

The $3,000 level was set almost 40 years ago. We know what has happened in the intervening years. So, we urge again, as with the substantially increased unified credit, the perdoni annual exclusion be revised upward substantially.

Finally, we would urge that when the tax does apply and use is made of various relief provisions of the code such as the right to defer the payment of estate tax or the right to a special use valuation for farming or ranching property and the like, that—and when the drafting of those provisions takes place, that you not be swayed by concerns of abuse situations which frequently encrust those statutes with conditions and restrictions that allow administrative interpretations that preclude relief and that reverse congressional intent, you start out with relief, but estates and our clients end up with little value out of many of these Code provisions because of overconcern at the drafting stage with abuse prospects.

So, keep your eye on relief and leave it there.

Thank you very much, Senator.

Senator SYMMS. Thank you very much for a very excellent statement.

Now for an old friend, Ben Wallis, of San Antonio, Tex.

STATEMENT OF BEN WALLIS, SAN ANTONIO, TEX.

Mr. WALLIS. Thank you, Mr. Chairman and Senator Grassley.

My name is Ben Wallis. I am an attorney. I operate a small family ranch. I appear here today representing the National Association of Property Owners, an organization representing some

3,000 members who nationwide are engaged in ranching, farming, finance, energy, minerals, timber, development and other fields.

In addition, NAPO represents more than 200 local affiliate organizations with approximately 500,000 members.

A majority of NAPO's members would be classified as owners and operators of family businesses. This would include family, farm, ranch and timber operations.

Family businesses, especially those in agriculture and timber today face extinction. They are an endangered species. The chief villain in the plight of these family operations is our antiquated, unjust and inappropriate tax structure.

While unrealistic income tax structures merely inhibit and deter the productivity and growth of family businesses our present estate tax laws make it virtually impossible for the family owned business to survive.

In an effort to be brief I would like to make these points. The size of indebtedness on a family business increases substantially, normally increases substantially, each time the business undergoes its periodic refinancing. This is especially true in agricultural operations.

Many family operations borrow heavily each generation just to pay estate taxes. It is a burden that lasts throughout that generation.

Present estate taxes make it necessary for most family businesses to either be mortgaged or sold upon the death of the owner.

I think also, and I assert, that the family business is essential to America. Relief from estate taxes is necessary if the family farm and the family business is to survive.

Our recommendation quite simply is to eliminate all estate taxes. Now knowing full well that while the American public may be ready for that, that the American Congress may not be, we offer these alternative recommendations.

Raise the estate tax credit to an equivalent of $500,000 and add a lifetime exemption of $300,000. Couple those together.

Now, an alternative to this might simply be to establish an exemption of $1 million and start from there.

There should be an unlimited marital deduction.

Special use valuation should be drastically extended and it should benefit any and all heirs who are actively involved in any way in closely held businesses.

Our recommendation also is to eliminate the unified credit and establish gift exemptions of $25,000 per year, along with a $300,000 lifetime gift exemption.

We also feel it is ludicrous for the Federal Government to be entitled, as they are at the present time, to more than the heirs of an estate.

I had called in my remarks for a maximum tax of 50 percent. I think that is way too high in retrospect, and I think that should be limited to 30 percent.

Senator, I thank you for this opportunity to give testimony before the committee.

I hope we will see some meaningful reform.

Senator SYMMS. Thank you all very much for very excellent testimony.

[Statements follow:]

JOINT STATEMENT OF HARVIE BRANSCOMB, JR. AND JOHN S. NOLAN, CHAIRMAN AND CHAIRMAN-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
SENATE FINANCE COMMITTEE
JUNE 5, 1981

Mr. Chairman and Members of the Subcommittee:

My name is Harvie Branscomb, Jr. I am Chairman of the Section of Taxation of the American Bar Association, and am accompanied by John S. Nolan, Chairman-Elect of the Section, and Edward N. Delaney, Vice Chairman of the Section for Government Relations. We are here today at the request of American Bar Association President William Reece Smith, Jr., to testify on behalf of the Association and to express individual views on the fundamental transfer tax issues being considered by this Subcommittee.

Our statement is in three parts. The first relates to three formal legislative recommendations of the American Bar Association regarding the several estate and gift tax issues addressed by the bills before this Subcommittee. We are also presenting a statement of critical factors which we and other tax lawyers who work with the estate and gift tax laws believe should be considered when this Subcommittee acts on proposals to repeal or reduce the estate, gift, and generation-skipping taxes. Finally, we will present a statement discussing several other major estate and gift tax issues addressed by provisions of the bills before this Subcommittee.

As stated, we will identify matters on which the American Bar Association has taken a formal position. Views expressed with respect to other matters are individual views of members of the Section of Taxation and others working in the gift and estate tax area on which neither the Section nor the Association has taken a formal position.

I. SPECIFIC ESTATE AND GIFT TAX RECOMMENDATIONS OF THE AMERICAN BAR ASSOCIATION

A. ELECTION TO USE THE UNIFIED CREDIT

The American Bar Association supports adoption of Sec. 8 of S. 395 which would amend §2505 to provide for optional use of the unified credit for gift tax purposes.

Under §2505 of the Code, as enacted in 1976, the unified credit must be applied, to the extent available, to offset tax on lifetime transfers, because §2505(a)(2) requires use of the unified credit "allowable".* This was a change from prior law under which use of part or all of the old $30,000 lifetime exemption was optional.

The effect of requiring a donor to use the unified credit "allowable" for gift tax purposes is to prevent such donor from setting at rest questions of valuation in certain cases. Thus, if the donor must apply the unified credit, the donor cannot cause the statute of limitations to begin to run where the gift is

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* See Rev. Rul. 79-160, 1979-1 C.B. 313.

in an amount which will not result in a gift tax after applying such credit. While the usual three-year statute of limitations bars the Internal Revenue Service from assessing a deficiency in gift tax as to transfers reported on a gift tax return, it does not bar the Service from increasing the value of gifts reported on prior returns for purposes of computing the gift tax payable in respect of later gifts. Under §2504(c), if the Service does not increase the value of a gift during the statutory assessment period, the Service is thereafter bound by the value reflected on the return for the purpose of computing the amount of gift tax payable on subsequent transfers. Section 2504(c) applies, however, only if a gift tax is assessed or paid. When no gift tax is assessed or paid, a later adjustment in value of gifts reported on prior returns which are barred by the statute of limitations may be made. Prior to the Tax Reform Act of 1976, under former §2521, a donor was not required to use his $30,000 lifetime exemption and could thereby incur and pay a gift tax and activate §2504(c). The applicability of §2504(c) was significantly limited when the Congress, in §2505(a), required use of the allowable unified credit to reduce or eliminate the gift tax otherwise owed.

Valuation questions should be settled when evidence is fresh. The Service should not be permitted to adjust values many years after the transfer at issue is made. This was the legislative purpose behind §2504(c). After the statute of limitations has run, the value of a gift for a prior year with respect to which a gift tax was assessed or paid should be conclusive in determining the tax rate to be applied to subsequent gifts.

The amendment would change the law by returning to the principles applicable under pre-1977 law. It is anticipated that a donor who seeks to fix the valuation of transferred property for future transfer tax purposes would defer a part of the available unified credit so as to incur a tax. Though a sophisticated taxpayer may use these principles to his advantage, that was possible (and widely accepted) under pre-1977 law. In our judgment, the need to provide a machinery for fixing values far outweighs this concern.

Section 8 of S. 395 does not go far enough, however. The American Bar Association also proposes that the Internal Revenue Code be amended to make it clear that the provision for making the value of a gift conclusive for gift tax purposes extends as well to the computation of estate and generation-skipping taxes. At present the Service can question, for estate tax or generation-skipping tax purposes, the value of lifetime transfers where a gift tax was paid or assessed. Section 2504(c) expressly applies only to gift tax computations. The Code contains no counterpart for the estate tax or the generation-skipping tax. In a unified transfer tax system, such a provision is needed.

B. DISCLAIMERS

Section 2518 was enacted by the Tax Reform Act of 1976 to provide, for the first time, a comprehensive set of rules governing the estate and gift tax effects of disclaimers.* Prior to the enactment of §2518, the rules governing disclaimers were scattered throughout the Internal Revenue Code and the Regulations and did not provide adequate guidance to the taxpayer wishing to renounce an interest in property passing by will, intestacy, or gift. To a large extent the estate and gift tax effects of a disclaimer depended upon its validity under state law. As the laws of the states varied greatly, the lack of uniform federal rules was a source of great difficulty.

The stated congressional purpose in enacting §2518 in 1976 was to achieve uniformity in the application of the estate and gift tax laws to disclaimers.** It soon became apparent, however, that the goal of uniformity had not been achieved. The principal problem is the requirement in §2518(b)(4) that as a result of the disclaimer of an interest in property "* * * the interest passes without any direction on the part of the person making the disclaimer * * * to a person other than the person making the disclaimer". The effect of this provision is to require, as prior to the 1976 Act, validity under state law; and, as was the case prior to the 1976 Act, the laws of the states vary greatly.

Two examples will demonstrate the difficulties caused by the "pass to" requirement of §2518(b)(4).

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* Section 2045 incorporates by reference the provisions of §2518.

** H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. (1976); H.R. Rep. No. 94-1515, 94th Cong., 2d Sess. (1976).

1. Under the laws of some states, an intestate interest cannot be validly disclaimed. Therefore, a resident of such a state, even though he complies with substantially all of the requirements in §2518 for a qualified disclaimer, cannot validly disclaim an intestate interest because under the law of his state the interest will not "pass to" another without any direction on his part.

2. Section 2518 requires, generally, that a disclaimer must be made within nine months after the transfer creating the interest. Many state statutes, however, have shorter time periods. The Arizona statute,* for example, requires that the disclaimer be made within six months. As a result, a resident of such a state who renounces within nine months, but not within the shorter time period required by the state, will not be deemed to have made a qualified disclaimer under §2518 because his renunciation was ineffective under state law to "pass" the interest to another without any direction on his part.

These examples demonstrate the problems that arise when state law is a factor in determining federal taxation of disclaimed property. Such differences depending upon state of residence are undesirable and run contrary to the goal of uniformity of treatment, the very purpose of §2518.

Accordingly, the American Bar Association supports the adoption of Sec. 10 of S. 395. We believe that permitting

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* Ariz. Rev. Stat. Ann. §14-2801.

a disclaimant to perfect a disclaimer which would otherwise not be valid under state law to "pass" the property to someone other than the disclaimant will promote the uniformity of treatment which was the original purpose of §2518. This will be consistent with the formal position of the American Bar Association that the Internal Revenue Code be amended to provide comprehensive uniform rules for disclaimers.*

C. ANNUAL REPORTING OF GIFTS AND PAYMENT OF GIFT TAX

The American Bar Association strongly supports changes in the Internal Revenue Code to provide for the annual filing of gift tax returns and payment of gift tax instead of quarterly filing and payment, as now required. Accordingly, we fully support S. 955.

A review of filing requirements for gift tax returns over the last decade will demonstrate the need for S. 955. Prior to 1971, gift tax returns were required to be filed annually. Beginning in 1971,** gift tax returns were required to be filed quarterly, with the expectation that quarterly filings would increase 1971 revenues by $100 million and that there would be "significant interest savings" to the government each year thereafter.***

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* Tax Section Recommendation No. 1974-2, 27 Tax Lawyer 818 (1974).

** Excise, Estate and Gift Tax Adjustment Act of 1970.

*** See H.R. Rep. No. 91-1635, 91st Cong., 2d Sess. 13 (1970).

It soon became apparent that quarterly filing was creating traps for unwary taxpayers, an additional burden for taxpayers and the Service alike, as well as technical problems. For these reasons*, in the Tax Reform Act of 1976, Congress eliminated the quarterly filing requirement for gifts of $25,000 or less, and in 1979 changed the due date of the return for the fourth quarter from February 15 to April 15.

These amendments were consistent with recommendations of the American Bar Association** that quarterly filing be abandoned unless taxable gifts for the year exceeded $100,000. They failed, however, to resolve entirely the technical problems created by quarterly filing, including the possibility of the unintended loss of the marital deduction,*** and practical problems created by the requirement of quarterly returns for larger donors. Moreover, the decreased importance of the gift

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* General Explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation 586 (December 29, 1976).

** Tax Section Recommendation No. 1974-2, 27 <u>Tax Lawyer</u> 825 (1974).

*** Section 6075(b) as amended continues the calendar quarter as the taxable period. Suppose donor (D), who has already given his spouse (S) over $200,000 in prior years, makes a gift of $4,000 to S in the first quarter of 1980, and also a gift of $28,000 to X in that quarter. A gift tax return is required for that quarter, and the gift tax marital deduction is limited to $1,000, just as under prior law. If D gives S $2,000 in the second calendar quarter of 1980, and also gives X $25,000 in that quarter, another return is required for the second quarter, and the marital deduction is $1,000. Thus D has received only a $2,000 marital deduction, whereas a $3,000 marital deduction would have been allowed if the gifts to S had been made in the same quarter.

tax in recent years argues in favor of the proposed change. In our judgment, the quarterly filing of gift tax returns should be entirely eliminated, as provided in S. 955. This will greatly simplify the operation of the gift tax law, both for taxpayers and for the Internal Revenue Service.

II. ISSUES RELATING TO REPEAL

A. REPEAL OF ESTATE AND GIFT TAXES

Proposals for repeal of federal transfer taxes must be carefully examined in light of the reasons for their enactment and the part they have played in our tax system.

The federal estate tax was first enacted in 1916. Initially, rates ranged from one percent on small estates to ten percent on estate values over $5 million. Between 1916 and 1942, the rates were raised or lowered on several occasions. The Revenue Act of 1924 introduced the federal credit for death taxes paid to the states for the purpose of encouraging greater uniformity in state death tax laws. In 1941 and 1942, during World War II, the estate tax rates ranged from three percent on small estates to 77 percent on estates over $10 million,* the estate tax exemption was set at $60,000, the gift tax exemption at $30,000, and the annual gift tax exclusion at $3,000. The Revenue Act of 1948 introduced the marital deduction, but the rates and exemptions remained unchanged until the Tax Reform Act of 1976 established the present unified system and rate and credit structure.

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* Gift tax rates, established in 1932, were three-fourths of the estate tax rates.

Federal transfer taxes serve two purposes -- they are a source of revenue and they are a means of preventing undue concentrations of wealth. The debates preceding the various Acts reflected sharp differences in social, economic and political philosophies. In 1924 and 1926, Secretary of the Treasury Andrew Mellon sought repeal of the estate tax, arguing that death duties were within the exclusive domain of the states and that there was no social necessity for breaking up large fortunes. The Secretary also argued that the estate tax would lead to the destruction of capital and be harmful to the community.* After compromises, however, proponents of the tax prevailed.**

In 1934, the Senate Finance Committee, in proposing a top estate tax rate of 50 percent, stated that it "will tend to prevent undue concentrations of wealth". In 1935, during the Depression, when the rate was increased to 70 percent, President Roosevelt stated that "transmission from generation to generation of vast fortunes by will, inheritance or gift, is not consistent with the ideals of the American people".***

It is apparent that the question whether the purposes for enactment of the federal transfer taxes have been achieved and are in fact "* * * consistent with the ideals of the American people", has been debated for years.

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* Paul, Taxation in the United States pp. 134-138 (1954).

** The Revenue Act of 1926 repealed the gift tax; it was re-enacted in 1932.

*** Paul, supra, at 183.

These taxes, which in 1981 will produce slightly over 1% of total revenues (an estimated $7.2 billion), are not a major source of revenue.* Inflation, however, will increase the absolute amount of such taxes in the future, as under any progressive rate structure, and if income tax reductions are enacted which result in increased savings, estate and gift tax collections would increase still further.

Proponents of the transfer tax system argue that these taxes contribute importantly to the objective of raising Federal revenues by reference to ability-to-pay -- that in this respect they complement the intended effect of our income tax system. Further, while the income tax does not reach individuals to the extent they invest their savings in non-income producing property which is held until death, or in tax-exempt bonds, or tax shelters, the estate tax is imposed at progressive rates on the accumulation of assets during the course of a lifetime. The proponents argue that the estate tax thereby helps to distribute the tax burden among all individuals, an important objective, according to such proponents, because our income tax system is a voluntary compliance, self-assessment system resting in part on public confidence in the tax system as a whole.

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* Pamphlet Setting Out Background and Description of Estate and Gift Tax Bills prepared by the Staff of the Joint Committee on Taxation (May 1, 1981).

The proponents also suggest that the fundamental purpose of limiting undue concentrations of wealth is as valid today as it was in 1916 and 1924 and that untaxed transfers of substantial wealth conflict with basic social values, principally equality of opportunity. They point out that throughout the world, in developed countries in which property is privately-owned, taxation of property at death is a common form of taxation.

Opponents of the transfer tax argue that it is a tax on capital which adversely affects the incentive to save. They point out that it results in enormous complexity in the transfer of wealth from generation to generation, often causing lock-in effects, decreasing the mobility of capital, and imposing other inefficiencies and transaction costs. They point out that it is not properly justified as a back-stop to the income tax system because it imposes tax burdens on persons who accumulate their estates entirely out of fully tax-paid income to the same extent as those who have held non-income producing property, tax-exempt bonds, or tax shelters.

Such opponents argue that our transfer tax system has failed to break up concentrations of wealth; has failed to enhance equality of opportunity; and, as stated above, has been a disincentive to investment, productivity, and enterprise.

Against this background of argument, we suggest that the following considerations, among others, are certainly relevant:

1. The purposes and effects of the federal transfer tax laws, as outlined above, must be carefully weighed in light of long term economic, social, and political objectives, and in light of revenue needs. The proper place for these laws in our tax system requires consideration of the appropriate level of rates, the degree of progessivity, and the amount of the exemption or the threshold at which a person's transfers of property during life and at death begin to be taxed. In other words, to the extent that the purposes and effects of these laws are valid, the segments of society which are to bear the burden of these transfer taxes must be determined consistent with the economic, social, and political objectives to be achieved.

2. Under existing economic conditions in the United States, the impact, if any, of the estate tax on the propensity to save and upon the actual stock of savings must be considered. Repeal or reduction of the tax by reference to these considerations would, however, require a decision as to the most effective allocation of the estate tax revenues in question, both now and as they might increase in the future. Would the effect on savings be greater if these tax reductions took the form of reduced marginal income tax rates? What are the most important disincentives to saving?

3. If Congress determines that the fundamental purposes of the laws do not justify their existence, in whole or in part, in light of their perceived disadvantages, Congress must consider the implications of repeal.

a. Current law provides a new income tax basis for assets held at death. Repeal of the estate tax would remove a major justification for not imposing a tax at death on unrealized capital gains. It is possible, then, that the estate tax would be replaced by another "death tax".

b. The present estate tax law permits a limited credit for death taxes paid to the states. Repeal may be replaced by higher state levies and may lead to more competition among the states. Some states could create "havens" from death taxes, thereby encouraging a migration of older citizens to those states, a phenomenon which occurs to a lesser extent under the present system.*

c. Tax-free lifetime transfers may create opportunities for intra-family gifts to persons in lower tax brackets, resulting in an erosion of the income tax base, although it is arguable that imposition of federal death taxes has the same effect.**

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* It is instructive that the increase in the state death tax credit in 1926 from 25 percent to 80 percent had the support of those states which then had inheritance taxes but feared that their wealthy residents would move to states with no inheritance taxes. It was thought that the retention of the federal tax made it useless to move. Another effect of the increase in the credit was that it permitted the states to preempt for themselves revenues which would otherwise be payable to the federal government. Paul, Taxation in the United States 139 (1954).

** Miller, The Federal Gift Tax: Rate Revision, 51 A.B.A.J 333 (April, 1965).

d. The present system, by allowing deductions for transfers to charity, provides a major incentive for taxpayers to make gifts to charitable organizations during lifetime and at death. Congress should consider the impact of repeal on these organizations; such consideration, however, should also take into account the Federal income tax treatment of charitable gifts and of charities themselves.

Finally, consideration should be given to the fact that the estate tax is criticized as forcing the sale of family farms and closely-held businesses. Provisions exist in the estate tax law for deferred payment of estate taxes, for virtually income tax-free redemption of stock to enable payment of such taxes, and for special farm-use valuation of certain assets. It may well be that these relief provisions are too tightly drawn; as subsequently noted, they certainly are unduly complex. The burdensome impact of the estate tax on farms and closely-held businesses calls for thorough reconsideration of these provisions.

B. REPEAL OF GENERATION-SKIPPING TAX

The generation-skipping tax was enacted in 1976 to provide equal transfer tax treatment between families that used generation-skipping trusts for the transmission of wealth and those that did not. Congress determined that while the tax advantages of generation-skipping trusts were theoretically available to all, in actual practice they were used more often by the wealthy. Accordingly, the Congress sought to establish a system to tax wealth once each generation.*

If transfer taxes are to be retained, it is arguable that the goal sought to be achieved by this tax is as valid today as it was in 1976. Proponents say that we cannot allow individuals to leap-frog the imposition of the estate tax by complex trusts or other dispositions. On the other hand, many lawyers who work extensively in the estate and gift tax field believe that the tax is largely ineffective. It is horrendously complex and results in stilted and often inefficient forms of property transfer at substantial estate planning costs.

Against this background of argument, we suggest that the following more specific considerations, among others, are relevant:

1. While the tax was aimed at a device employed by the very wealthy, it may be precisely that segment of society which is able to avoid the tax, at least in part, by avoiding the use of generation-skipping trusts and adopting a device known as "layering". It may be that the less affluent, those do not have sufficient wealth to "layer", are those most affected by the tax.

2. The tax has a potential impact on more estates than originally anticipated -- for example, when the order of deaths is other than the most actuarially probable.

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* General Explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation 564 (December 29, 1976).

3. Some experts believe that the provisions are so extremely complex and subtle in their terms and operation that taxpayers and their advisors will never be able adequately to comply. Estate planning of necessity must often be done by general practice lawyers who will not be able to master these provisions, and they do not lend themselves to standard dispository plans.

4. Adequate administration of these provisions by the Internal Revenue Service will require increased capacity for storage and retrieval of information accumulated over many years, as well as examining agents who can be trained to enforce this complicated tax. Opponents argue that it is doubtful whether the Service will ever be able to achieve these objectives.

5. Although the tax was enacted in 1976, proposed regulations on substantive matters were not issued until early this year. These proposed regulations have been severely criticized and may require substantial revision. The Section of Taxation submitted over 100 pages of detailed individual comments. Furthermore, although the first returns are due June 30, 1981, the Service has yet to issue return forms -- four and one-half years after the enactment of the tax.

As might be expected, the generation-skipping tax will produce little revenue: its purpose is to make the estate tax work by removing any advantage of dispositions which would otherwise avoid the effect of the estate tax.* The extreme complexity

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* The tax is estimated to produce $280 million per year. General Explanation of the Tax Reform Act of 1976, Staff of the Joint Committee on Taxation 21 (December 29, 1976).

of the tax and the ability of some to avoid it by "layering" may well call for reconsideration of its effects and operation. The question whether outright repeal is justified calls for careful balancing of the resulting effects on the integrity of the estate tax and the extreme complexities and burdens which a generation-skipping tax may necessarily require.

III. OTHER ESTATE AND GIFT TAX ISSUES

A. THE UNIFIED CREDIT AND RATE SCHEDULES

The appropriate level of exemption from transfer tax accomplished through the unified credit, and the appropriate level of rates and degree of progressivity, are closely related to the issue of repeal of these taxes. If the Congress determines that the fundamental purposes of the estate and gift tax laws are valid today, then Congress must determine the level of wealth to be taxed and the burden to be imposed on such wealth. Also relevant in these decisions is the extent to which Congress determines that lifetime giving should be encouraged, a consideration which may not have been given adequate attention in the changes in the Tax Reform Act of 1976.*

If the exemption level is set at $600,000, it is estimated that the number of estates incurring tax would be reduced

* Miller, The Federal Gift Tax: Rate Revision, 51 A.B.A.J. 333 (April, 1965).

from two and eight-tenths percent of all decedents to three-tenths of one percent.*

Obviously, inflation is increasing the value of property so that transfer tax burdens are increasing although there are no corresponding increases in real wealth or purchasing power. The estate and gift tax rates are progressive; this factor, plus the implementation of the equivalent exemption through a fixed-dollar credit, causes the increase in tax burden despite the absence of any increase in real value.

The present level of the exemption equivalent of $175,625 was set in the Tax Reform Act of 1976. Many experts feel that Congress should at the least reconsider the appropriate level of exemption, and the possibility of indexing this exemption for future changes in value of the dollar.

B. ANNUAL GIFT TAX EXCLUSION

The annual gift tax exclusion of $3,000 per donee was set by the Revenue Act of 1942. The original purpose of the exclusion was "to obviate the necessity of keeping an account of and reporting numerous small gifts, * * * to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts"** -- that is, to

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* Pamphlet Setting Out Background and Description of Estate and Gift Tax Bills prepared by the Staff of the Joint Committee on Taxation (May 1, 1981).

** S. Rep. No. 665, 72d Cong., 1st Sess. (1932), 1939-1 Pt. 2 C.B. 496, 525.

exempt from the gift tax routine intra-family gifts made for essentially non-tax reasons.

Proponents on an increase in the exclusion argue that in light of the substantial increases in price levels the exclusion generally fails to carry out the congressional purpose in enacting it. Opponents, on the other hand, argue that in light of present day sophistication in estate planning, particularly in connection with life insurance and certain other forms of saving, an increase in the exclusion would increase unduly the opportunity to avoid the effect of the transfer tax system by annual gifts to those persons who are the natural objects of the donor's bounty.

The amount of the exclusion is a matter of policy to be determined by Congress, taking into account the foregoing considerations and other factors such as the interaction between the exclusion and §2035(b), which includes in a decedent's gross estate transfers within three years of death.

Whether or not the amount of the annual exclusion is increased, many observers agree that two particular areas require special consideration. First, parents pay significant amounts for a child's college education after the child has reached the age which under state law relieves the parent of the obligation of support. In many schools today, tuition and related expenses exceed $10,000 per year. Second, many individuals, though not obligated under their state law to support their parents or grandparents, nonetheless in fact pay large amounts for food, clothing, nursing care, medical expenses and shelter to support their aged parents and grandparents.

Under present law the expenditures in both of these cases are transfers subject to the gift tax, but most taxpayers do not regard them as gifts and do not report them for gift tax purposes. Furthermore, it is doubtful that taxpayers can ever be convinced to treat such transfers as "gifts". Because it is difficult to define transfers for consumption, many experts in this field suggest that Congress consider amending the Internal Revenue Code to provide that the following transfers shall not be treated as transfers subject to gift tax:

1. Transfers from a parent to or for a child expended within one year for tuition and other costs of higher education.

2. Transfers from a child to or for a parent or grandparent expended within one year for food, clothing, nursing care, medical expenses and shelter.*

C. MARITAL DEDUCTION

The purpose of the marital deduction provisions, as originally enacted by the Revenue Act of 1948, was to achieve greater equality in the estate and gift tax treatment of

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* On March 4, 1971, Rep. Pickle introduced H.R. 2324 which, in addition to providing for an increase in the annual gift tax exclusion under section 2503(b), creates a new section dealing with transfers for consumption.

residents of community property states and common law states.* The provisions allow a deduction of 50 percent of the value of property transferred to a spouse during lifetime and a deduction of up to 50 percent of a decedent's adjusted gross estate for property passing to a spouse at death. The changes in the marital deduction provisions enacted by the Tax Reform Act of 1976 were intended to provide relief to modest estates. Congress believed that a decedent with a medium-sized estate should be able to leave a $250,000 minimum amount of property to his surviving spouse free of estate tax; and that the gift tax on lifetime transfers between spouses was too restrictive, tended to interefere with normal interspousal lifetime transfers, and should permit during life a one time $100,000 tax free transfer between spouses.**

We submit that the following be considered in any revision of the marital deduction provisions:

1. These provisions do not lead to precise equality of treatment between residents of community property states and common law states.*** This was apparent when the provisions were

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* H.R. Rep. No. 1274, 80th Cong., 2d Sess., pp. 24-26; Sen. Rep. No. 1013 (Part I), 80th Cong., 2d Sess., pp. 26-29. See, generally, 4 Mertens, Law of Federal Gift and Estate Taxation pp. 438-440 (1959).

** General Explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation 533 (December 29, 1976).

*** A taxpayer in a common law state wishing to equalize a $2 million estate with his spouse in 1981 by transferring $1 million to her would incur a federal gift tax of $108,290 (assuming no prior taxable gifts). This result is achieved automatically without tax in a community property state.

enacted.* Inequality results most dramatically in common law states where the less wealthy spouse dies first, because any opportunity to have half the family property taxed in the estate of each spouse is later lost.

2. Under present law jointly-owned property will continue to be a source of difficulty. The tracing requirements of section 2040(a) are burdensome to estates and survivors. Furthermore, there is widespread noncompliance because few taxpayers understand the gift tax consequences to spouses acquiring personal property as joint tenants.

3. Some practitioners believe the current rules frequently lead to distortion of estate plans. For example, the individual with a modest taxable estate is often counseled to leave outright to his spouse just that part of his estate that qualifies for the martial deduction and to leave the balance in a trust, the purpose being to avoid a second tax upon the death of the surviving spouse. Implementation of such a plan, however, can produce complexity and expense out of proportion to the amount of tax saved. On the other hand, failure to adopt such a plan may result in double taxation.

Although not a part of any of the bills presently under consideration by this Subcommittee, many experts suggest that the amount and "qualitative expansion" of the marital deduction be reviewed and studied. The basic concept underlying qualitative

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* Paul, Taxation in the United States 497 (1954).

expansion is that a person should be able to leave property in trust for his spouse, providing income to her for life but with no power to dispose of the remainder, and still have that property qualify for the marital deduction. At present, the trust would be a "terminable interest" which would fail to qualify for the marital deduction. Qualitative expansion would presumably be coupled, however, with a provision for including the value of such a trust in the surviving spouse's gross estate in all events, although this would probably add complexity to the law.

Proponents of qualitative expansion argue that the present requirements for allowance of the marital deduction frequently put people who are remarried in the difficult position of choosing between tax savings (as a result of the marital deduction) and the assurance that their wealth ultimately will pass to their children, often of a prior marriage. Even absent prior marriages, the proponents argue that spouses are frequently faced with the dilemma of weighing tax savings against non-tax considerations (such as the possibility of remarriage) that would counsel leaving the property in trust. Arguably, this dilemma will be heightened if an unlimited marital deduction were enacted without qualitative expansion, because there would then be a greater inducement to give "all" to the surviving spouse and not provide for children.

D. DEFERRED PAYMENT OF ESTATE TAXES ATTRIBUTABLE TO INTERESTS IN CLOSELY-HELD BUSINESSES

The earliest provision of the Internal Revenue Code granting a deferral privilege to estates as a matter of right* was §6166 added to the Code in 1958. It was "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 an imposition of a heavy estate tax".** This was to be accomplished by spreading out the period over which the estate taxes would be paid to permit earnings of the farm or closely-held business to be used to pay the estate taxes.

In the Tax Reform Act of 1976, Congress changed the section number of existing §6166 to §6166A, and added a new §6166, which provided a longer payout period and a lower interest rate for those estates which meet its more stringent qualification tests. It was added in response to concern that some businesses were not profitable enough to permit both payment of estate tax and interest thereon, especially if the interest rate is high.*** The Revenue Act of 1978 amended §6166

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* Under §6161(a)(2) of the Code the time for payment of estate taxes may be extended for up to ten years by the Secretary of the Treasury upon a showing of reasonable cause. Since §6161 does not permit deferral as a matter of right, its utility as a planning tool is limited.

** H.R. Rep. No. 2198, 85th Cong., 2d Sess. (1958).

*** H.R. Rep. No. 1380, 94th Cong., 2d Sess. (1976).

(but not §6166A) to provide for the application of certain constructive ownership rules in determining if a decedent's estate owned the minimum percentage interest required to constitute an "interest in a closely held business" for purposes of §6166.

As a result, two sections now deal with the same subject, each having different tests as to what property constitutes "an interest in a closely held business" as to which deferral is available, what minimum value the interest must have in relation to the value of the estate in order to qualify for deferral, under what conditions two or more "interests" may be combined to meet the threshold requirement, under what conditions acceleration of the deferred tax takes place, what maximum period of deferral is available, and what rate of interest is payable on the unpaid installments. There are also numerous other differences between the two sections.

The Tax Reform Act of 1976 also changed the test under §303 for the minimum value which the stock of the redeeming corporation owned by the estate must have in relation to the value of the estate to qualify for "exchange" redemption treatment. Thus, this minimum value percentage is no longer the same as any of the threshold minimum value tests of either §6166 and §6166A.

Simplification of the tax laws would be greatly promoted by combining §§6166 and 6166A and coordinating those provisions with §303. The Wallop Bill, S. 395, addresses some of these questions. However, more can and should be done. The Section of Taxation is in the process of developing a comprehensive report on this subject and hopes to soon be able to discuss the report with the Joint Committee and Treasury Staffs.

E. ORPHANS' DEDUCTION

Section 2057 was enacted by The Tax Reform Act of 1976 to provide a limited estate tax deduction for an interest in property passing to a minor (defined as a child under age 21) orphan. The deduction is not allowable, however, if the interest passing to the minor orphan would violate the terminable interest rule of section 2056 if it were an interest passing to a surviving spouse. Moreover, the deduction is available only where the decedent is not survived by a spouse and the minor child has no known parent.

There are significant problems with the orphans' deduction. Primary among them is the requirement that the interest in property passing to the minor orphan not violate the terminable interest rule. This results in undesirable complexities. Enactment as part of the Revenue Act of 1978 of the provision recognizing "Qualified Minors' Trusts" as further exceptions to the terminable interest rule only served to increase those complexities -- complexities which are now reflected in the wills of most parents of minor children. This undoubtedly results in increased estate planning fees, though the deduction will actually be used very infrequently. Though the objective of Congress in providing for the deduction is obviously laudable, many responsible tax lawyers believe that in furtherance of the simplification of our tax laws, it should either be repealed in its entirety or the burdensome requirements attendant to its application should be eliminated.

In any event, whatever changes in the law may be considered, the problems of implementing new proposals are formidable and should be carefully studied before enactment. Many estate plans have been implemented based on present law, and changes should be made slowly and carefully, if at all.

CONCLUSION

The Section of Taxation of the American Bar Association has a deep and abiding interest in the integrity of our tax system. We are particularly committed to the cause of simplification, to the extent consistent with objectives of economic efficiency and equity of the tax structure. We look forward to further opportunities to present our views to the Congress.

SUMMARY OF TESTIMONY
OF JOHN A. WALLACE
ON BEHALF OF
THE AMERICAN COLLEGE OF PROBATE COUNSEL
ON
ESTATE AND GIFT TAX REFORM
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

June 5, 1981

The College recommends that the unified credit for estate and gift taxes should be increased substantially if the fundamental purposes of our estate and gift tax laws are to be served. A substantially increased unified credit would effectively repeal the federal estate and gift tax for smaller and medium-sized estates and would also produce a number of other collateral tax and nontax benefits that are desirable.

Following a determination of the appropriate level of the unified credit, the estate and gift tax rate schedule should be reexamined, particularly from the standpoint of a possible reduction of the minimum and maximum tax rates and a revision in the progressivity of the rate schedule.

The College supports an unlimited estate and gift tax marital deduction only if the terminable interest rule in Section 2056 is amended to allow a deduction for transfers of a current beneficial interest in property to a surviving spouse. In the absence of a modification of the terminable interest rule, an unlimited marital deduction will unduly influence taxpayers concerning interspousal transfers.

The College urges a repeal of the overly complex and burdensome generation-skipping transfer tax. If it is felt that some tax must be imposed upon multi-generational transfers of property that are otherwise not subject to a transfer tax, that issue should be considered carefully by a study group composed of competent tax practitioners and any legislative action should be postponed until their recommendations are received.

The College also supports a substantially increased per donee annual gift tax exclusion, but does not support an expansion of the exclusion by exempting transfers of property for current consumption. The College also supports an annual gift tax return filing requirement and an amendment that would allow taxpayers the option of utilizing the unified credit against a gift tax liability.

The College supports a revision of Sections 6166 and 6166A that would bring those statutes into conformity with each other and with a related statutory provision, Section 303. The College also recommends that the interest rate charged on deferred estate tax liability be decoupled from the interest rate charged on underpayments and late payments of income tax.

The College also submits that many interpretive problems have been raised with respect to the operation of Section 2032A during the five-year period following its passage and that substantial amendments are needed to redress those problems.

Finally, the College urges that the present inquiry into our estate and gift tax laws proceed on an orderly basis that is designed to provide long-term solutions to the problems raised. In this manner, it is to be expected that, following the enactment of additional estate and gift tax legislation, our estate and gift tax laws will remain unchanged for some substantial period of time, thus producing the stable environment that is vital to effective estate planning.

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June 5, 1981

This statement has been prepared by the Estate and Gift Tax Committee of the American College of Probate Counsel (the "College"), although the positions presented have been specifically approved either by the Board of Regents or the Executive Committee of the Board of Regents of the College, and are submitted at the express direction of the President of the College, Milton Greenfield, Jr., Esq. of St. Louis, Missouri. The membership of the Executive Committee of the Board of Regents and the Estate and Gift Tax Committee of the College is listed on Exhibit A of this statement.

The College is grateful for being given the opportunity to appear at this hearing and to express the views of our membership, which is composed of more than 2,000 lawyers who specialize in the practice of trusts and estates law and related tax matters, concerning the estate and gift tax legislation now pending before this Subcommittee. A major purpose of the College from its inception more than thirty years ago has been the improvement and reform of probate laws and procedures, with the ultimate goal of simplifying to the maximum extent possible the disposition of property and the administration of estates in this country. There is no doubt that our estate and gift tax laws represent the most complex and expensive aspect of our system of property disposition, and we welcome and accept once again the challenge of working with the present Congress to find ways of ameliorating the unduly harsh impact of these laws on our clients.

Increased Unified Credit

Two of the bills pending before the Subcommittee today - S.395 and S.858 - would increase the estate and gift tax exemption for property transfers substantially, either through an increased unified credit or through a combination of an increased unified credit and reduction of the transfer tax rates. Obviously, to the extent the unified credit for estate and gift taxes is increased, estates below the exemption level will be permanently removed from the transfer tax system; in effect, the increased unified credit will repeal the federal estate and gift tax for these estates.

The College enthusiastically endorses this effort to increase the unified credit. It is patently obvious that the present federal transfer tax system, i.e., the combination of the estate, gift and generation-skipping tax laws, is overly complex and burdensome. Transfer taxes force far too many taxpayers to develop, with the assistance of knowledgeable but expensive advisors, complicated estate plans that frequently represent an unhappy compromise between the taxpayer's true wishes about the disposition of his or her property and tax realities. Moreover, in recent years changes, and proposed changes, in our transfer tax laws have caused these estate plans, and the documents implementing them, to be reviewed and revised with greater frequency, adding to the expense incurred by these taxpayers. The upshot has been an increasing level of resentment on the part of taxpayers concerning the estate, gift and generation-skipping tax laws. As inflation pushes more and more estates into the transfer tax system, or increases the tax burden of estates that are already in the system, all without a corresponding increase in the real value of those estates, the impact of these taxes is being felt by more and more taxpayers. This resentment over the heightened intrusiveness of the estate, gift and generation-skipping taxes into the lives of our citizens is undoubtedly reflected in much of the estate and gift tax reform legislation pending before this Subcommittee today.

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The question of whether, and how, transfers of property should be taxed is ultimately a political issue. This issue should be resolved, however, with the fundamental purposes of the estate and gift taxes in mind. The College submits that throughout the long and often checkered history of our federal estate and gift taxes these purposes have been clouded by an ambivalence between adherence to the social policies underlying these taxes and revenue considerations. The estate and gift tax laws were examined in some depth at an American Assembly program held in Atlanta, Georgia during December of 1976. At the conclusion of this program the following summary was published:

> Americans who acquire and hold property express themselves in the way they deal with it: using it, spending it, saving it, giving it away. The social order around us tends to honor our choices on the basic theory that private decision making is better than public control. To hold property and to have wide discretion over it are closely associated with our concepts of freedom.
>
> One's property rights, however, are not absolute and accommodations must be made to the interests of others in society. Care must be taken that wealth does not give rise to excessive power - that is, the power unduly to limit economic opportunity or to govern the lives of others.
>
> One aspect of private property, and a traditional area of free choice, has occupied this Assembly's attention: the right of succession and the freedom to dispose of property during life and at death. The Assembly

has examined the extent to which that right and that freedom should exist or be limited.

Intervention by society is justified to curtail harmful concentration or perpetuation of economic power. In addition, freedom of testation may be regulated so that property is not given to persons or in forms that are believed unfair to family members or otherwise socially undesirable.

Some Basic Premises

Much of the law of succession has origins in the past, some of which are no longer compelling or relevant. We are concerned that much of today's law and even some recent legislation, including tax legislation, has developed without adequate analysis of fundamental reasons for or against public intervention.

Our systems of wealth transfer can be appreciated, or properly altered, only after their premises, structures and procedures have been subjected to philosophical inquiry, testing them against economic, social and political values of today. The Assembly has attempted that, with particular emphasis on the transfer of substantial wealth from one generation to another.

The institution of succession serves a variety of values cherished by a free society. These include reinforcement of family ties and responsibilities, economic and social pluralism, encouragement of private philanthropy to improve the quality of life.

At the same time, transfers of substantial wealth tend to conflict with other basic social values, including equality of opportunity, dispersal of economic power, reward according to merit, and avoidance of rigid class distinctions.

Perhaps at a more fundamental level, the institution of succession is a proper response of society to elemental motives, ranging from concern for one's immediate family to a desire to extend one's personality beyond death. In fact, established patterns of inheritance may be the least objectionable means of deciding property ownership on a person's death.

Excessive unearned wealth, however, may arouse deepseated resentment, and possibly alienation from our society, over someone's "getting something for nothing."

Examined from an economic perspective, the right to transfer wealth has the positive values of fostering incentives in the form of rewarding industry, ingenuity and creativity, encouraging capital formation through saving and investment, permitting continuity of on-going enterprise, and supporting diversity in priorities. In addition, such transfers are, indeed, often justified by significant, if but not always evident, economic contributions by those who receive them.

There also may be adverse economic implications in permitting significant wealth transfers, including loss of potential tax revenues, tolerance of continuing concentrations of economic power, inefficiency in investment resource allocation and reduced incentives to productivity among heirs.

It should be noted that there was not in this Assembly, any more than there is in American society as a whole, a consensus concerning the amount of individual wealth to be considered objectionable when one weighs the particular positive and negative qualities enumerated here. It was frequently suggested that the impact of those qualities may vary considerably depending upon the character and dispersion of the wealth transfers involved. It would appear that limitations on wealth transmission ultimately will be set by political judgments rather than solely by a process of reasoning and logic.

. . . . .

Taxation of Wealth Transfers

> There will continue to be a call for the relatively modest revenues generated by transfer taxes, but a realistic assessment of the justification for these taxes must focus on their role in redistribution of wealth. This fact, however, does not lead us to a conclusion that the goal of redistribution, in light of other relevant social and economic considerations, now justifies either an increase or a decrease in the present levels of death and gift taxation.

The considerations reflected in the above summary make an ~~effective case~~ for the proposition that the federal estate and gift tax laws should be used primarily as an instrument of social policy rather than an effort to produce public revenues. This conclusion may be contrasted with the approach reflected in a recent pamphlet prepared for the use of the Committee on Finance by the Staff of the Joint Committee on Taxation in which the role of estate and gift taxes as a revenue source, rather than to implement social goals, is emphasized. Background and Description of Bills (S.395, S.404, S.574 and S.858) Relating to Estate and Gift Taxes, prepared for the use of the Committee on Finance by the Joint Committee on Taxation on April 30, 1981, pages 19-20.

If a fundamental objective of the estate and gift tax laws is to enhance equality of opportunity in this country by preventing the undue concentration of wealth and power in the hands of a few, the level of the exemption equivalent afforded by the present unified transfer tax credit, now $175,625, is, by any standard, ridiculously low. In all too many estates the value of the decedent's interest in his or her home, household furnishings and other miscellaneous noninvestment assets exceed this amount. In other instances the availability of insurance arrangements and employee benefit plans push many middle-management taxpayers, who, during their lifetimes find it difficult to make mortgage payments, into estate tax brackets that are well above the present level of exemption equivalent. Viewed from this perspective it seems appropriate to ask whether $175,625 is really the level of wealth that is deemed "undue" from the standpoint of our social goals.

The report of the American Assembly that has been referred to previously also takes the view that transfer taxes should not conflict with other basic social values, including "rewarding industry, ingenuity and creativity, encouraging capital formation through saving and investment, permitting continuity of on-going enterprise, and supporting diversity and priorities." While the case may be made that a system that permits transfers of enormous wealth from generation to generation may breed pensioners rather than entrepreneurs among the recipients of that wealth, an equally compelling case can be made for the proposition that transfers of wealth that are not deemed excessive provide a desirable continuity of economically productive capital in the private sector of the economy. If the owners of successful businesses are not disrupted from their affairs by transfer tax concerns, their energies will continue to be directed toward the pursuit of business opportunities, the creation of jobs and the improvement of the productivity of the nation. Again, viewed from this standpoint, the wisdom of imposing estate and gift taxes upon transfers of property at a level just above $175,000 should properly be questioned.

The case for a substantially increased unified credit was stated in the following manner by J. Thomas Eubank, Esq. on March 24, 1980 at hearings before the Subcommittee on Taxation and Debt Management Generally of the Committee on Finance:

> "In view of the fundamental purposes of the estate and gift tax laws, which I believe have been neither stated well in legislative histories nor observed well when laws were written, I now ask whether it is proper to tax a $500,000 estate very much. What about a $1,000,000 or even a $2,000,000 estate? Are these really concentrations of wealth and power that we want to break up significantly? Are not

> those holdings the very backbone of the private sector economy that we wish to preserve, because they are large enough to include significant investment capital needed in the private sector economy but not large enough to create undue social problems? Comparatively, estates below $250,000 in value typically consist largely of personal assets, such as residences, household goods, personal effects, automobiles, and boats, and are woefully short of investment capital. Because of these differences in the nature of assets depending on estate size, our estate tax laws have tended in the aggregate to hit investment capital harder and personal assets easier. Exceptions in the income tax laws for residences indicate that the same is true there to an extent. A nation wanting to be stronger economically would not disfavor investment capital, especially when there is a shortage of investment capital. The concern Congress expressed in 1976 about farms and their productivity for the nation should be expanded to include a concern for all productive investment capital, which our nation needs so much"

At the time Mr. Eubank was testifying as an individual and not as a representative of any firm or organization, but it is appropriate to point out here that he is a member of the Board of Regents and an officer of the College, and that his views reflect a common concensus among our membership.

Viewed from the standpoint of revenue concerns, a substantially increased unified credit will clearly cause a sharp decline in the revenues produced by the estate and gift tax laws, because most estates can be found at the lower echelon of the economic scale. Since the federal estate and gift tax laws produce a very low percentage of overall tax revenues, the impact of the revenue loss produced by a substantially increased unified transfer tax credit can be absorbed rather easily, either by adjustments to the income tax or excise tax levies, or through reduced governmental expenditures. The increased unified credit will also result in a significant reduction both in administrative enforcement costs and tax-deductible fees, other factors that will offset the anticipated revenue loss.

Any effort to draw the line between taxable and tax exempt estates is a difficult task that necessarily involves an arbitrary exercise of judgment by those charged with the responsiblity for developing our tax laws. We submit, however, that it will be impossible to make a rational determination about the level of the unified credit unless Congress during the deliberative process first identifies the fundamental purposes for the estate and gift tax laws. Otherwise, a Congress that is struggling mightily with the complex problem of avoiding budget shortfalls will naturally focus upon the revenue impact of statutory change in this area. We are concerned that a preoccupation with revenue considerations will force Congress to select a threshold level for the transfer tax system that does not provide sufficient relief for our farmers, ranchers, businessmen and the other taxpayers who now control the economically productive capital in the private sector of the economy. When the exemption equivalent for estate and gift taxes was increased to $175,625 in 1976, the increased exemption was phased in over a five year period in order to ameliorate the adverse impact on tax revenues. If, as we submit, the fundamental purpose of our transfer tax laws is to implement certain socially desirable goals, rather than to produce revenue, a decision that is based upon a preoccupation with revenue implications will inevitably miss the mark. We urge that the amount of the unified credit be established at a level that encourages the formation of private capital, provides an incentive for estate accumulation and removes from the transfer tax system those taxpayers whose estates should clearly be spared the agony of dealing with a necessarily complex tax process.

It should finally be noted that many nontax benefits will ensue for taxpayers with smaller and medium-sized taxable estates from a substantially increased unified credit. First, and perhaps foremost, the documents needed to implement most of their estate plans will be shorter, easier to understand and less expensive to prepare. These taxpayers will therefore have some idea of what they are doing when they execute wills and trusts or administer estates. Furthermore, the necessity for many trust arrangements, which are now used solely to minimize estate taxes, will be eliminated. Many unsophisticated taxpayers are very leery of such esoteric devices as trusts and would be relieved to know that they will not forfeit tax savings by failing to use them. Last, but certainly not least, the energies of trusts and estates lawyers and professional fiduciaries can be redirected toward more useful and productive pursuits if they are relieved of the obligation of preparing complicated estate planning documents for clients who do not understand or like them and often as not highly resent the fees incurred in their preparation and implementation.

Rate Reduction

The questions of the amount of the unified credit and tax rates are inextricably intertwined. This is illustrated by two bills now pending before the Subcommittee. S.858, the Family Farm Protection Act of 1981, would provide an exemption equivalent from estate and gift tax for estates with a value of $600,000 and less by 1985 through the medium of increasing the unified credit from $47,000 to $192,800 without any change in the estate and gift tax rate schedules. On the other hand, S.395, the Family Enterprise Estate and Gift Tax Equity Act, would achieve the same exemption equivalent by increasing the unified credit from $47,000 to $124,750 and by what can generally be described as a 10% across-the-board reduction in the estate and gift tax rates.

The College submits that the question of rates should be postponed until a decision is made about the level of the unified credit. For the reasons stated previously, a substantial increase in the unified credit seems to be entirely warranted, particularly when the fundamental social goals that the estate and gift tax laws seek to implement are considered. After the level of the unified credit has been determined, however, it would be appropriate to consider a general reduction in the estate and gift tax rates in order to provide further tax relief. For example, the current tax rates impose a tax of 32% on the first dollar above the present exemption equivalent of $175,625. The College feels strongly that this level of initial taxation is entirely too high. Moreover, it seems appropriate to the College that the top tax rate, now set at 70%, be reexamined in light of the current trend toward reduction in the top income tax rates. If the top income tax rate on earned income has been set at 50%, is there any reason to tax the capital that enables taxpayers to earn that income at a higher rate? Finally, while the tax rate structure is being examined, it would also be appropriate to consider whether the slope of the present graduated rate structure should be altered. The present slope would appear to be biased against the smaller and medium-sized taxable estates, thus presenting the issue of whether changes in the tax rates should be implemented more slowly for these estates and adjusted more sharply upward as the size of the taxable estate increases. Again, we would call the attention of the Subcommittee to the testimony and the charts presented by J. Thomas Eubank, Esq. to the Subcommittee on Taxation and Debt Management Generally of the Committee on Finance on March 24, 1980. There is much food for thought in that material about the present estate and gift tax rates, and we submit that the conclusions reached by Mr. Eubank merit the close attention and scrutiny of this Subcommittee during its analysis of our transfer tax laws.

Marital Deduction Changes

Section 4 of S.395, the Family Enterprise Estate and Gift Tax Equity Act, authorizes an unlimited estate and gift tax deduction for property transfers between spouses. While this proposal is labeled as an unlimited marital deduction rule, and will be referred to as such in this statement, it really authorizes unlimited interspousal transfers because it applies both to transfers of separate and community property between spouses.

The College supports the proposed unlimited marital deduction, with the key proviso that this change in the marital deduction rules be accompanied by a change in the terminable interest rule that would allow property transfers between spouses to qualify for the deduction even though the interest of the recipient spouse is limited to a life estate in the case of outright transfers or an income interest in the case of transfers in trust.

There are a number of reasons why this change is desirable. The adoption of an unlimited marital deduction rule, which effectively considers spouses as a marital unit rather than separate individuals for purposes of the transfer tax structure, will bring the estate and gift tax laws into conformity with the widely-held view among married couples that what belongs to either of them belongs to both. It would also permit spouses owning only separate property to avoid the disparate transfer tax treatment accorded spouses owning only community property under present estate and gift tax laws. A spouse owning only separate property cannot now arrange to transfer one-half of that property to his or her spouse prior to death without the risk of a substantial gift tax liability. On the other hand, one-half of any community property is automatically deemed to be owned by each spouse. The advantage accorded to community property under present estate and gift tax laws is most obvious where the spouse that does not have title to the property dies first. The surviving spouse owning only separate property would continue to own all of the property for transfer tax purposes and would not have the advantage of a marital deduction at death because of the loss of his or her spouse. As to community property, on the other hand, at the death of either spouse the ownership interest of that spouse in the community property would be taxed at the time of death and would not be taxed again, if properly handled, at the death of the surviving spouse. An unlimited marital deduction rule would allow spouses to transfer their separate property assets and structure their separate property estates in a manner that would produce the transfer tax advantages now obtained automatically by spouses owning community property.

It is also likely that an unlimited marital deduction rule will result in the elimination of many joint property arrangements that now exist between spouses. A husband or wife will frequently register property with his or her spouse as joint tenants or tenants by the entirety to reflect the fact that the spouses consider that the property is owned by the marital unit. Under present law this use of joint tenancy will create gift tax problems unless the amounts involved are within the limits of the gift tax marital deduction and the annual exclusion. Many taxpayers, however, do not have the remotest idea that these types of transfers can give rise to gift tax problems. These taxpayers think either that someone ought to be able to make any transfer to a spouse tax-free or that the transfer simply reflects the actuality that the spouse already has an equal ownership interest in the property. In any case, many spouses do not consider that the use of joint names involves a gift. Thus, the adoption of an unlimited marital deduction rule will undoubtedly generate desirable tax compliance benefits.

Another favorable offshoot of this change is that most if not all of the joint interest property rules under Section 2040 can be scrapped, which will lead to much needed simplification of the present estate and gift tax laws. Finally, in an era when many marriages involve couples who are both working, and thereby jointly producing the income used to acquire marital property, any tax rule that facilitates transfers between spouses also reflects social realities.

While there may be some initial revenue loss attributable to unlimited transfers of property between spouses, most of this revenue loss will be recouped subsequently because the estates of surviving spouses, and the corresponding tax bite on those estates, will be increased substantially. Today, particularly in the case of larger separate property estates, spouses adopt property disposition arrangements that split the separate property estate into two parts, one of which will be included in the gross estate of the surviving spouse for transfer tax purposes and will be deductible from the gross estate of the first spouse to die under present marital deduction rules, while the other is structured in a manner that affords the surviving spouse the benefit of the property without inclusion of that property in his or her estate at death. An unlimited marital deduction rule, particularly if coupled with a qualitative expansion of that rule, may cause many taxpayers to change this strategy in favor of a transfer of the entire separate property estate to the surviving spouse in order to obtain a full deferral of estate tax at death, even though a larger transfer tax will be paid at the death of the surviving spouse than would have been paid by the combined estates of the spouses under the split estate approach just described.

It must be recognized that a quantitative expansion of the present marital deduction will force many taxpayers, who were previously in a quandry over the use of the marital deduction

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(because the price of the deduction is giving the surviving spouse full control over the qualifying property) into a more difficult dilemma about the use of this deduction. Because the attraction of a complete deferral of estate tax through use of the unlimited marital deduction is so great, the College supports the enactment of the unlimited marital deduction rule only if that change is accompanied by a modification of the terminable interest rule now contained in Section 2056. The proposed modification would allow a taxpayer to claim the marital deduction for a transfer of property to a spouse without necessarily granting the surviving spouse an unrestricted right of disposition over the transferred property at his or her subsequent death. At present, Section 2056 contains a terminable interest rule that denies a marital deduction for any transfer of property to a surviving spouse if that spouse is not given an unrestricted right to control the disposition of that property at his or her death. Thus, the tax deferral achieved through the marital deduction is available only if the transferor spouse is willing to concede to the transferee spouse ultimate control over that property. In many instances a taxpayer will forego the benefit of the marital deduction because of a concern that the surviving spouse will direct the property at his or her death to persons who are unacceptable to the taxpayer. Every experienced tax practitioner has encountered situations in which taxpayers have agonized over the use of the marital deduction for this very reason. These situations arise most frequently where multiple marriages are involved, particularly where the transferor spouse has children by a prior marriage. The quantitative expansion of the marital deduction from a maximum of the greater of one-half of the adjusted gross estate or $250,000 to the entire estate will obviously exacerbate this dilemma in these situations. There does not appear to be any reason, however, for increasing the likelihood that a taxpayer must adopt an estate plan that does not accurately reflect his or her true wishes or which may not be best suited to the circumstances of his or her family as a condition for receiving an added tax benefit. For this reason we recommend that the expanded marital deduction rule be enacted only if that change is accompanied by a relaxation of the terminable interest rule. As we envision this new qualitative marital deduction rule, the marital deduction would be available for a transfer of property in trust for a surviving spouse if the surviving spouse must receive the income for life (and, if desirable, encroachments upon capital) but is not given a power of appointment over the trust remainder interest, so long as the transferor spouse makes a binding election to have the full value of the assets remaining in the trust subjected to estate tax at the death of the surviving spouse. This approach would allow spouses to take advantage of the quantitative expansion of the marital deduction rule without a concern that children may be disinherited through the subsequent actions of a surviving spouse who may not have been the parent of those children.

The College also recommends that this expansion of the qualitative marital deduction rule be limited to transfers in trust where the surviving spouse is the sole beneficiary of the trust during his or her lifetime or to transfers of property where the surviving spouse is given a legal life estate in the transferred property. If the marital deduction election were extended to transfers of property in trust in which beneficiaries other than the surviving spouse have current beneficial rights, the governing tax rules will necessarily become very complex. In 1969 the Treasury Department published a comprehensive study and set up recommendations for revisions of the estate and gift tax laws that, among other things, supported an unlimited marital deduction on a qualitatively expanded basis that encompassed transfers in trust for multiple beneficiaries, including the surviving spouse. The College is concerned that the rules required to implement a qualitative marital deduction on this basis will be overly complex. The underlying purpose for a qualitative expansion of the marital deduction is, after all, to protect remainder beneficiaries from disinheritance. It does not follow from this step that the marital deduction should be extended to allow those beneficiaries to have a present interest in the transferred property. In the absence of any qualitative expansion of the marital deduction, the only person who would have any interest in the property would be the surviving spouse; thus a qualitative expansion of the marital deduction rule that is designed to protect remainder beneficiaries does not either require or support a further expansion of the rule aimed at allowing those beneficiaries to receive current rights over the transferred property during the lifetime of the surviving spouse.

Generation-Skipping Tax

The present generation-skipping tax rules contained in Chapter 13 of the Internal Revenue Code are an inappropriate response to the question of whether multi-generational transfers should be subject to a tax if they do not otherwise attract a tax liability under present estate and gift tax laws. This conclusion is supported by a number of factors. First, Chapter 13 in its present form is entirely too complex and is virtually unworkable from an administrative standpoint. In addition, it imposes a generation-skipping tax in many instances in which that tax should not be imposed. Furthermore, the tax operates at value levels that are set entirely too low and imposes burdensome recordkeeping requirements upon affected taxpayers and the Internal Revenue Service for lengths of time that literally span decades. Finally, since the estimates of the anticipated revenue from this tax are so slight, that information alone calls into question the necessity for and the validity of a tax that accomplishes so little at the expense of so many.

The College arrives at these views on the basis of actual experience. With very few exceptions, most experienced tax practitioners will confirm that they have failed to implement compliance procedures in their offices to deal with the generation-skipping tax, even though Chapter 13 was adopted almost five years ago. These practitioners will also confirm that when will and trust documents that create generation-skipping tax issues are submitted to professional fiduciaries for review and comment, that review does not prompt any meaningful response as to the generation-skipping tax considerations involved. To some extent this inactivity on the part of tax practitioners and professional fiduciaries may be attributed to the grace period allowed under the Tax Reform Act of 1976 for wills and revocable trusts that were in existence on June 11, 1976, since that grace period extends through the end of 1981. This inactivity may also be attributed, however, to the fact that the response from the Treasury Department with respect to interpretive regulations and tax forms can, at best, be described as inadequate and tardy; in those instances in which regulations have been issued either in proposed or final form, they are technically deficient in many areas and fail to respond to many critical issues that must be answered in the process of planning for the generation-skipping tax. The truth is that there has been inactivity and confusion on both sides of the fence insofar as this particular transfer tax is concerned.

After careful consideration of this state of affairs, the College submits that Congress should repeal Chapter 13. It may also be appropriate to convene a study group composed of qualified practicing professionals to study this issue and file a report that considers what methods, if any, might be appropriate to subject untaxed multi-generational transfers to some form of transfer tax, and, if so, what form that tax should take and at what level it should become operative.

Gift Tax Changes

Legislation now pending before the Subcommittee would increase significantly the $3,000 annual per donee exclusion from gift tax contained in Section 2503(b). The $3000 per donee gift tax exclusion level was set back in 1942, at a time when that amount would purchase two Cadillac automobiles. The impact of inflation over the intervening period of almost forty years has obviously eroded this dollar standard almost completely. Many transfers, such as the payment of college tuition by a parent for a child who has reached the age of majority (now 18 in many states) now cause gift tax problems that should not be raised. In fact, unless the level of the annual per donee gift tax exclusion is increased significantly, the College is concerned that compliance problems relating to transfers that contain some element of support obligation on the part of the donor toward donees over age 18 will become so severe that the voluntary gift tax system as a whole might be jeopardized.

The possibility of excluding transfers for current consumption from gift tax is another solution that has been proposed for redressing the inadequacy of the current level of the annual gift tax exclusion. This concept was considered in a study of estate and gift taxation published by the American

Law Institute in 1969. This proposal was couched as a supplement to the annual gift tax exclusion, so that transfers within the exclusion and transfers for current consumption would both escape gift tax.

In the American Law Institute's study, a transfer for current consumption was defined as an expenditure for:

> "I. The benefit of any person residing in the transferor's household, or the benefit of a child of the transferor under twenty-one years of age, whether or not he resides in the transferor's household, which does not result in the transferee's acquiring property that will retain any significant value after the passage of one year from the date of the transfer; or
>
> II. Current educational, medical or dental costs of any person, or
>
> III. Current costs of food, clothing and maintenance of living accommodations of any person or persons in fact dependent on the transferor, in whole or in part, for support, provided such expenditures are reasonable in amount."

It is apparent from a reading of the above quotation that the concept of transfers for current consumption would introduce into the law a fertile area for dispute and litigation. The terms "significant value", "in fact dependent on the transferor", and "reasonable in amount" alone would no doubt provide many new cases for an already overburdened Tax Court.

The College submits that simplification and avoidance of potential areas of dispute constitute overriding considerations in determining the amount of the annual gift tax exclusion. The objective of eliminating routine gifts from the impact of tax would best be served by increasing the annual exclusion to its purchasing power equivalent as of the date the present $3,000 amount was introduced into the law. The question of whether this amount should be indexed to maintain the value of the exclusion in terms of purchasing power should also be addressed.

Other legislative proposals would, in effect, restore two administratively helpful elements of the prior gift tax law, namely, that gift tax returns would be required to be filed only on an annual basis and that donors would be given the option of claiming the unified credit against taxable transfers. The College supports both of these proposals. It simply makes no sense to require taxpayers to file gift tax returns except on an annual basis. There is no justification, either from the standpoint of revenue impact or from the standpoint of administrative considerations, for requiring more frequent filings. In addition, under the gift tax law that existed prior to the Tax Reform Act of 1976, the use of the lifetime exemption for gift tax transfers was completely optional. No problems arose as a result of this option, which enabled donors to structure taxable gift transactions with a greater degree of certainty and with the expectation that any issue arising from the transfer would be resolved on an expedited basis. It should also be made clear that a final determination of the value of transferred property for gift tax purposes would be a binding determination of the value of that transfer as an adjusted taxable gift in the calculation of the federal estate tax liability. Again, basic fairness and the lack of any compelling objection to any of these changes, lends support for their enactment.

Relief Provisions

The legislation currently pending before the Subcommittee also contains a number of changes that would affect the principal relief provisions for estate and gift taxes, the deferral elections under Sections 6166 and 6166A and the redemption rules under Section 303. The College also submits that this reexamination of these relief provisions for closely held business interests, farms and similarly situated assets should focus not only on the level of relief that is justified, but also on the manner in which that relief is extended. For example, each of the provisions alluded to previously, Sections 6166, 6166A, and 303, contains a number of intricate rules that frequently operate as traps for the unwary and cause many deserving estates to lose the relief extended by the statute because of inadvertent errors. Many of these rules have been added to the relief provisions because of a preoccupation with the potential for abuse that might result from the relief rules. The College submits that the technical advice that has been given to Congress in the past in these areas has been overly cautious and, in many instances, has enabled the Treasury Department and the Internal Revenue Service to take technical positions that make a mockery of the statutory purposes involved. This unfortunate trend undercuts the concept of tax relief and it should be reversed.

Many of the proposed amendments in this area are designed to bring these statutes into conformity with each other. For example (and by way of illustration, only, since a number of other examples could be cited) Sections 6166 and 6166A, which are based on essentially identical policy considerations, differ as to:

(1) The maximum deferral period available,

(2) The amount of estate tax that can be deferred,

(3) The required relationship of a closely-held business interest to the estate for qualification purposes,

(4) The definition of "an interest in a closely-held business",

(5) The conditions under which two or more interests in closely-held businesses can be aggregated to meet applicable threshold rules,

(6) The rate of interest payable on unpaid tax installments, and

(7) The amount of withdrawals from a closely-held business or dispositions of interests in a closely-held business that will be permitted without accelerating deferred tax payments.

It is difficult to reconcile these differences. It is also difficult to reconcile the problems that are raised by the use of one or the other of these tax deferral provisions in tandem with redemptions of stock in a corporation that are designed to qualify under Section 303 for capital gains tax treatment. The College supports this effort to bring all of these statutory provisions into conformity with each other. The result would be tax simplification and tax equity. There does not appear to be any meaningful objection to this reconciliation effort; in fact, the necessity for these changes has been recognized by both the Treasury Department and tax practitioners for some time, and they are long overdue.

Most of the legislative proposals and commentators' suggestions for improvement and simplification of the deferred estate tax election provisions involve the consolidation of present Sections 6166 and 6166A into a single statute that would preserve the most favorable (from the standpoint of the taxpayer) provisions of each of the two existing statutes. The College supports this approach generally, provided that Section 303 is also brought into conformity with this new statute. For example, the new statute governing the election to defer estate taxes will undoubtedly contain some acceleration rule limiting both withdrawals from the closely-held business by the estate and dispositions of the estate's closely-held business interest during the deferral period. These rules and the restrictions that relate to redemptions under Section 303 should be compared to be sure that tandem use of these statutes is preserved to the maximum extent possible and that the measures required to utilize one provision do not cancel the relief afforded by the other. In addition, we submit that a good case can be made for the elimination of any threshold test, other than some appropriate *de minimus* rule, for the use of the election to defer estate tax payments, since the amount of the estate tax which may be deferred is limited by the percentage of the value of the closely-held business interest to the other estate assets in any event. At the same time the necessity for a threshold qualification test for use of Section 303 should be reexamined; here again, the amount of the protected redemption is limited by the amount of estate tax payments and certain administration expenses, which may provide adequate protection against the potential for abuse in that area.

The question of the interest rate charged on deferred tax installments should also be studied. With the exception of the 4% rate charged on limited deferred privileges under Section 6166, the rate of interest charged on elected deferred estate tax payments changes biennially with the rate of interest charged on underpayments and late payments of income taxes. This biennial interest rate adjustment tracks the level of commercial interest rates every other September under a formula contained in Section 6621. It is questionable whether the rate of interest charged on estate taxes that are deferred under a statutory relief provision should be tied to commercial interest rates. In many instances, particularly when commercial interest rates are high, as they are now, closely held businesses cannot produce the cash needed to pay operating expenses, deferred estate taxes and large amounts of interest. Moreover, while competitive interest rates on underpayments and late payments of income tax are needed to prevent taxpayers from deliberately borrowing from the Government, no such incentive to borrow deliberately from the Government is presented by the estate tax deferral rules under Sections 6166 and 6166A; in fact, the exact reverse is true, for estates that depend upon these statutory deferral provisions are presumably those who do not have ready access to commercial borrowing markets.

Section 2032A

A substantially increased unified credit, coupled with significant rate relief, will obviously benefit all estates without regard to the nature of their assets. Both of these steps should be implemented on a priority basis. Thereafter, the College submits that the amount and nature of additional relief that is justified for taxpayers whose estates are comprised of interests in family farms and ranches, and other closely-held businesses, should be determined.

Much of the estate and gift tax reform legislation pending before the Subcommittee today relates to changes in the provisions of Section 2032A. This statute, which was a part of the Tax Reform Act of 1976, enacted an entirely new concept for valuing real property devoted to farming, ranching, and other closely-held business use. As such, Section 2032A was, unequivocably, a relief measure intended to encourage continuation of family owned and operated farming and other enterprises by providing a lower estate tax valuation in those circumstances where, due to low production income and illiquidity, a family might otherwise be forced to sell a family farm or a family business in order to pay estate taxes. Section 2032A as enacted contains numerous conditions and requirements that are designed to ensure that its statutory relief will be limited to situations that reflect both family involvement and substantial liquidity concerns. Because the concept of special valuation is new, and because of the numerous conditions and requirements imposed upon its use, it was inevitable that Section 2032A would produce areas of vagueness, uncertainty and dispute. It is now clearly apparent that these areas require technical correction and oversight by Congress. This situation has been aggravated by the fact that soon after passage of Section 2032A it became apparent that its relief exceeded the projections of the Treasury Department in certain areas of the country. Therefore, the Internal Revenue Service has adopted an ill-disguised position of attempting to restrict the application of Section 2032A to the maximum extent possible in order minimize the tax benefits produced by the statute. The College submits that this effort has frustrated the Congressional intent inherent in Section 2032A and that clarifying amendments to the statute are required to address the many problem areas that have developed in this provision since 1976.

The problems that should be addressed by this Congress in the area of Section 2032A may be described briefly as follows:

1. By regulation and ruling interpretation, the Internal Revenue Service has disqualified property owned by a decedent who either rented the property to a member of his family for cash in more than three of the eight years preceding his death or was cash renting the property to a member of his family on the date of his death. Similarly, a qualified heir acquiring the property would immediately be subject to a recapture of the tax benefit if he were to cash rent the farm to a member of his family in the post-death period.

2. Retired and disabled persons owning otherwise qualified real estate may be denied the benefit of Section 2032A because of their inability to materially participate in the operation of the farm real estate without jeopardizing their social security benefits.

3. A surviving spouse (presumably a widow) of advanced years is frequently unable to preserve eligibility for special use valuation because of a physical inability to materially participate in the operation of the enterprise.

4. Although the statute specifically recognizes the planting and cultivating of trees as a method of farming, it has heen difficult for owners of woodlands to qualify under the material participation test because of the nature of the industry.

5. The statute requires continued material participation within the family group for a period of 15 years following death under threat of recapture of the tax benefit. This period of time has proven to be burdensome and a restraint on normal alienation of property as well as a restraint on the use of property as collateral for financing expansion of the enterprise.

6. In the case of qualified heirs who are spouses, minors, students or disabled persons, the material participation requirement is frequently difficult, if not impossible, to meet.

7. Many observers feel that the $500,000 limitation on the benefit from special use valuation has placed an undue restriction on the benefit from the statute.

8. Present rulings prohibit the benefit of Section 2032A if there has been a non-taxable exchange of qualified real property either in the 8-year pre-death or the 15-year post-death period.

9. The avoidance of recapture of the tax benefit in the event of involuntary conversion is presently an elective provision that is easily overlooked.

10. The valuation formula for farmland requires that there be available average cash rent figures for comparable land. In many areas of the country, cash rent is not commonly used and consequently, substantial land has been deprived of the benefit of special use valuation through inability to satisfy the formula requirement. In addition, the Service has taken a very narrow view of what is "comparable" for this purpose.

11. In the event of a cessation of qualified use or a disposition of the qualified property, the additional federal estate tax which is required to be paid is equivalent to the original estate tax based on fair market value. Nevertheless, the present statute denies the qualified heir the benefit the stepped-up basis ordinarily obtainable when an estate tax has been paid on the fair market value of the property.

12. Regulations deny special use valuation in the case of interests in otherwise qualifying real estate which do not qualify as present interests under Section 2503.

13. Present interpretations of the recapture provisions require an abnormally large recapture tax in the event of a partial disposition of the interest of the qualified heir. Most observers believe that a pro rata recapture would be more appropriate.

14. Present definitions include as members of the family of the decedent or qualified heir only relationships by blood, except for a spouse. However, in the case of a qualified heir, it is unduly restrictive if the family of the decedent is not also considered to be the family of the surviving spouse.

15. The agreement required to be signed by qualified heirs and interested persons must, under present regulations, be signed by a person legally authorized under local law to sign. This has necessitated opening statutory conservatorships for minors at substantial expense notwithstanding the fact that their interest might be a very remote interest.

16. To qualify for statutory relief, property must 'pass' from the decedent to the qualified heir. Present definitions indicate that property acquired through the exercise of an option to purchase property from the estate would not qualify for special use valuation.

17. The Internal Revenue Service takes the position that if special use valuation is used the deduction under Section 2053 for mortgage debts on the qualified property must be reduced proportionately to the reduction in value of the qualified property.

The College submits that the rules contained in present Section 2032A are inordinately complex and seem to serve primarily to obstruct the intended use of the statute. Therefore, to the extent Congress determines that additional relief should be extended for family farms and ranches, the provisions of this statute will require an extensive overhaul if that relief is to be a reality. There is simply no justification for extending relief to some farms and ranches and not to others simply because those farms and ranches are located in areas where cash rents are commonplace. In addition, the statutory rules relating to qualified use and recapture are open invitations (that have been readily accepted) for imaginative administrative curtailment of the relief authorized under the statute.

Many of the problem areas noted above are addressed by statutory proposals now pending before this Subcommittee. The College understands that an additional proposal relating to changes in Section 2032A that has been drafted primarily by the

Federal Tax Section of the Illinois State Bar Association will be submitted to Congress shortly. It is the position of the College that a careful and deliberate study of the nature and form of the statutory modifications required to implement the Congressional purpose inherent in Section 2032A should be undertaken. This would be a welcome contrast to the hurried nature of the enactment of Section 2032A back in 1976. That approach will also, we are confident, produce a statutory response that will properly reflect the wishes of Congress and will also meet the needs of affected taxpayers.

A Plea for Stability

Perhaps going as far back as 1969, when the Tax Reform Act of 1969 was enacted, but certainly going as far back as the late summer of 1976, when the estate and gift tax provisions of the Tax Reform Act of 1976 were suddenly inserted into that legislative package, our estate and gift tax laws have been in a state of flux. This is totally undesirable. Taxpayers expect to file income tax returns, both individual and corporate, on an annual basis, and, if they are not happy about the annual changes in the rules involved, they are by now reconciled to them. The same cannot be said for our estate and gift tax laws, since compliance with those laws necessarily involves the use of complicated documents that, hopefully, will stand the test of time and will not have to be reviewed and changed on an annual basis. The process of preparing wills, trusts and other forms of property disposition requires stability and predictability. Annual changes in the estate and gift tax laws, or the annnual issuance of key regulations interpreting estate and gift tax law changes, keep the transfer tax system in a state of turmoil that produces undue expense and intolerable compliance burdens. As a result, the College takes this opportunity to again suggest that the process of changing our estate and gift tax laws should proceed in a careful and informed manner and pursuant to a schedule that affords interested parties adequate time to review proposals for change and comment on them. Hopefully, that type of process will produce not only the appropriate solutions but also a bill that will settle all relevent pending issues in the transfer tax area for some time to come. This will allow taxpayers some relief from the destabilization that has unfortunately crept into this area of tax law in recent years.

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REMARKS OF BEN WALLIS BEFORE UNITED STATES
SENATE FINANCE SUB-COMMITTEE
ON MAJOR ESTATE TAX ISSUES

June 5, 1981

My name is Ben Wallis. I am an attorney and a rancher, and I appear here today representing the National Association of Property Owners, an organization representing some 3,000 members nationwide engaged in ranching, farming, finance, energy, minerals, timber, development, and other fields. In addition, NAPO represents more than 200 affiliated organizations with approximately 500,000 members. A majority of NAPO's members would be classified as owners and operators of family businesses, including family farm, ranch, and timber operations.

Family businesses, especially family agricultural operations, today face extinction. They are truly an endangered species. Chief villain in the plight of these family operations is our antiquated, unjust, and inappropriate tax structure. While unrealistic income tax structures merely inhibit and deter the productivity and growth of family businesses, our present estate tax laws make it virtually impossible for the family-owned business to survive.

The problems are most apparent with family-owned agricultural enterprises. Following World War II, inflation was rampant --everywhere but in agricultural product prices. Increased efficiency offset many of the pressures brought on by these inflationary trends of the products bought by agricultural operators. However, increased efficiency and production can do only so much. More and more, agricultural operators found themselves borrowing large sums of money on their land--in ever increasing amounts--as inflation pushed the price of land upward. For many agricultural operators, periodic refinancing became a way of life. The dangers were not truly evident until interest rates skyrocketed.

Now, much of agriculture finds itself in critical condition. The industry itself, always fragile, faces wholesale bankruptcy. Even those operations considered sound, and in excellent financial condition, face a very uncertain future upon the death of the present owner. Estate taxes make the retention of a healthy family agricultural operation virtually impossible. A common scenario in the past has called for the heirs of an agricultural operation, upon the death of the original owner, to borrow large sums of money, by mortgaging the land, to pay the estate taxes. By the end of those heirs' lifetimes, those debts may be paid off, only to see the cycle repeated again for the next generation.

During the last several years, however, the cycle has been distorted. Inflation has pushed the valuation of land to a point where, in operations of a size sufficient to be viable, a portion of the estate must be sold to pay estate taxes. For family operations, the "reform" of the 1976 Estate Tax Revisions was a cruel hoax.

A not uncommon scenario is that of the heir to a small family operation, working at a second job, and who has never made more than $15,000 per year in his life, inheriting properties on which up to 70% estate tax must be paid, rendering it impossible to retain the operation. Even if he is able to hold a portion of the property--or to hold all by borrowing a large enough sum to pay the estate taxes--at his death, the cycle will be repeated.

The "family farm" operation is essential to America. The industry itself is one of rugged individualists. These individuals' love of the land, their dedication and efficiency, their willingness to work long (and often uncompensated) hours, their willingness to take the accompanying risks, all are elements of competition that keep our food prices low and our supplies high. Remove the family farm, and we have either rapidly escalating food costs, or famine.

Estate taxes derived from these family operations are hardly essential to the operation of the national budget. The amounts collected are relatively insignificant. Yet, to the individual operation, these taxes often are devastating. If we are to retain the family business, the "family farm"--the epitome of the "American dream"--relief from estate taxes must be granted, and <u>it must be done now!</u> Time is short.

In an effort to help remove the family-owned business from the "endangered" list, the following recommendation is made:

ELIMINATE ALL ESTATE TAXES

Realizing full well that, while the American public may be ready for such a change, the United States Congress may not be, we recommend several alternatives:

1. Raise the estate tax credit to an equivalent of $500,000, and add a lifetime exemption of $300,000 for each estate.

2. Establish an unlimited marital deduction, and extend those benefits to children of the decedent.

3. Expand the special use valuation, and extend its use to all closely-held businesses where heirs are actively involved in the business--define "active involvement" so that the IRS cannot circumvent the will of Congress, as is so often the case.

4. Eliminate the unified credit; gift and estate taxes should be considered separately; establish a $25,000 per year gift exemption, along with a $300,000 lifetime gift exemption.

5. A maximum tax on estates and/or gifts should never exceed 50%. It is inconceivable that the government should be entitled to more than an heir.

The exemptions and credits should be available to all estates; however, at a minimum, the above exemptions and credits should at least be available in transfers to those actively engaged in the closely-held business. The definition for those actively engaged in the business should be defined to include those beneficiaries of trusts who have any active involvement in the operation of the business.

For years, Congress has given lip service to the concept of the "family farm" as we speak of farm and ranch (including timber) operations. This may well be the last opportunity that Congress has to save the "family farm". What Congress does with Estate Tax Reform will be a message to the American public as to whether Congress feels the individual really is important, or whether the concept of the "family farm" has simply been a cruel hoax perpetrated upon the American public to generate votes during re-election.

We have spent billions to preserve endangered plants, animals, fish, and birds. If individuals really are important to Congress, this is one of the best chances Congress will ever have to prove it.

Senator SYMMS. We will call up the next to the last panel.

The Chair would announce, we do have a very difficult time constraint. The plane I am leaving on leaves at 12:45.

I would like to call up the panel of Lynn E. Stalbalm, William Stimpson, Robert Bellatti, and Donald Knutson.

I have been informed that Senator Armstrong may be able to show up at 12:20. I think if all members would be willing to submit their testimony, maybe we could hear from these last two panels here in the next 15 minutes or so.

I know many of you gentlemen have come a long ways to testify before the committee. We are glad to have your testimony here. I want to assure you that your testimony will be a part of our record. It will be under the consideration of this committee and members of the committee in the ensuing markup which is to come in the next month, I hope, in marking up the President's recommended tax proposal.

I hope we can address and make some real headway with respect to the inheritance and gift tax.

STATEMENT OF LYNN E. STALBAUM, LEGISLATIVE REPRESENTATIVE, NATIONAL MILK PRODUCERS FEDERATION, WASHINGTON, D.C.

Mr. STALBAUM. Mr. Chairman, before I start——

Senator SYMMS. I might mention that Lynn is a former member of the House of Representatives. We are always glad to have him before the committee here.

Mr. STALBAUM. Thank you, Senator. With some embarrassment on that point, I ask to make a correction in my prepared statement, on page 3, in the second paragraph, someone in our staff spelled your name wrong and Senator Grassley's name wrong, indicating you only have 3 cosponsors instead of 31.

If that House Agriculture Committee wasn't so busy with the dairy section yesterday, I would have caught it.

But, be that as it may——

Senator SYMMS. That will be corrected, don't worry.

Mr. STALBAUM. I thank you very much. I apologize for the error.

We are fundamentally supporting, and I represent the National Milk Producers Federation, modification in the estate tax law, primarily as they are incorporated in bill S. 395.

All of these are features which we believe would be helpful to the family type dairy farm which makes up the great share of our cooperatives and membership.

The proposal to increase the estate tax exemption to $600,000 merely covers an average sized dairy farm of 50 to 60 cows. The repeal of the widow's tax will get me brownie points all over America because farm wives have long said, "Why should we have to pay an estate tax when we have worked alongside our husbands in developing this farm estate."

The bill corrects deficiencies in the determination of the special use valuation, both for the determination of the party who is now deceased and for the heirs. We support those.

We support the increase in the gift tax exemption from $3,000 to $10,000.

There are two items which the bill S. 395 does not touch, one of which I would hope could be incorporated in the drafting of legislation.

That is the mechanics of determining special use evaluation.

Some of this was taken up in an earlier hearing, in a subcommittee, by Senator Grassley, on share rentals. It goes further than that in determining comparable properties.

A former home secretary of mine, when I served in the House, is in the legal field, in this activity now, and finds that it is very difficult for him as a lawyer to go out in the country and ask five different people how much rent they are paying on their land.

It would seem to me an appraisal value determining yield on the farm would be far preferable. We would hope the committee would consider something of that type.

The second one, which may take a little bit longer, is, How can we develop a practical way of making gifts in a family farm?

We support raising the limit from $3,000 to $10,000, but you can't give a son who works with you a piece of a tractor or a piece of a silo or even a piece of the acreage unless you are going to conveyance and appraisal and surveys, filing and so forth.

By contrast, people who own stocks and other investments can readily transfer them simply by looking in the morning paper, determining the value of the stock and limit the transfer by gift so it stays under the exclusion if they so desire.

We would hope, over a period of time, and I know we can't do this by the time this legislation is considered, we can work out a more meaningful way of permitting transfers within a family from the parent to a son who has worked with them.

Even in incorporated farms we run into difficulties because the IRS contends the book value of the property does not reflect the actual value of the gift transfer.

Thank you very much, Mr. Chairman.

Senator SYMMS. Thank you very much for an excellent statement.

William Stimpson.

STATEMENT OF WILLIAM H. STIMPSON, CHAIRMAN OF THE BOARD, GULF LUMBER CO., MOBILE, ALA.

Mr. STIMPSON. Mr. Chairman, my name is Billy Stimpson. I am one of three owners of Gulf Lumber Co., a corporation cutting pine timber in Mobile, Ala., with approximately 200 employees.

We buy over two-thirds of our timber from nonindustrial landowners. That is one of the main reasons that I am here to testify today.

Besides that, I am a private landowner myself. I appreciate this opportunity to testify for the forest industries committee on timber valuation and taxation.

Our committee speaks on behalf of more than 5 million timber owners of all sizes and from all regions of the country.

For purposes of this testimony, we also represent 64 forest related associations.

Over 5,000 consumer products come from the forest, products that are essential to education, sanitation, health, and in general speaking, the American way of life.

I come here today, gentlemen, to tell you that our country faces a significant shortage of timber in the decades to come.

The Federal estate tax law must be changed if we are to maintain or increase our timber production.

The real problem, gentlemen, is that I am on the firing line every day, trying to buy timber for our mill. At the same time, I am trying to talk these landowners into properly regenerating these lands that we cut over.

I get these negative answers. I will die before the trees are old enough to cut. There is too much risk because of fire, disease, and storms. You can't prove to me that this is a good investment. There is no annual income like rents or dividends. Also, I am afraid my heirs will have to clearcut all of the timber or either sell all of the land and the timber to pay for the taxes.

Senator SYMMS. On that point, I have wondered why we haven't had more support from some of the so-called environmental groups to come in and testify on behalf of this, because there is no question about it, the grave robbers tax, as you have referred to it in other statements when I heard you speak about it is antienvironmental, because it forces rapid liquidation of timber that may not be ready to harvest.

Mr. STIMPSON. True.

Our committee has actually run computer models on whether it is feasible to invest in expensive site preparation and planting pine trees and it is not possible for them to make a fiscally responsible investment.

We have even plugged in the computer a maximum of 30 percent, a maximum tax rate of 30 percent or a graduated tax of 30 percent and it still is not a real profitable investment.

In other words, I really think it needs to go down to 20 percent, but that is me personally talking.

So what happens is the landowner invests his money elsewhere.

I have talked to three of our outstanding southern forest consultants in the South. They are not advising their clients to spend money site preparing and planting, because they say it is not a good investment and it is not.

Our social emphasis of using taxation to break up accumulated estates at death has blinded us to tax timberland fairly.

Most of the large estates have already been broken up. They have been sold to large corporations or either they have been forced into foundations. But, gentlemen, we do not have to continue this method of fragmentization of timber estates.

Actually, I, like you, Mr. Chairman, personally think that the inheritance tax should be abolished. But this may not be politically feasible.

Therefore, we think the Wallop bill is a good start.

Senator SYMMS. Well, it may not be politically feasible, but I might mention the fact that the American people have elected Ronald Reagan President. He is the most popular President we have had in my lifetime that I can remember of, and that is what he thinks too, that it should be abolished.

So, I don't know why we can't get it done. I refuse to accept the fact that we can't get it done. It is a matter of putting it on the tax code that is being phased out in the next 5 years and get rid of it.

Mr. STIMPSON. I am with you again.

Our committee strongly supports the Wallop bill because of the political feasibility. But, as I said, it does not go far enough. We believe special provisions should be added so that timber itself can be specially valued and a lower rate of tax assessed.

This will keep timberlands in the hands of private landowners and will stimulate increased productivity. It will promote capital formation to get trees in the ground and will help our balance of payments.

I might digress here just for a minute just to say that the major corporations also recognize the fact that the estate taxes do make people sell these lands and they need their moneys to build new plants and replace valuable machinery in these days of such galloping inflation.

They support very strongly as good a tax law as we can get, even though these lands, when they are sold, they are the only buyer that is available.

What I am telling you is that the big corporations are behind us in this effort.

Senator SYMMS. The big corporations end up—they need to be buying modern saws and equipment instead of wasting their money investing it in land. They need to let the private citizens own that and farm it.

I agree with you.

I thank you very much for a very excellent statement.

Mr. STIMPSON. Thank you, sir.

Senator Armstrong has agreed to show up here at 12:10. So, I guess the last panel, unless we can find some other Senator to conduct the hearing—I apologize about this, but I have five suitcases to check and I have to get to the airport to be in Idaho this afternoon. I have to leave in a minute.

If you two can summarize here, here in the next couple of minutes. I don't want to cut you short. If you would prefer to come back at 12:20 you might.

Mr. BELLATTI. I would say a couple of words and come back at 12:10.

Senator SYMMS. Your entire statement will be a part of the record.

If you could just summarize for a minute. I have to recess the committee and leave.

STATEMENT OF ROBERT M. BELLATTI, CHAIRMAN, FEDERAL TAX SECTION, ILLINOIS STATE BAR ASSOCIATION

Mr. BELLATTI. Yes.

I am here, my name is Robert M. Bellatti. I am chairman of the Federal tax section, Illinois State Bar Association.

I am pleased to be here on behalf of our 25,000 attorneys. Basically, what I am here to do is to indicate that we are in favor of estate and gift tax reform. We have expended great efforts in coming up with our own draft of legislation, using bills that have been previously introduced.

We are generally supportive of many of these bills.

Many of our members personally are in favor of repeal. Our association does not have an official position on that, but we do feel that politically, as others have indicated, maybe there is a problem in getting it repealed this year, and if that is not done, we must have estate and gift tax relief this year.

I can report that yesterday, in both the Senate and House of Representatives, our legislation was introduced. It is H.R. 803, in the House, introduced by Congressman Ed Madigan, of Illinois.

In the Senate it is S. 1332, introduced by Senators Percy and Dixon, from Illinois.

We expect there will be a number of additional cosponsors to particular on the House legislation.

S. 1332 goes beyond S. 395, although we would like to highly commend the sponsors of S. 395 for their efforts in bringing attention to these matters.

In particular, S. 1332 deals much more comprehensively with the problems under special use valuation. I would like to stress and then I will quit, because I said a couple of minutes here, we must have more than an increase in the unified credit this year.

We must have the special use valuation provision.

We have a complete disaster on our hands as far as the fairness and equity of the IRS situation under 2032(a).

We feel that our bill, which builds on the Wallop bill in many respects and special use valuation, will be helpful to the committee in coming up with a position.

Before you leave, I would like to say one other thing. These four gentlemen that are on the end, on the last panel, are all from Illinois. They represent different groups, but they are going to tell you why the generation skipping tax should be repealed.

The Illinois State Bar Association has voted in favor of that. Perhaps the greatest single threat to our self-assessment tax system is the generation skipping tax.

It is simply incomprehensible and I know almost no attorneys who express any confidence in understanding it.

Thank you.

Senator SYMMS. Thank you very much. I appreciate your statement. I would just like to compliment the Illinois State Bar for the effort you have obviously made in consideration of coming up with some positive reforms to the current situation.

Don, would you like to submit your statement to the record and summarize it?

STATEMENT OF DONALD KNUTSON, CONGRESSIONAL LIAISON, MINNESOTA FARMERS UNION, ST. PAUL, MINN.

Mr. KNUTSON. Yes; I can summarize in a few minutes, Mr. Chairman.

My name is Don Knutson. I am congressional liaison, Minnesota Farmers Union, St. Paul, Minn.

Do you have a comment?

Senator SYMMS. I was going to say it will have to be very brief. I absolutely have to apologize. I have to leave.

Mr. KNUTSON. Yes.

Senator SYMMS. Go ahead if you can make it in a minute.

Mr. KNUTSON. My remarks here today basically are here to——

Senator SYMMS. Otherwise, you are welcome to come back at 12:20 and participate in the last panel.

Mr. KNUTSON. I think I can wrap it up in a minute or so. My remarks today are basically in reference to Senator Durenberger's bills, S. 360 and S. 858. We are in favor of the $600,000 exemption for the estate tax, and the doubling of the $3,000 per year gift tax.

We do however oppose any proposal to totally eliminate estate taxes for all estates, as we believe such a tax policy would further precipitate the trend to larger farms.

We realize this committee is going to soon compromise on a number of legislative tax proposals affecting small businesses and family farms.

The decisions of this committee, if approved by Congress, will perhaps remedy some of the problems affecting family farmers. However, it is the belief of Minnesota Farmers Union that changing the estate tax and gift tax laws will still leave the most important tax problem facing family farmers unresolved, and that problem is the ability to transfer the family farm prior to death, to succeeding generations.

I bring this problem to the committee's attention at this time, because in many respects the problem parallels the estate and gift tax problems.

Changing the estate tax laws to allow more efficient transfer of farmland often leaves the farm to people who already in their forties and fifties.

We need to get the farms back to people who are 20 and 30 years old to insure the future of American agriculture.

In conclusion, I would again like to voice our support for the various provisions of Senate bills 360 and 858, affecting our members, and again, I urge this committee to continue working on developing programs to get our young people back on the farms.

Thank you.

Senator SYMMS. Thank you very much.

The committee stands in recess until 12:20, and then we will hear from the last panel.

[Whereupon, at 12:01 p.m., the hearing recessed, to reconvene at 12:20 p.m., the same day.]

[Statements follow:]

84-582 O—81——16

national milk producers federation

30 F Street, N. W., Washington, D. C. 20001
(202)393-8151

Patrick B. Healy
Secretary

The National Milk Producers Federation is a national farm commodity organization representing virtually all of the dairy farmer cooperatives and their dairy farmer members who serve this nation by producing and marketing milk in every state in the Union.

Since its inception in 1916, the Federation has actively participated in the development of dairy programs which are a part of a total system of agricultural law and policy which can appropriately be termed a national food policy.

The policies of the Federation are determined by its membership on a basis that assures participation from across the nation. The policy positions expressed by NMPF are thus the only nationwide expression of dairy farmers and their cooperatives on national public policy.

Before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

of the COMMITTEE ON FINANCE

UNITED STATES SENATE

With regard to

Major Estate Tax Issues

June 5, 1981

Lynn E. Stalbaum
Legislative Representative

<u>Summary of Testimony</u>

Because of the increasing value of the investment in a typical dairy farming operation the National Milk Producers Federation has long been interested in the impact of estate taxes on the continuing operation of such units, including a transfer through inheritance.

Of the several bills currently before the Senate it believes that bill S.395 is the most practical current vehicle to update estate tax law. The Federation supports all of its provisions. These are: (1) To increase the estate tax exemption from $175,000 to $600,000; (2) To repeal the so-called "widows tax"; (3) To correct deficiencies in present law on determining special use valuation; and (4) To increase the gift tax exemption from $3,000 to $10,000.

In its testimony the Federation raises questions about two specific areas which, in its opinion, are not covered by any of the pending Senate bills. These relate to the mechanics of determining the special use valuation and to the difficulties of making gifts of farm assets.

The National Milk Producers Federation is the national farm commodity organization representing dairy cooperative marketing associations owned and operated by dairy farmers throughout the nation. Most of the nation's milk supply is marketed through the cooperative associations represented by the Federation. It is the only organization whose policy represents a national concensus of dairy farmers. As such it has long been interested in legislation, including that relating to estates and gifts, which directly affects the structure and effectiveness of dairy farms.

Your committee is to be commended for its consideration of badly needed changes in estate and gift tax law, particularly as they relate to family farms. It is worth noting that when the exemption from estate taxes was set at $60,000 in 1942 it far exceeded the equity found in a typical dairy farm at that time. Today the $175,000 exemption lags behind the value of such an estate and even those modifications which are being most seriously considered barely cover the value of an average operation of this type.

While there are larger dairy farming operations in some parts of the country, the average commercial dairy farm today is one with 50 to 60 milking cows, operated on 300 to 400 acres of land. A conservative appraisal of this type of operation reveals the following values:

Land at $1,000 per acre	$300,000	to	$400,000
Milk cows at $1,200 per head	60,000	to	72,000
Replacement stock at $600 per head	10,000	to	15,000
Feed	10,000	to	15,000
Equipment (tractors, etc.)	75,000	to	100,000
Total	$455,000	to	$602,000

The most commonly proposed adjustment in exemption is to $600,000. From the above it can be seen that this barely covers an average dairy operation and with the present inflationary trend that will shortly be surpassed.

The point we are making is that the adjustments which are being considered are not a bonanza for some super-sized operation. They barely cover an average operation.

The Senate has before it a number of bills which modify the estate and gift tax laws in varying degrees. It is our belief that bill S.395, introduced by Senator Wallop, co-sponsored by Senators Syms, Grassly, Boren and Byrd and three other Senators, is a realistic and practical proposal to correct a number of inequities which now exist. Permit a brief comment on each aspect of this piece of legislation.

Increasing the exemption from $175,000 to $600,000. As discussed above, an adjustment of this type is necessary to more realistically reflect the value of a present-day family-type dairy farming operation. If this committee or the Senate were to consider increasing this adjustment even further we would support such a move.

Failure to make adjustments in the existing exemption level will continue the problem we have sought to overcome--the jeopardizing of a family farm structure in order to pay the estate tax. As inflation persists, the progressive schedule of estate tax rates will only tend to make this situation worse. An adjustment is badly needed now.

Repeal of the "widows tax". No other facet of estate tax law has distressed dairy farmers more than the requirements that an estate tax was due on transfer to a spouse. Prior to the changes in law made in 1976, these were extremely onerous because they totally failed to recognize the role of the farm wife in the development of equity in a family farm. Nowhere is this more true than in dairying, where the day-to-day nature of the operation has prompted the wife to work directly with her spouse in livestock husbandry and in the maintenance of facilities and equipment.

The 1976 legislation was a decided step in recognizing her role by crediting one-half of the farm estate (or $250,000 if higher) to her.

But--logically--why should there be any tax obligation when property transfers in good faith to a spouse, particularly when the spouse has been a participant in the development of the estate? Repeal of this provision is a welcome section of bill S.395.

Special use valuation. Bill S.395 also corrects some deficiencies which have been found to exist in current law, particularly with regard to material participation in the farming operation, both by the decedent and by the heirs.

This bill is designed to correct a most serious anomaly which had developed under existing law. For property to qualify the decedent had to materially participate in its operation at the time of death. Conversely, if he did so he was not eligible to collect Social Security benefits if he materially participated and the income exceed the earned income limitation under that program. S.395 recognizes and corrects this problem.

Similarly the special use valuation benefit, under present law, is lost if the heir does not continue to operate the farm. Unwittingly this has inflicted a hardship on one of the types of cases which the law was intended to benefit--the young widow, probably with small children, who, for legitimate reasons, could not physically take over the farming operation. S.395 provides relief in this type of case.

We feel, however, that S.395 has failed to address one serious problem area relating to special use valuation. That is the mechanics of determing such value. Much of this stems from the need to determine comparative values in other properties. In one Wisconsin case the special use valuation could not be taken on a barn, because no other barns were rented separately nearby. The same estate almost lost this benefit on its land because of the reluctance of other farmers to divulge their leasing agreements.

Other problems have arisen, notably on share leasing and on rather strict interpretations of this provision of law by IRS.

It would therefore seem far more preferable to have the special use valuation determined on some appraisal basis of the farm. Such appraisal might be on a yield basis, which could then be converted to an agricultural value.

We encourage your committee to consider this problem and offer our cooperation in finding a viable solution.

Increase in gift tax exemption. Incredible as it may seem the present gift tax exclusion has remained at $3,000 for 35 years. If it was a reasonable figure when enacted it is totally unrealistic now. Adjustment to $10,000, as is proposed, is long overdue.

There is, however, a problem in connection with transfers of farm assets by gift, regardless of the exemption level. Farm operators often desire to transfer the farming operation to a son in an orderly manner. This is particularly true where the son has been involved in the farm enterprise. A logical way to do this would be to transfer an increment of the farm, by gift each year, thereby gradually increasing the son's share of the farm equity.

Currently, even if the gift tax exemption is increased, this is all but impossible physically. A farmer cannot give his son a piece of a tractor or a piece of a silo. He cannot eve transfer a portion of the acreage except by a cumbersome appraisal, survey and recording process.

Even if the farm is incorporated, difficulties are encountered in determining the value of the share of stocks which are being transferred.

By contrast the owner of corporate stock has no such problem in making a gift. He need only check the current stock quotation (usually listed in his daily newspaper) and then limit his gift of stock accordingly to stay within the legal exemption.

It is hoped that ultimately a meaningful approach can be developed which will permit the transfer of farm assets by gift as readily as other types of assets can be so transferred.

In summary, an area as complex as estate tax legislation has so many components that no one bill fits every person's concept of all that should be done. Bill S.395 does much, however, to recognize existing problems and offer meaningful solutions. We, therefore, urge its passage.

Forest Industries Committee on
TIMBER VALUATION AND TAXATION

1250 Connecticut Avenue, Washington, D.C. 20036 (202) 223-2314

SUMMARY AND STATEMENT OF

WILLIAM H. STIMPSON
CHAIRMAN OF THE BOARD
GULF LUMBER COMPANY, INC.

ON BEHALF OF THE

FOREST INDUSTRIES COMMITTEE ON
TIMBER VALUATION AND TAXATION

BEFORE THE

SUBCOMMITTEE ON ESTATE
AND GIFT TAXATION

COMMITTEE ON FINANCE

U.S. SENATE

WASHINGTON, D.C.

JUNE 5, 1981

Mr. Chairman, I appreciate very much this opportunity to testify on behalf of the Forest Industries Committee on Timber Valuation and Taxation. Our Committee speaks on behalf of more than five million forestland owners of all sizes and from all regions of the country. For the purposes of this testimony we also represent 68 forest-related associations, including the American Paper Institute, American Plywood Association, American Pulpwood Association, Forest Farmers Association, Industrial Forestry Association, National Forest Products Association, and Southern Forest Products Association. A list of the 68 associations is attached to this testimony as Appendix A. (Made part of official Committee records.)

The principal public policy objective of our Committee is the attainment and preservation of equitable Federal tax provisions that reflect the long-term nature of forest investments and the unique risks involved.

We come here today to stress one simple fact: Our country faces a significant shortage of timber in the decades to come. The Federal estate tax law must be changed if we are to maintain or increase timber production in this country. Excessive Federal estate taxes now deter reforestation and force premature harvesting on our nation's private forestlands. To this extent our tax policy interferes with our attainment of the wood and fiber requirements of future generations of Americans.

We support Senator Wallop's bill, S. 395, the general provisions of which allow:

(i) a Rate Reduction and Increased Unified Credit,

(ii) an Unlimited Marital Deduction, and

(iii) an Increased Annual Gift Tax Exclusion.

But I would like to focus today on timberlands. We especially support the bill's amendments to Section 2032A, which provide an alternative special use valuation for timberlands, and believe the bill should go further. Special provisions should be added so that timber itself can be specially valued according to the income it produces, or, in the alternative, at 50 percent of market value.

I. Ensuring Timber Supply: A National Goal

We start with the premise that ensuring an adequate timber supply is a vital national goal.

A. Timber Supply and Demand

The Forest Service projects that domestic demand for paper and wood products will double by the year 2030. The Forest Service projects demand for paper and wood products to reach 28.7 billion cubic feet in the year 2030, up from 13.3 billion cubic feet in 1976. Table I summarizes the projected supply/demand situation:

Table I

Summary of U.S. supply and demand for softwoods and hardwoods in 1976 and for 2030*/

Category	- Billion Cubic Feet - 1976	2030
Softwoods		
Total U.S. demand	10.3	19.9
Exports	1.3	1.0
Imports	2.4	3.9
Demand on U.S. forests	9.2	17.0
Supply from U.S. forests	9.2	13.5
Supply/demand balance	0.0	-3.5
Hardwoods		
Total U.S. demand	3.0	8.8
Exports	0.2	0.4
Imports	0.3	0.6
Demand on U.S. forests	2.9	8.6
Supply from U.S. forests	2.9	7.7
Supply/demand balance	0.0	-0.9
All timber		
Total U.S. demand	13.3	28.7
Exports	1.5	1.4
Imports	2.7	4.5
Demand on U.S. forests	12.1	25.6
Supply from U.S. forests	12.1	21.2
Supply/demand balance	0.0	-4.4

Source: U.S. Forest Service

One reason that insufficient timber supplies are projected for the future is because excessive Federal estate taxes have deterred reforestation and have forced premature harvesting on our nation's private forestlands.

*/ Assumes price rises similar to those experienced from late 1950's to mid-1970's.

The Forest Industry Council's Forest Productivity Project shows the enormous need for reforestation and for carefully managed harvesting. For example, on private, non-industrial timberlands, only one out of seven acres in the Southwest and one out of nine acres in the South Central region are being adequately regenerated.

B. Importance of Timber Growing to National Economy

Over 5,000 consumer products are derived from our forests--commodities which are essential to education, communication, sanitation and health and many of which contribute in unique ways to the maintenance of the American standard of living. A side benefit is that growing forests contribute significantly to the overall ecosystem.

Forest Service statistics show that for every dollar that is invested in timber management, a total of $17 is generated in other economic activity. This is illustrated in Table II.

Table II

Estimated value added and employment attributable to timber in timber-based economic activities, 1972

Economic activity	Value Added (MMM$) Attributed to timber	Employment (MM People) Attributed to timber
Timber management	2.9	0.1
Harvesting	3.1	0.2
Primary manufacturing	8.8	0.4
Transportation and marketing	9.3	0.8
Secondary manufacturing	12.5	0.9
Construction	11.9	0.8
Total	48.5	3.2

Source: U.S. Forest Service, Unpublished

The reference to "timber management" in Table II indicates that the value of timber that was harvested in 1972 was $2.9 billion on the stump. Harvesting added $3.1 billion in value, primary manufacturing added $8.8 billion, etc.

Thus, an incentive to help private nonindustrial forest owners manage their lands rather than neglecting them will benefit the entire nation.

C. Environmental Considerations

Unlike other basic resources, forests are renewable. Timber, a storehouse of solar energy, is most compatible with man's use in his present environment because of its strength, its versatility, its ease of production, and its biodegradability.

In addition to the quality of renewability, wood has significant environmental advantages over other materials in the processing stage. Timber products are produced and processed with much lower energy requirements and with relatively little adverse environmental effect. Processing steel for construction, for instance, takes four times the energy of processing lumber for the same purpose. For aluminum, it takes 20 times the energy.

Production of wood substitutes also creates more air, water and solid waste pollution than does the production of wood. Much of wood fiber can be recycled. What is not is biodegradable and returns to the earth. Charts I and II compare the low energy and pollution cost of processing solid wood products compared with other substitutes.

Chart I

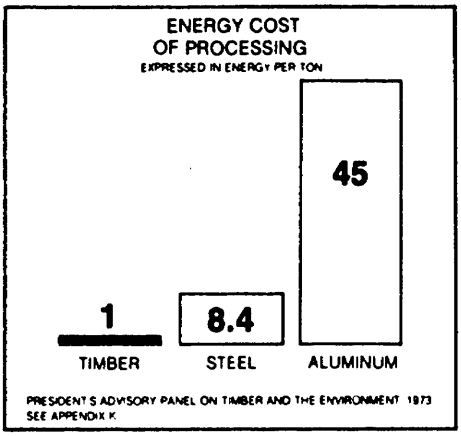
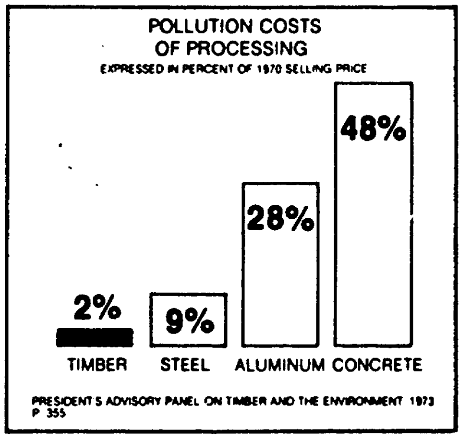


Chart II



Moreover, timberlands help provide a home for our wildlife, support livestock herds, and provide recreational opportunities.

D. Impact on Inflation

If our tax policies create a reduction in timber production, severe shortages may result. Historically, such shortages have exerted pressure on the price of wood building materials and housing. The effects are felt throughout the entire economy.

E. Balance of Payments

With prudent scientific management, wood and fiber products could go a long way toward improving our balance of payments. Lee Smith's article in the November 5, 1979 issue of Fortune magazine, entitled "The Neglected Promise of Our Forests," outlined the following facts:

> The United States is peculiarly well endowed to be the most efficient producer of useful wood in the world. Competitors, chiefly Canada, Scandinavia, the U.S.S.R., and Brazil, all have special strengths, but no other country has such a favorable combination of advantages as the U.S., including high-quality species of trees, warm climate, relatively low labor costs, an extensive transportation network, and abundant factories to turn trees into everything from Pampers to rocking chairs.
>
> Yet the U.S. trade deficit in forest products has tripled in the Seventies. Last year it reached a record $2.9 billion, 7.4 percent of the nation's total $39-billion trade deficit. In an era when the U.S. is being drained of dollars to pay the staggering cost of foreign oil, it is paying a needlessly hefty sum to import wood and paper despite its enormous stands of trees.

F. Difficulty of Attracting Capital

It is estimated by forest economists that an investment of $5.3 billion would be required to adequately stock or convert the 51.5 million acres of potentially productive timberlands which are non-stocked, poorly stocked, or in need of conversion to another species. Such an investment would result in a net gain in annual growth of 5.4 billion cubic feet.

Unfortunately, however, forest landowners know all too well the hazards of forest investments. You hear these kinds of comments:

1. I'll die before the trees are old enough to cut.

2. There is too much risk of fire, disease, and storms. Casualty loss insurance is simply not available on standing timber at any price.

3. The initial capital investment costs (land preparation, roads, plantings) and annual maintenance costs are higher than ever before.

4. There is no annual income, like rents or dividends.

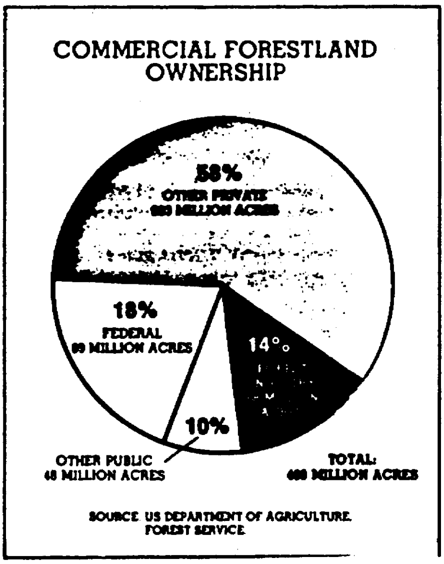
5. I'm scared that Uncle Sam will take whatever profits I make away from me with confiscatory taxes.

Easing the burden of estate taxes would be an important step in correcting the problem outlined above.

II. Increase in Timber Supply Must Come From Private Nonindustrial Landowners

Chart III shows the distribution of forestland ownership in this country. Of the categories shown, the greatest potential for increased production comes from the 283 million acres owned by 5 million private landowners. In general, these lands are not intensively managed for timber production and produce wood at only about 63 percent of their potential.

Chart III



In contrast, public lands are under constant pressure for uses other than commercial forestland. Harvest levels are nearly static and funds perennially have not been provided for adequate forest management. The industry lands comprise only

14 percent of the total and are producing at close to their full potential. It is therefore less feasible to achieve significant improvements in timber production from industrial or public lands than from nonindustrial private lands.

III. Tax Policy: An Effective Incentive

In any discussion of the impact of tax policy on forest productivity, it is essential to emphasize at the outset that absent the same capital gains treatment that is applicable to all capital assets, there are no ongoing special tax benefits for growing timber. There is nothing, for example, in timber tax treatment comparable to percentage depletion. The "cost depletion" applicable to timber is nothing more than the same "cost recovery" applicable to other capital assets and is not taken into account until the timber is sold.

In 1944, Congress extended capital gains treatment to the full range of qualified timber transactions rather than only to lump sum, liquidation-type sales. What followed was the most dramatic change in growth and planting in the history of American private forestry.

Charts IV and V show the impact in terms of U.S. timber growing stock and annual plantings in private forests. Prior to 1944, seven billion cubic feet more timber was harvested than was grown annually. Since 1944, we have grown an average of over four billion cubic feet more than we harvested each year, a substantial net gain.

And, in the case of planting, annual plantings on private lands have increased from practically zero to over one million acres per year.

Chart IV

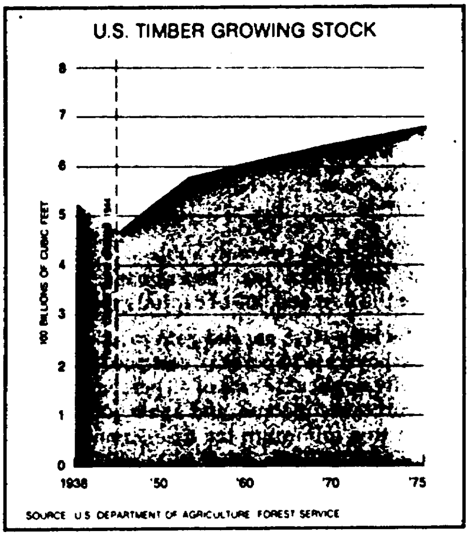
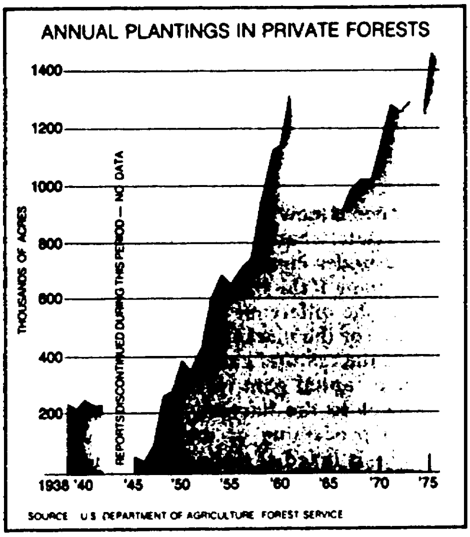


Chart V



IV. Why the Current Estate Tax Cuts Down Productivity on Private Nonindustrial Forestlands

The current estate tax lowers productivity for two basic reasons. First, the estates of landowners are often forced to cut timber before its proper time in order to pay the estate tax. Articles that we have attached as Appendix B underscore this point.

Cutting younger trees before they have reached optimal harvestable size is bad management. Depending on the region, tree species and forest management practices, timber crops take between 30 and 100 years to reach harvestable size. It is during the latter part of this lengthy growing period the timber will be increasing in value most rapidly.

Rapid liquidation of timber just to meet tax liabilities is bad forestry in that it may not coincide with either optimal biologic or economic management considerations.

The second reason the estate tax lowers productivity is that it discourages reforestation. As Mr. Larson of our Committee noted earlier, studies have shown that the present law reduces the rates of return on growing timber below the level required for continued investment. An owner usually will replant solely in order to benefit his heirs. I emphasize again, the average growing time for mature trees ranges from 30 to 100 years, which is usually long after the death of the planter. Yet, before the trees grow to a size that will yield a fair return, the owner will die and the trees will be cut in order to pay estate taxes. Neither the owner nor his heirs will ever see a fair return on the initial investment.

The importance of the long-growing period is further underscored by an American Forest Institute survey which shows that 37 percent of all tree farmers in 1972 were over 60 years old and 28 percent were between 50 and 60 years of age. These statistics indicate that 65 percent of the owners of private forestlands could be involved in estate tax proceedings between now and the end of the century. Thus, the impact of the estate taxes may be larger than for other asset groupings with a different ownership pattern.

The result of this scenario is a matter of simple economics. We have reached the point among timber owners where the obvious adverse economics are redirecting investments away from forestry. Owners are shying away from replanting after harvest and intensive management is being curtailed.

V. <u>Section 2032A and the Wallop Bill</u>

We believe that one effective way to reduce the excessive tax burden on timberlands is through the special use valuation provision found in Section 2032A. Section 2032A of the Code was clearly intended to provide at least a measure of relief by placing a lower special use valuation on woodlands, as well as other farmlands. Unfortunately, however, special use valuation has been placed beyond the reach of many private timberland owners. As I indicated earlier, there are five major problem areas with the law as it now applies to timberlands. Three of these the Wallop bill addresses; two it does not.

A. Percentage Requirements
(Section 2032A(b)(1)(A) and (B))

As the law currently stands, 25 percent of an estate must be comprised of timberland "real property" and 50 percent timberland related "real" or "personal property" in order to qualify for the special use valuation.

Unlike other farmland or closely held businesses, timberland is not the principal source of livelihood for many private owners. Section 2032A's percentage requirements make the special use valuation unavailable to many small owners whose timberland holdings are not the major asset in their estates.

In addition, even when timberland is the major asset of an estate, the Internal Revenue Service has interpreted the statute in such a way as to eliminate again the benefit of the special use valuation. See Appendix C.* When land containing timber is valued, the value of the timber may not be counted as real property in the 25 percent test, although it is counted in valuing the whole estate. Timber, however, is often worth many times more than the land itself. Obviously when the

* Made part of Committee's official file.

land by itself is worth less than 25 percent of the whole estate, the timberland estate will not qualify for the special use valuation. As a result, the only timberland that will ever qualify for special use valuation will be land that has been clearcut or that contains a poorly stocked stand of timber.

If the pattern of small ownership of timberlands is to be continued and encouraged, these percentage requirements should be eliminated in the case of timberland. Section 6(a) of the Wallop bill corrects this problem.

B. Material Participation Requirement (Section 2032A(b)(1)(C)(ii))

Current Section 2032A(b)(1)(C)(ii) requires the decedent or a member of his family to have "materially participated" in the operation of the timberland to qualify for special use valuation. It is extremely difficult to meet this requirement in the case of timberland. Most privately owned timberland operations do not require day-to-day management decisions and material participation of the owner. As the Wallop bill proposes in Section 6, the material participation requirement should not be applicable to timberland.

C. The $500,000 Limitation (Section 2032A(a)(2))

As the law now stands, the most by which the value of real property in an estate can be reduced by the special use valuation, is $500,000. However, the double-digit inflation of recent years has dramatically increased the appraised value of timberland, and this $500,000 figure is now obsolete. We, therefore, support the provision of the Wallop bill that repeals this limitation.

D. Special Use Valuation Methods (Section 2032A(e)(7) and (8))

One problem that the Wallop bill should be amended to correct involves the methods currently used for arriving at the special use valuation. Current law under subparagraph (e)(7) permits farm property to be valued solely on the basis of the average annual gross cash rental for comparable property. This valuation method is virtually meaningless in the case of timberland. Often there is no comparable property for which cash rental figures can be obtained. In addition, comparable property is usually not rented for "cash." Finally, the formula in (e)(7) does not work well because timberland does not produce a recurring annual crop. Often, timberland is harvested in commercial quantities only once every 10, 20 or even 30 years.

To solve this problem the Wallop bill ought to be amended to provide an additional special use valuation formula that an executor may elect for timberland. This formula should determine the special use valuation by dividing:

(i) the excess of the average annual income which the property can be expected to yield in its current use over the amount of the average annual State and local real estate taxes for such qualified real property, by

(ii) the average annual effective interest rate for all new Federal Land Bank loans.

The computations made under the preceding sentence shall be made by determining the expected yield over a reasonable period of time under prudent management, taking into account current stocking, soil capacity, terrain configuration, and similar factors.

This alternative is essentially the same approach taken in current Section 2032A(e)(8)(A). Section 2032A(e)(8)(A) is one of the five factors of (e)(8) that current law allows to be taken into account in the valuation of qualified real property.*/

In addition, we propose another alternative for situations where the executor either cannot or does not use the aforementioned formula. Instead of permitting property to be valued under the highly subjective five factor method now used in (e)(8), we suggest eliminating current (e)(8) and allowing the executor simply to value qualified property at 50 percent of its fair market value.

Finally, it is not clear under current law whether an election to use a particular method of valuation is irrevocable. Because of disputes that may arise in audit concerning certain aspects of formula valuation, it may be advantageous for an executor to change his method of valuation. As a

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*/ This method is further supported by a recent U.N. study. *See* U.N. Economic Commission for Europe, *Effect of Taxation on Forest Management and Roundwood Supply*, (50-51) XXXIII Timber Bulletin for Europe (1980 Supp. No. 4).

solution to this problem, we suggest allowing an executor to change his method of valuation to the 50 percent method, described above. This new election could be made at any time before the statute of limitations for assessing additional estate tax has run.

E. Availability of Special Use Valuation for the Timber Itself

As I mentioned previously, Section 2032A on its face states unequivocably that timber is to be granted a special use valuation. The Section is designed to preserve family-owned timberlands and to encourage capital investment in reforestation. However, the Internal Revenue Service's interpretation of Section 2032A and "timber" has made the special use valuation unavailable.

To remedy this problem, the Wallop bill should be amended to provide that timber qualifies as "real property" "used for a qualified use" under Section 2032A. This would insure that timber could be specially valued under the methods of current Section 2032A. As an additional incentive for capital investment in reforestation, we also recommend that executors have the option of giving timber a special use valuation of 50 percent of its fair market value.

VI. Summary

The current estate tax law interferes with our attainment of an adequate supply of wood and fiber for the future. The estate tax law should be amended so that it encourages reforestation and proper management techniques.

The Wallop bill's amendments to the special use valuation provision, Section 2032A, are a step in the right direction. We also believe the bill should include provisions that allow timber to be specially valued according to the income it produces or, in the alternative, at 50 percent of market value.

Minnesota Farmers Union
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My name is Don Knutson, congressional liaison for the Minnesota Farmers Union in St. Paul. Minnesota Farmers Union is a general farm organization representing more than 24,000 family members in our home state.

I appreciate the opportunity to submit testimony to this committee on an issue our organization perceives to be of vital importance: the taxation and transfer of farm land. My remarks today will be in reference to the tax proposals submitted to Congress by Senator Dave Durenberger (S.360).

Minnesota Farmers Union supports the provisions of S.360 affecting family farmers. The major points of interest, as we see them, are the measures increasing the estate tax exemption to $600,000 and the doubling of the per year gift tax exemption to $6,000 per donee. We do, however, oppose any proposal to totally eliminate estate taxes for all estates as we believe such a tax policy would further precipitate the trend to larger farms. The doubling of the per year exemption is a timely increase in light of the inflation rate since the $3,000 limit was first enacted into law.

Historically, estate taxes were conceived by Congress as a method to prevent excessive accumulation of wealth. In retrospect, estate tax laws have tended to force the largest estates to be divided upon the death of the owner. In recent years, however, the increased value of farm land caused by population growth, expanded food demand, the nation's inflation rate, and pure land speculation have caused even average sized farmers considerable estate tax problems. The proposed $600,000 estate tax exemption is a sizable exemption, but with land values in excess of $2,000 per acre in many regions of the Midwest the actual exemption would permit an heir to inherit less than 300 acres tax free.

Under our present estate tax laws, the same 300 acres of farm land too often has to be sold outright or divided and sold just to pay the tax liability. It needs to be emphasized that estate taxes were intended by Congress to break up the largest estates, not to confiscate the smaller ones.

Corporate investment in farming is an issue that should concern all Americans. The Minnesota state legislature has been a leader in passing laws preventing the spread of corporate ownership of farm land in our state. Minnesota Farmers Union believes Congress should also do what it can to stem the tide toward corporate farming. For this reason, we suggest that the "capital formation" provision of S.360 should not apply to farming enterprises organized as small business corporations. The investment tax credit incentives called for in the capital formation section, for example, could lead to the formation of small business farming corporations capable of owning thousands of acres of prime agricultural property.

We understand this committee will soon compromise on a number of legislative tax proposals affecting small businesses and family farms. The decisions of the committee, if approved by Congress, will perhaps remedy some of the problems confronted daily by our nation's farmers. However, it is the belief of Minnesota Farmers Union that changing the estate and gift tax laws will still leave the most important tax problem facing family farmers unresolved. The problem is the ability to transfer the family farm to succeeding generations at a price and at terms suitable for a beginning farmer.

I bring this problem to the committee's attention at this time because in many respects the problem parallels the estate and gift tax problem. Changing the estate tax laws to allow more efficient transfers of property upon death often results in the estate being handled by the oldest surviving child. In short, the oldest surviving child is often in his or her 40's or 50's before the estate is transferred.

This committee needs to study this issue and work to develop tax legislation that encourages farm land transfers to younger, beginning farmers. Under our present laws, older farmers nearing retirement age often can really only sell their farms to established farmers with sound assets and credit records. Young people interested and knowledgeable about farming simply cannot cope with IRS regulations regarding imputed interest rates and fair market value determinations. Additionally, older farmers are naturally concerned that selling their property at a "reduced rate" to give a beginning farmer a chance will result in a gift tax liability long after the property is officially transferred.

We see the need for Congress to approve tax legislation aimed at allowing qualified beginning farmers to purchase a farm at less than a fair market value price and at an interest rate the young farmer can live with. Such a federal program along with estate tax reforms proposed by Senator Durenberger are parallel in that both would marginally reduce federal tax revenue while helping to insure the long range vitality of American agriculture.

In conclusion, I would like to again voice our support for the various provisions of S.360 affecting our members, and I urge this committee to continue work on developing programs to encourage our young people back to the farm.

Thank you.

Senator ARMSTRONG [acting chairman, presiding]. The committee will continue its deliberations with a panel on the subject of generation skipping tax.

May I apologize for the delay. We are spread a little thin here today. I apologize that I was not able to arrive before my predecessor had to excuse himself.

I do regret the delay.

The next panel consists of Mr. Douglas S. Keyt, Mr. Malcolm A. Moore, Mr. W. Timothy Baetz, Mr. Randall J. Gingiss, and William P. Sutter.

Mr. KEYT. Mr. Chairman, if you would not have any objection, we from Chicago have coordinated our testimony.

We would like to start off with Mr. Sutter, followed by myself and then Mr. Gingiss and Mr. Baetz, if that would be agreeable to you.

Senator ARMSTRONG. Please do so, and just proceed in whatever way you feel would be most constructive to the committee.

Mr. KEYT. Thank you very much.

STATEMENT OF WILLIAM R. SUTTER, PAST PRESIDENT, ILLINOIS BAR ASSOCIATION

Mr. SUTTER. Thank you, Senator.

I am William P. Sutter. I am a past president of the Illinois Bar Association and a lawyer that has practiced in estate planning and the Federal Tax Code work for 35 years.

All four of us from Chicago will present the unified front in favor of repeal of what we believe to be the most totally indefensible tax in the Internal Revenue Code which is to say the generation skipping tax.

It is with some sense of deju vu that I am here, because 8 years ago, I appeared before the House committee and testified that simplicity in taxation was a lot more important than somebody's idea of what might conceivably be equity.

When the equity was newly perceived or the inequity was a newly perceived inequity that nobody has seen for the entire existence of the estate tax, it wasn't much of an inequity and if it brought great complexity, it was a mistake.

At that time, I was talking about carryover basis, capital gains at death and the generation skipping tax.

Unfortunately a couple of years afterward we got both carryover basis and the generation skipping tax.

Immediately thereafter, the disaster that carryover basis was became evident to virtually everybody and it wasn't so long before it was repealed with virtually no opposition whatsoever.

Today, we, as well as other previous witnesses urge that the generation skipping tax follow carryover basis into the limbo to which well-intentioned, but totally unworkable taxes should go.

The only justification for the generation skipping tax if there is one, is there ought to be some kind of a tax on capital transfers once every generation.

That, of course, runs contrary to the other policy of capital formation, trusts, invest in stocks and bonds and make money available for investments.

But more to the point, it doesn't in fact impose a tax on transfers every generation, as these gentlemen will point out, the wealthy can avoid it and so forth.

My point is simply to discuss and stress that it is absolutely incomprehensible to anybody. There are no lawyers, with the exception of a very few who specialize in this field that can possibly understand it.

There are certainly no laymen who can understand it without endless coaching and there are very few trust officers who can understand it.

When you have a tax that is that complex, then only a few people know to whom it applies, when it applies and how best to avoid or minimize it.

Under those circumstances the tax will be either completely ignored by taxpayers or if they have experts they may have to pay it, which is unfair, or they will be expert enough to find a way around it, which is unfair again.

Tax collectors cannot enforce it except the most sophisticated revenue agents. As a consequence, when it is enforced, it will be enforced almost entirely against people in the middle classes, without high priced and skilled counsel.

That isn't the kind of tax that enhances the respect of the public for our system of laws. It doesn't raise any revenue. The revenue estimates are absolutely minimal and it is a tax which in short really is an evil worse than any perceived inequity which it is designed to correct.

I am not going to try to talk about all of the funny things in the tax. But, just for example, it is possible to give $250,000 to a grandchild that is not subject to tax, even though the grandchild spends it all on riotous living, as Senator Long was speaking about this morning.

A second grandchild comes along and gets $250,000 to provide for lifetime medical care because of a drastic illness and that $250,000 will be subject to a tax of at least $23,000 and perhaps a great deal more because of the peculiar way in which the grandchild exclusion works.

You can have two children, a brother and a sister, who are assigned to two different generations and a transfer to the one will be totally tax free. The transfer to the other will be totally taxable in the right situation.

You can have a parent and a child who are assigned to the same generation. You can have a parent and a child who are assigned as a first and a third generation.

It is absolutely impossible for anybody to believe that these things are true. They are true. I touch on them in a little detail in my paper. This is a tax which is evil, and should be abolished.

Thank you, Mr. Chairman.

Senator ARMSTRONG. Thank you very much.

Mr. Keyt.

STATEMENT OF DOUGLAS S. KEYT, VICE PRESIDENT, THE NORTHERN TRUST CO., CHICAGO, ILL.

Mr. KEYT. Mr. Chairman and members of the committee. My name is Douglas S. Keyt and I am a vice president in the trust department of the Northern Trust Co. in Chicago, Ill.

The Northern Trust Co. is a major financial institution and has been providing trust services since it was founded in 1889.

Through its trust subsidiaries in Florida and its trust department in Chicago, we administer personal trust accounts with assets valued at nearly $6 billion.

This makes the Northern Trust Co. the largest personal trust operation in the United States.

At the Northern Trust Co. I am responsible for the tax and accounting services that are required in the administration of probate estates and personal trust accounts.

My purpose in coming here today is to attempt to describe for you some of the administrative difficulties we have experienced since the generation-skipping transfer tax was passed nearly 5 years ago as part of the 1976 Tax Reform Act.

We respectfully suggest these provisions are so complex that they are incapable of administration or enforcement and should be repealed.

Your subcommittee is considering a number of proposals which call for major transfer tax reform. Issues relating to such things as reduction in the estate and gift tax rates, increase in the unified estate and gift tax credit, increases in the marital deduction, and so forth, are indeed very important and significant issues for this subcommittee to consider.

As my comments and those of several of my colleagues here today demonstrate, the generation skipping transfer tax, a tax, which since its enactment in 1976, to the best of my knowledge, has generated little or no revenue, is frought with all kinds of uncertainties and is extremely costly to administer.

Consequently, repeal of these provisions is likewise a major estate and gift tax transfer that merits your full consideration and support.

First, permit me to describe for you briefly some of the efforts that we have undertaken at the Northern Trust Co. in the last 4½ years in an effort to comply with this law.

Over the past 4½ years, I and members of my staff have spent in excess of 3,500 hours, attempting to understand and apply the tax statute and its regulations.

In addition to this, attorneys in our legal department have spent more than 5,000 hours trying to assist us in understanding the law and identifying trusts to which it applies.

The very moderate rate of $30 per hour, this represents an expense for the Northern Trust Co., and more importantly to its beneficiaries and trust customers of over a quarter of a million dollars.

Not included in the above are the numerous hours we have had to spend writing explanatory material, trying to educate our personal trust administrators who are on the frontline trying to administer this tax.

What is particularly frightening about all of this is that after all of these efforts I can only say that perhaps four or five people within our organization would even profess to have even a moderate understanding of this tax.

It should also be noted that after all of this effort, we have yet to identify our first taxable distribution or our first taxable termination, let alone pay our first penny of generation skipping transfer taxes.

What is more, in attempting to comply with the law in the future our costs can only go up.

The second major point I would like to make is that the extent chapter 13 is enforced, it will be the individual of more moderate means, in other words, America's already overtaxed and overburdened middle and upper middle classes.

That will bear the brunt of the generation skipping tax and the cost of administration.

These are the very people that quite properly should use trusts for the protection of families from a very uncertain and most likely a very inflationary future.

You may be interested to know that the Northern Trust Co. administers nearly 7,000 personal trust accounts for the benefit of more than 20,000 beneficiaries.

More than 40 percent of these trusts are valued at less than $250,000 and more than 70 percent of these trusts are valued at less than $500,000.

In this day and age, considering the ravages of inflation and the effects it has had on the cost of education, medical care, general cost of living for which many trusts are designed to protect against an estate of $500,000 or even $750,000 can no longer be considered substantial.

Also keep in mind these are the people who during their middle years, are the entrepreneurs and producers who are most likely to be motivated by our capitalistic system.

These individuals subscribe to the principle that something should be set aside and invested each month to protect themselves and their families from financial hardship in the future.

In other words, these are the people for whom the trust vehicle is a valid estate planning vehicle.

In summary then, I would suggest that if professionals cannot understand the tax, consider the difficulty the individual fiduciaries as well as corporate fiduciaries will have in attempting to comply with the tax. I would suggest that it cannot be done and recommend that chapter 13 be repealed.

Thank you for the opportunity to testify today.

Senator ARMSTRONG. Thank you. I appreciate your statement. I read through a portion of it before you presented it. After we have heard from other members of the panel, I have a question.

I was going to ask you one thing. Where do you hire those attorneys for $30 an hour? [Laughter.]

Please continue.

STATEMENT OF RANDALL J. GINGISS, SECOND VICE PRESIDENT, CONTINENTAL ILLINOIS NATIONAL BANK & TRUST CO., CHICAGO, ILL.

Mr. GINGISS. Thank you. Mr. Chairman, my name is Randy Gingiss. I am here to represent the Corporate Fiduciaries Association of Illinois. I am a second vice president of the Continental Illinois National Bank & Trust Co., of Chicago.

We are here to testify today on that portion of Senate bill 404 which advocates the repeal of the generation skipping transfer tax.

The Corporate Fiduciaries Association takes no position on the repeal of the estate and gift taxes, a measure we regard as one of political or economic philosophy.

Such is not the case with the generation skipping transfer tax.

As Bill Sutter pointed out to you, the purpose of the tax is ostensibly to prevent the use of trusts to hold property for multiple generations and to enact a tax that would have been there had the property been distributed outright.

Not only does that tax fail to accomplish its objective, its complexity is so massive that it is heretofore unknown in a tax of such widespread application. It affects a significant number of areas which have no relationship to the purpose of the legislation.

I think it will have a very deleterious effect on the self-assessment system of which this country has long been proud.

Significantly, through the use of sophisticated tax counsel, the very wealthy can avoid the main thrust of this tax while the middle class and perhaps even those less wealthy than that will have to bear the full burden of recordkeeping and potential liability.

Some of these problems are addressed by my colleagues Doug Keyt, Bill Sutter, and Tim Baetz. I have read their statements and endorse them without reservation.

In my written statement, I went through some of the technical ways in which the wealthy can avoid this tax. What concerns me more is the surprising way this can hit some in the middle class or even less wealthy.

A typical situation involves a custodian under the uniform gift to minors tax. While it is not clear that the tax applies to that, the IRS says it does.

What you are dealing with is really an outright distribution to a minor who simply is not old enough to receive the assets outright.

If you believe the regulations, a man with as little as a couple of thousand dollars just gives it to his nephew's children, let's say one is 17 and one is 21 and both use it for a year at college, for room and board, there is a tax on the $1,000 going to the 17-year old, but not to the 21-year old.

And of course, if it is $10 million, there is no tax at all, because you just give it in trust, properly drafted, with sophisticated counsel.

It points out that where as in the estate and gift tax areas, you have $175,000 unified credit which we are already talking about as being too small, going to $600,000, and in addition, there is a $3,000 exemption for the gift tax, we are again talking too small, going up to $10,000, where the deemed transferor is alive, there is no deminimus exemption from the generation skipping transfer tax.

If that deemed transferor who is nothing more than one parent or the other of the beneficiary is alive, you can have a tax on so much as a single dollar.

I don't think that is what was intended.

Most of the trusts that estate planners and estate trust companies deal with as Doug Keyt pointed out, our trusts are really designed until minors reach a certain age, and while if they all live and everybody dies in their actuarially proper order, you don't have a tax.

If somebody just dies out of order, you can generate the tax related to no purpose that the Government could possibly have.

This leads me to one final area. To you, the Government, how are you going to enforce this thing? The custodian——

Senator ARMSTRONG. Make everybody die in the right order. [Laughter.]

Mr. GINGISS. Well, that is the only way to do it.

Senator, if you can do that, I am all with you. [Laughter.]

I hadn't realized the Government had gotten quite that powerful, but maybe we have.

Your custodian is never going to know about this tax. There is nothing in the 1040, the only tax return they are going to file is going to tell the parent of the child about it.

The Government is not going to have any notice of it and even when you are talking about trusts where they might with sophisticated agents, when they find out about it, I don't think the Government has the manpower to audit the returns they are supposed to audit now outside it, much less audit the generation skipping transfer tax.

I don't believe that the middle class and the poor are ever going to file their returns. I don't believe the Government is going to catch them. I think it is going to make a mockery out of a system of self-assessment which this country has been justifiably proud.

The Corporate Fiduciaries Association of Illinois urges its immediate repeal.

Senator ARMSTRONG. Thank you.

STATEMENT OF W. TIMOTHY BAETZ, CHICAGO BAR ASSOCIATION

Mr. BAETZ. Senator, my name is Tim Baetz. I am here today representing the 16,200 members of the Chicago Bar Association of which association I am a past committee chairman.

In addition, I am the chairman of the generation skipping tax subcommittee of the tax section of the American Bar Association. I have been instructed to tell you that I am not representing that group today.

I have listened to 26 witnesses, over several hours, and with great interest, speak on a number of issues, relating to the Federal transfer tax system.

While their views on a number of estate and gift tax questions may be to some extent disparate, I have not heard a single witness today say one nice thing about the tax on certain generation skipping transfers, and indeed, I have heard several witnesses call for wholesale repeal.

The Chicago Bar Association doesn't travel to climates this warm very often. You have not enough snow for us here. But we wanted to come today because we believe this generation skipping tax is an exceptionally dangerous device and breeds wholesale disrespect for our voluntary compliance system.

You have heard several witnesses comment upon the complexity of the tax. It is worse than complex. It is an army of pompous phrases moving across the landscape in search of an idea.

It is not simply that it is complicated. All of us who do tax work are used to complicated provisions. It is the fact that the tax applies in such a broad range of situations. It is not a tax aimed primarily at America's super wealthy. It is a tax that impacts people of modest means all the time.

Many lawyers in this country perform valuable will and trust drafting assignments for their clients. Few of those folks, particularly the fellows working in rural areas, would hold themselves out to be transfer tax experts. It is beyond possibility that these individuals can master this tax and as a result they and their clients are going to have to suffer incredible hardship.

Even the few of us who have the luxury of spending all our working hours with this tax can't understand it.

My law firm, according to a recent survey, is the largest estate planning firm in this country. Over 30 of us do nothing but estate planning and many more do it some of the time.

When we passed 10,000 man hours in our self-education with respect to this tax, we stopped counting.

Even today we admit what we are doing for clients makes no sense at all. It is an embarrassment to us to recommend the kinds of shenanigans that are necessary to try to cope with this tax and even in trying to cope, we are simply guessing.

You warp the natural dispositive preferences of clients almost invariably.

Indeed, the tax applies when trusts aren't involved. It applies to arrangements that are so far removed from any perceived abuse as estates, custodianships, and conceivably guardianships for orphan children.

It may even apply to any corporation, shareholders of which are assigned to more than two generations.

It doesn't affect the wealthy, as I have said. It affects the middle class all the time. It was supposed to be equivalent to the gift and estate tax. There is no gift tax equivalence whatsoever and far from full estate tax equivalence.

It does not coordinate with other provisions of the Internal Revenue Code. So, for example, in a case where this tax applies, the throwback tax can also apply. You can have a combined throwback tax and generation skipping tax, and this is not uncommon, that equals far more than 100 percent of the property involved.

If there was any way to patch this thing up, I suppose, we would do our duty and put a long-winded proposal before you. It is not possible. The only answer is wholesale repeal. We would hope this would be very high on your list of priorities in deliberations on transfer tax rules.

Thank you very much.

Senator ARMSTRONG. Thank you.

Mr. Bellatti, are your remarks on the same general subject?

Mr. BELLATTI. Senator, I would prefer that you ask questions of these speakers before I testify again.

Senator ARMSTRONG. I do have a couple of questions I want to address.

I would like to ask first of all, who wrote this tax provision?

Mr. SUTTER. Well, it appeared as if by magic, in the 1976 act when a number of things appeared overnight as if by magic, tax magic.

Senator ARMSTRONG. Are you familiar with the legislative history of that? Was this put in in the House or in the conference?

Mr. BAETZ. It was originally part of a House bill. That bill died on the floor. Then a new bill started through the Senate, and, in fact, Senator Long, by a floor amendment, tacked on the generation skipping tax provisions.

Senator ARMSTRONG. He did what to them?

Mr. BAETZ. He tacked them on to the other tax provisions that had arrived from the other House.

At the conference level, and I was here, at midnight one night, they started deliberations on this thing, and some tinkering was done, and as I recall it was about 2 in the morning when they decided that they had agreement.

Senator ARMSTRONG. Was this in the Senate Finance Committee or conference committee?

Mr. BAETZ. This was in the conference committee.

Senator ARMSTRONG. In the conference.

Mr. BAETZ. Yes, sir.

Senator ARMSTRONG. You mean that it was at 2 o'clock in the morning that they had agreement on this issue or on the bill altogether?

Mr. BAETZ. I think everyone was very anxious to get some sleep and agreed that what they now had in front of them was the best they could do.

Senator ARMSTRONG. Was this the same bill that had the decedents' carryover basis provision?

Mr. BAETZ. Yes; same bill.

Senator ARMSTRONG. If it is appropriate for me to do so, I would like to just let the Illinois Bar Association know that one of the minor crusades I am interested in is to put a stop to the final vote in conference committee until there is a printed report available for the benefit of members and a reasonable period to review it. I would think 3 days would be a reasonable period for members of the body and public and maybe even the Illinois Bar Association to read the language before it is voted on.

I mention that because, while I am not familiar with the generation skipping tax, I am familiar with decedents' carryover basis, the legislative history of how it got into the law, and the circumstances of the horrible all night conference.

The thing that might surprise some of you is that this is not an uncommon way of doing business. It doesn't just happen on tax bills. It happens all the time and only, in my experience, on the most important legislation. Those matters which are relatively trivial are handled in daylight; a committee report is issued in 3 days and frequently 3 months pass before we are asked to vote on it. It is handled with all due regard for procedure.

If you get something really important, like the Tax Code, the Chrysler bill, defense authorization, or anything that has really got a lot of consequences, it generally ends up being handled in exactly the way this one was.

At the right time, when I am about to get a vote on my proposal to require adequate notice, I am going to send a letter to the Illinois Bar Association seeking support.

Mr. SUTTER. Senator, we wish you would come and run for something in Illinois. [Laughter.]

Senator ARMSTRONG. That I will not do.

I would also like to ask this question. You made the point very well that the generation skipping tax is not well written.

Is it also your position that the idea is a bad one or is it simply poorly drafted?

Mr. SUTTER. I think it is probably brilliantly drafted. If anything, it is simply that it cannot be drafted so as to be comprehensible or really to work.

You could tinker with it. You could do some relief things. You could put in exemptions. You could do a lot of things like that. But you would never ever in my opinion have a bill that was enforceable or understandable either by the public or Government employees that have to enforce it.

It was my understanding is that it was largely drafted by outside experts, in whom I have the highest faith in their expertise.

It is the kind of a thing somebody said last night, you could probably get it down so that a couple of fellows who really like to play the Japanese Go Game, with a computer, could have more fun with this than anything in the world.

That is not a tax bill that should be foisted on the American public.

Senator ARMSTRONG. That brings me to the last matter I want to ask about and comment on and that is the question of what this kind of tax law says to taxpayers about the voluntary compliance.

Mr. Gingiss, you made the observation that it fostered disrespect to the point of almost making a mockery of our system.

Two or three of you have made that point. I would be inclined to agree. I see that as an increasingly serious problem throughout our tax laws. They are too complicated, and that somehow justifies improper activity by taxpayers.

Disrespect of the tax laws is growing because of the complexity. The same people who wouldn't dream of breaking other laws, somehow think it is justified to do so in this case.

I don't know if you see this in your professional lives. I see it among people I come in contact with. Some think it is somehow honorable to cheat the tax collector. It is a very dangerous precedent.

Mr. BAETZ. Senator, I think there are two areas of abuse there. I would judge that by far the greater number of folks won't comply out of simple but honest ignorance.

The problem is there is another much smaller group, I am afraid, who takes sustenance from that. They fail to comply knowing that they should have, but that nobody else is, and therefore, there will be no penalties imposed if somebody catches it.

Even more important, on the other hand, you can't catch them. You would need a computer the size of Alaska to retain the information necessary to know when taxable events have occurred under this tax.

Senator ARMSTRONG. I don't disagree with your observations. The point I was making is that the tax law generally has become so complex that it is really impossible for average people to prepare their tax returns and know what their tax liability is if there is anything out of the ordinary involved.

Their recourse in many cases is simply to turn it over to the practitioner.

But in a lot of instances, even practitioners don't know. I am not now talking about the generation-skipping tax, I am talking about a lot less exotic kinds of every day transactions.

Frequently it is hard for businessmen, and in real life I am a businessman, and for business to know what the tax law is.

I think of myself as being reasonably knowledgeable about such matters. I had an accounting major in college. I did my own tax return from 1954 through about 5 or 6 years ago.

I finally reached a point where I couldn't be sure I was filling out my tax form properly, and as a Member of the Congress of the United States, I perceived it would be really embarassing if I got caught doing something wrong. It was sort of with a sense of defeat that I turned my tax return over to our firm of CPA's. It was a matter of some pride to me that I was doing my own tax return, even though they were checking it.

Finally, about 5 or 6 years ago, I just threw up my hands and said, "OK. You guys do it." I now sign it but I don't understand what I am signing. The same situation occurs with about 99 percent of people who have any degree of complexity in their tax return at all.

Mr. BAETZ. Senator, I am a tax lawyer. I am not embarassed to tell you I turned my tax return over to a specialist the same year you did. [Laughter.]

Mr. SUTTER. I practiced tax law for 30 years and almost nothing else, and I haven't prepared my own tax return for at least 10.

People don't really mind paying taxes. They may grumble about taxes and everyone wishes they were lower, and I don't think anybody has come and said "Why don't we abolish taxes," to any committee.

People are willing to pay taxes. But they are not willing to pay taxes on things that they don't think make sense.

When you have this gift tax theoretically imposed on the money spent to educate somebody in college, that doesn't make sense to the public and they are not going to pay that tax. I don't care if they get caught, they are not going to pay that tax.

The things that happen in this tax, they are not going to pay. If somebody points out to them they are supposed to be taxable, and we said time and again in this one, they will never know it any way.

That is the problem with the Tax Code. Tax experts worry so much about perceived loophole, perceived inequity that you can't close every conceivable loophole that the ingenious mind of man can devise without creating something that falls of its own weight.

That, unfortunately, is what has become of our Internal Revenue Code. It was pretty bad when I started. I started just in time to get the 1939 Code repealed. I had to learn a whole new Code when the 1954 Code came along.

From that time on, it has all been downhill, I am afraid.

Senator ARMSTRONG. You make a very good point.

One final point I would like to make. Not only do inordinately complex tax provisions, foster disrespect for the law, but they also divert an enormous amount of productive effort out of producing and distributing goods and services into the business of just figuring your taxes or devising tax shelters.

I believe, Mr. Keyt, you made the point that your firm had devoted thousands of hours to the generation-skipping tax provisions. Someone else said they stopped counting at 10,000 hours.

I presume that these are all people who could have been doing something else. That same process can be multiplied throughout our economy, not just with respect to the generation-skipping tax, but to other parts of the tax law. I think of all the business and professional people, who instead of devoting their time and attention to creating new productive enterprises are monkeying around with all kinds of what seems to me at least crazy tax shelter deals, because there is more profit in an unproductive tax shelter, in many cases, then there is in a very productive business enterprise.

I think you have done us a service here today. I am sorry all my colleagues were not here to take part in this.

Thank you all very much.

[The statements of the preceding panel follow:]

THE NORTHERN TRUST COMPANY

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DOUGLAS S. KEYT
VICE PRESIDENT

TESTIMONY OF DOUGLAS S. KEYT

ON BEHALF OF THE NORTHERN TRUST COMPANY

ON ESTATE AND GIFT TAX REFORM

BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

FINANCE COMMITTEE, UNITED STATES SENATE - JUNE 5, 1981

Mr. Chairman and Members of the Committee:

My name is Douglas S. Keyt and I am a Vice President in the Trust Department of The Northern Trust Company in Chicago, Illinois.

The Northern Trust Company is a major financial institution and has been providing trust services since it was founded in 1889. Through its Trust Department in Chicago and its trust affiliates in Florida and Arizona, The Northern Trust Company administers personal trust assets valued at nearly $6 billion. This makes The Northern Trust the largest personal trust operation in the United States. As a result of our long tradition in the trust business and a commitment to providing the highest quality trust services, we are recognized nationwide as a leader in the trust industry.

At The Northern Trust Company, I am responsible for the tax and accounting services that are required in the administration of personal trusts and probate estates for which we act as trustee or executor. My purpose in coming here today is to attempt to describe for you some of the administrative difficulties we have experienced since the generation-skipping transfer tax under Chapter 13 of the Internal Revenue Code was first enacted by the Tax Reform Act of 1976. We respectfully suggest that these provisions are so complex that they are incapable of administration or enforcement and should be repealed.

Major Estate and Gift Tax Issues

Your Subcommittee is considering a number of proposals which call for major transfer tax reform. Issues relating to such things as a reduction in estate and gift tax rates, an increase in the unified estate and gift tax credit, increases in the marital deduction and gift tax annual exclusion and revisions to Sections 2032A, 6166 and 6166A are indeed important and significant issues for this Subcommittee to consider. As my comments and those of several of my colleagues here today clearly demonstrate, the generation-skipping transfer tax, a tax which since its enactment in 1976 to the best of my knowledge has generated no revenue, is fraught with all kinds of uncertainties and is extremely costly to administer. Consequently, repeal of these provisions is likewise a major transfer tax issue that merits your full attention and support.

Generation-Skipping Transfer Tax Complexities

A Joint Committee on Taxation Staff Pamphlet setting forth the background and description of estate and gift tax bills being considered by your Subcommittee was published on May 1, 1981. The description of the generation-skipping transfer tax contained in the pamphlet suggests that these provisions are basically very simple. For example, the pamphlet states in Part II, Paragraph 7:

> "In order to prevent the avoidance of the Federal gift or estate taxes through the use of generation-skipping arrangements, Congress enacted the generation-skipping tax provisions as part of the Tax Reform Act of 1976...
>
> "The tax is imposed on generation-skipping transfers under a trust or similar arrangement upon the distribution of the trust assets to a generation-skipping heir (for example, a great-grandchild of the transferor) or upon the termination of an intervening interest in the trust (for example, the termination of an interest held by the transferor's grandchild). Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations which are younger than the generation of the grantor of the trust...
>
> "The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation. For example, where a trust is created for the benefit of the grantor's grandchild, with remainder to the great-grandchild, then, upon the death of the grandchild, the tax is computed by adding the grandchild's portion of the trust assets to the grandchild's estate and taxable gifts and computing the tax at the grandchild's marginal transfer tax rate."

To the contrary, the generation-skipping transfer tax provisions are not simple at all. In order that you and your staff might gain a greater understanding of this tax as well as an appreciation for its complexities, I have attached to this statement a copy of an article entitled "Coping With The Generation-Skipping Transfer Tax" (Parts 1 & 2) by William C. Weinsheimer, Bernard T. Wall and James R. Hellige which appeared in ILLINOIS BAR JOURNAL, Volume 69, pages 166 and 228. This article and the following commentary confirms that the generation-skipping tax provisions are in fact so complex that they will do nothing but confuse and mystify even the most knowledgeable trust administrators, insurance people, accountants and attorneys alike.

In order to further demonstrate these complexities for you, permit me to briefly outline the analytical process that must be followed with respect to each and every personal trust in order to determine whether it is subject to the provisions of Chapter 13:

1) Is the trust grandfathered? Generally, the Tax Reform Act of 1976 provides transitional rules for existing irrevocable and revocable trusts. Trusts which were irrevocable prior to June 11, 1976, were generally grandfathered from application of the generation-skipping transfer tax provisions. Revocable trusts created prior to June 11, 1976 are likewise excluded from the generation-skipping tax provisions, provided the settlor dies before January 1, 1982. Therefore, the first admittedly simple step in the generation-skipping transfer tax analysis is to determine when the trust was created and if irrevocable, when it became irrevocable.

2) <u>If the trust is grandfathered, were there any actual or constructive additions made to the trust after June 11, 1976</u>? The next step in the analysis is to determine whether any actual or constructive additions were made to the trust after June 11, 1976. Generally, such additions will be subject to the generation-skipping tax. These additions can occur in any number of ways. A donor might make a gift of the $3,000 annual exclusion amount to an irrevocable gift trust which he created prior to June 11, 1976. A life insurance policy made payable to a trust after June 11, 1976 would also constitute an addition. Or, consider a typical family estate plan where a marital trust terminates on the death of a widow and, in default of the exercise of a general power of appointment, pours over to a residuary trust. If the surviving spouse dies after January 1, 1982, this will constitute an addition for generation-skipping transfer tax purposes. Assets of an estate which are poured over to a grandfathered trust under agreement pursuant to a will executed after June 11, 1976, will likewise constitute an addition for these purposes. An example of a constructive addition would be where property remains in trust following the release, exercise or lapse of a general power of appointment. Most important, however, is the fact that in each of these cases, trust records must be thoroughly examined to determine whether such additions have been made. If so, costly

separate accounts and records must then be set-up and maintained, assuming of course that this would be permitted under the terms of the trust instrument or local law.

3) <u>Who are the trust beneficiaries?</u> The next step in the generation-skipping tax analysis is to identify all possible present and future beneficiaries of the trust. For example, many times a trustee is directed to pay all income to one beneficiary and then is given discretionary power to distribute income or principal to a class of beneficiaries, such as grandchildren or great-grandchildren, according to their needs. Many of these permissible beneficiaries very probably will be born at some undetermined time in the future. Detailed records regarding each and every one of these beneficiaries must be maintained in order to avoid making payments that will have unintended results under the generation-skipping transfer tax provisions. Needless to say, this process can be time consuming, expensive and extremely complex.

4) <u>What kind of interest or power does each beneficiary possess?</u> Once all permissible beneficiaries have been identified the next step is to establish the exact nature of the interest or power which each beneficiary possesses. For example, is it a vested or contingent interest? Is the beneficiary only a permissible recipient of income or corpus? Is his interest present or future? Does he have the power to alter the beneficial enjoyment of income or principal? Is his power limited solely to the management of trust property?

5) <u>To which generation is each beneficiary assigned?</u> A taxable event occurs whenever there is a distribution of corpus to a younger generation beneficiary who is younger than any other younger generation beneficiary. A younger generation beneficiary must, of course, be assigned to a younger generation than that of the grantor. More specifically, a taxable event can occur when distributions to such a beneficiary exceed trust accounting income, which is then called a "taxable distribution" or when an interest or power terminates, which is then called a "taxable termination." Obviously, it is necessary to know the generation to which each beneficiary is assigned in order to determine whether a payment to that beneficiary is a generation-skipping transfer.

6) <u>Who is the "deemed transferor"</u>? Once all of these questions have been answered, the "deemed transferor" must then be determined since the generation-skipping tax is calculated on the basis of his marginal estate tax rate. What is particularly onerous and burdensome is the fact that the "deemed transferor" does not necessarily have to be alive when the taxable event occurs and need not have ever had any interest in the trust. The "deemed transferor" concept, which has been roundly criticized as inequitable, causes administrative nightmares. An example of the complexity of this concept is where a family member creates a trust for his

nephew and great-grandson. When the nephew dies and the great-grandson receives the balance of the trust, the "deemed transferror" is the grandchild and not the great-grandparent or the nephew as one might expect. Moreover, the grandchild in this case is not even a beneficiary of the trust.

Generation-Skipping Transfer Tax Regulations and Returns

When all of the basic generation-skipping questions have been answered and it has been determined that a taxable event has occurred, the next step is the preparation of required tax returns. Form 706-B(1) is an information return which must be completed by the trustee for all taxable terminations or distributions and filed with the I.R.S. Service Center where the distribution, rather than the trustee, resides. At the same time the trustee must also complete and send to each distributee of a taxable distribution a Form 706-B(2) information return. The actual generation-skipping tax return, Form 706-B must then be prepared by the distributee in the case of a taxable distribution or the trustee in the case of a taxable termination. Moreover, the Form 706-B must be filed even though no tax liability results from a given transfer. Thus, even if the $250,000 grandchild exclusion exempts the transfer from tax, a generation-skipping tax return must, nevertheless, be filed.

More than 4 years elapsed after enactment of the Tax Reform Act of 1976 before regulations on generation-skipping definitions and special rules were proposed or first drafts of generation-skipping tax returns were published for comment. Due to the fact that the regulations in proposed form were so complex and incomplete, the American Bar Association's Section on Taxation was prompted to submit 136 single-spaced pages of comments. Other professional groups such as the Chicago Bar Association and the American Bankers Association have likewise submitted voluminous comments.

As a result of the I.R.S.'s inability to draft these forms in a timely fashion, the initial date of February 5, 1981 for filing Forms 706-B(1) and B(2) was first postponed until June 30, 1981. I understand that there will be a further postponement of this date, until August 15, 1981, pending publication of new and substantially revised forms.

Realistically, the I.R.S. could not have been expected to issue proposed regulations or generation-skipping tax forms any sooner. In a letter dated May 12, 1981, written by Nelson A. Brooke, Chairman, Tax Forms Co-ordinating Committee, Internal Revenue Service, to Joy Tucker, Agency Clearance Officer, U.S. Treasury Department, regarding the generation-skipping tax return forms, it was stated, "The fact that the tax is extraordinarily complex results in forms which are more complex than we desire. However, the forms must reflect the law." If the Internal Revenue Service is unable to fully comprehend the underlying statute so as to issue understandable regulations or forms, how can Congress reasonably expect taxpayers or their tax advisors to even begin to attempt to comply with the law. In short, the underlying statute is so complex that it is incapable of being enforced and should therefore be repealed.

Internal Revenue Service Record-keeping Requirements

A trustee or distributee who is required to file a Form 706-B may request from the I.R.S. pertinent data needed to prepare the return and compute any tax that may be due. This request for information must be filed not less than 90 days before the due date for filing the Form 706-B, otherwise the failure to obtain information necessary to complete the return will not be considered reasonable cause for failure to file a timely return or pay the tax.

In order for the I.R.S. to be able to provide a taxpayer with the information needed to properly prepare a Form 706-B, it will need to store and maintain complete and detailed records of all transfers made by all individuals filing gift, estate or generation-skipping transfer tax returns. This is necessary because, at the time an individual makes a gift or dies, the I.R.S. cannot determine in advance whether such individual will be considered a "deemed transferor" in some future generation-skipping transfer tax situation.

According to the May 1, 1981 Joint Committee on Taxation Staff Pamphlet on pending estate and gift tax bills, an estimated 111,733 federal estate tax returns will be filed in 1981. Each one of these decedents is a potential "deemed transferor" for generation-skipping transfer tax purposes. Assuming such records were to be maintained for a modest period of only 75 years and that the number of federal estate tax filings remains constant, the I.R.S. will ultimately be required to maintain records on nearly 8.4 million potential "deemed transferors." For the I.R.S. to commit the manpower and information systems resources in an attempt to enforce a tax which, according to current projections, will provide little revenue, and which the wealthy are generally able to avoid anyway, is a wasteful expenditure of time and money and serves no justifiable purpose.

Generation-Skipping Transfer Tax does not accomplish its intended purposes

Generally the stated purpose of Chapter 13 is to insure that a transfer tax is assessed upon the death of each generation. With respect to reasonably wealthy individuals with estates of say $2 million or more, the generation-skipping tax does not and will not accomplish the purposes for which it was enacted. The reason for this is that there are a number of estate planning techniques which wealthy individuals can employ to benefit various generations and still avoid generation-skipping transfer taxes. For example, one such technique is to create separate trusts for each separate generation. Since two younger generations do not share benefits from the same property, the generation skipping transfer tax will not apply. This technique is available only to the wealthy since only they can afford the extra administrative expense of creating separate trusts.

To the extent Chapter 13 is enforced, it will be the individual of more moderate means, i.e. America's already overtaxed and overburdened middle and upper middle class that will bear the brunt of the generation-skipping tax and the costs of administering it. These are the very people that quite properly should use trusts for the protection of their families from a very uncertain and most likely a very inflationary future.

You may be interested to know that of the nearly 7,000 personal trusts which The Northern Trust Company administers, more than 40% of them are valued at less than $250,000, more than 70% are valued at less than $500,000 and more than 80% of our trusts have values of less than $750,000. In this day and age, considering the ravages of inflation and the effects it has had on the cost of education, medical care or the general cost of living, an estate of even $750,000 can no longer be considered substantial. For example, on the basis of the past 8 years inflation rate, an estate of $750,000 today would be the equivalent of only $370,000 in 1974. Also, keep in mind that these are the people who during their middle years, are the entrepreneurs and producers who are most likely to be motivated by our capitalistic system. These individuals subscribe to the principle that something should be set aside and invested each month to protect themselves and their families from financial hardshipin the future. These are also the people who view the trust vehicle as a valid means for achieving their financial goals and they ought not to be discouraged from doing so simply because of the budensome nature of the generation-skipping transfer tax.

It should also be noted that the "deemed transferor's" $47,000 unified gift and estate tax credit is not available when computing the generation-skipping transfer tax. As a result, after giving effect to the $250,000 grandchild exclusion assuming it applies, the very first dollar of every generation-skipping transfer will be subject to tax. This is but one more example of the unfair and discriminatory nature of this tax.

A common misconception is that trusts last for many generations and substantial periods of time. While it is true that some trusts can be structured to last for several generations spanning 50 or 60 years, this is clearly the very rare exception. Based on recent internal samplings, the life of a trust in our Department averages between 12 and 15 years. This is far less than the normal 20 to 25-year age span between generations and clearly demonstrates that the vast majority of trusts do not last for multiple generations or even for unreasonable long periods of time. Accordingly, this suggests that the imagined evil the generation-skipping tax was intended to correct does not in fact exist. Moreover, I submit that the existing unified estate and gift tax structure is more than sufficient to accomplish the stated social goal of the estate tax which is to increase social and economic mobility by reducing large accumulations of wealth. Once again, considering the moderate size of many trusts and the common purposes for which they are established such as the support of widows, minor children and others of moderate means in need of financial assistance, the expenses associated with administering this tax are a burden which this class of people ought not to have to bear. Since the generation-skipping transfer tax will not reach the wealthier people it was intended to affect, it serves no useful purpose, is a drain on society and ought to be repealed.

Administrative Burden and Expense

Over the past 4-1/2 years, I and members of my staff have spent in excess of 3,500 hours attempting to understand and apply the generation-skipping tax statute and regulations. In addition to this, attorneys in our Legal Department have spent more than 5,000 hours trying to assist us in understanding the law and identifying trusts to which it applies. At a very moderate rate of $30 per hour, this represents an expense to The Northern Trust Company over the past 4-1/2 years well in excess of one-quarter million dollars.

Not included in the above are the numerous hours we have had to spend writing explanatory material and trying to educate our personal trust administrators. Considering all of this, we have yet to identify our first taxable distribution or termination or pay our first penny of generation-skipping tax.

As indicated earlier, The Northern Trust Company administers nearly 7,000 personal trust accounts. You may be interested to know that in 1980, we only had 400 accounts created after June 11, 1976 or 6% of our total, where distributions to beneficiaries exceeded trust income and were therefore potentially subject to the generation-skipping tax. Extensive data on more than 900 account beneficiaries that was needed to determine the generation-skipping tax consequences of these distributions, was collected. Due to the fact that we were able to obtain much of this vital information through the use of sophisticated computer systems, we were able to limit the time devoted to this aspect of the project to a very modest 175 man hours. Again, assuming a very low rate of $30 per hour for technically trained personnel, the total expense to The Northern Trust Company for this supposedly simple project was in excess of $5,000. Even more significant is the fact that as a result of our analysis, we did not find one trust that had made a taxable distribution in 1980. However, we did find four trusts that will be subject to the generation-skipping tax when they terminate at some undefined time in the future and we found eleven trusts that might be subject to the generation-skipping tax, depending upon the order of deaths of the remaindermen.

Extensive consideration has been given to automation of record-keeping and analytical processes involved in the identification of possible generation skipping trusts and younger generation beneficiaries. Mr. Dic Dorney, a prominent tax attorney working for a large trust company in Detroit has attempted to define how such a system might work. His definition, which is 1-1/2 inches thick and approximately 500 pages long, required more than 1,000 hours of his professional time and that of his staff to compile. It is estimated that the cost of programming this system alone would approximate $250,000. These costs do not include any estimates for a user's cost of converting trust files or beneficiary information to the system, the equipment needed to access the system, or the staff expense that would be incurred just to keep the information in the system current. Preliminary estimates are that it would cost The Northern Trust Company more than $100,000 to make the initial conversion to this system. Thereafter, the annual expense of storing this information on the system, maintaining it and accessing it when necessary to obtain required data or do a generation-skipping analysis would very likely exceed $70,000 per year. These expenditures reflect the enormity of the burden of attempting to administer this extremely burdensome tax. Such a commitment of resources, particularly in view of the revenue experience thus far, does not justify the diversion of these substantial resources from other productive purposes.

<u>Conclusion</u>

The complexity of the generation-skipping transfer tax and its broad application to trust as well as non-trust entities (the "generation-skipping trust equivalents") suggest that as a practical matter only the most sophisticated trust companies and tax practitioners will be equipped to make a good faith effort at compliance. However, individual executors and trustees are likewise faced with the task of attempting to comply with this burdensome tax. For example, in 1980 there were 1,884 estates over $100,000 in value that were opened in Cook County, Illinois. Banks served as executor in only 339, or 18% of these estates. In other words, individuals rather than professional corporate executors were appointed in more than 1500 Cook County estates. If one assumes that individual trustees are designated in only 10% or 150 of these estates, consider the difficulty these individual fiduciaries will have in complying or the Internal Revenue Service will have in enforcing the generation-skipping transfer tax provisions. I respectfully suggest that it cannot be done and therefore strongly urge that Chapter 13 be repealed.

Respectfully submitted,

Douglas S. Kay

**STATEMENT OF W. TIMOTHY BAETZ
ON BEHALF OF THE CHICAGO BAR ASSOCIATION
FOR THE HEARING ON MAJOR FEDERAL TRANSFER TAX ISSUES
HELD BY THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE
June 5, 1981**

Mr. Chairman and Members of the Committee:

My name is W. Timothy Baetz, and I am here today on behalf of The Chicago Bar Association, an association of 16,200 attorney members. I am a past Chairman of the Association's Trust Law Committee, and I am a partner in the Chicago law firm of McDermott, Will & Emery, specializing in estate planning and tax matters.

Subject Matter to Which My Remarks Are Directed

The Chicago Bar Association is grateful for this opportunity to testify in connection with major federal transfer tax issues. The Association realizes that this hearing has been called for the purpose of obtaining information with respect to a wide range of subjects pertaining to the federal estate, gift and generation-skipping taxes. The Association does not intend today to state a position with respect to any federal estate or gift tax issue, but rather wishes to take this opportunity to address difficult and dangerous issues presented by the tax on certain generation-skipping transfers.

Members of the Association have wrestled with the tax on certain generation-skipping transfers for five years. The more we have studied, the more concerned we have become. It is apparent to us now that the problems created by this new tax are insolvable, and we are worried that continuation of the tax will threaten this nation's voluntary compliance tax system and result in substantial and counterproductive expenditures of time and effort both by the federal government and by a great many taxpayers.

With these thoughts in mind, the Association recently passed a resolution supporting repeal of the tax on certain generation-skipping transfers. In the past few months, a great many other professional organizations and trade associations have done likewise.

Need for Immediate Attention

The resolution of the generation-skipping tax problems need not and should not be tied tightly to Congressional decisions involving the federal estate and gift taxes. The estate and gift tax systems are venerable and generally understood, and decisions regarding major departures from those systems may require lengthy deliberations and very detailed consideration. The generation-skipping tax system is, on the other hand, new and novel and will never be generally understood, and Congressional decisions with respect to the generation-skipping tax may be separated from, and can come before, major government action with respect to federal estate and gift tax laws.

As the following remarks will indicate, there is an immediate need for Congressional action as to the generation-skipping tax. We are on a collision course with certain effective dates that, unless changed, will occur very soon and, without question, long before either the taxpaying community or the federal government is in a position to respond adequately to the new rules which these dates will trigger.

For the reasons stated below, The Chicago Bar Association is hopeful that Congress will decide at an early date to repeal the tax on certain generation-skipping transfers or, at the very least, defer its application pending further investigation and study of its implications and consequences.

Revenue Effect

The generation-skipping tax has never been and cannot be defended on revenue grounds. According to the Staff of the Joint Committee on Internal Revenue Taxation, this tax was projected to have no revenue effect in its early years and only $400 million of revenue generation effect in its twentieth year. Such revenue impact is miniscule when compared with the $7.3 billion recently estimated by the Staff of the Joint Committee as being the current annual revenue produced by the federal estate and gift taxes.

Can Chapter 13 Work?

While the generation-skipping tax cannot be defended on revenue grounds, neither can it be attacked on the ground that under no circumstances can the statute, Chapter 13 of the Internal Revenue Code, be made to work. As the following comments indicate, the statute does not work now, but it is theoretically possible that remedial legislation could be designed to eliminate the many technical deficiencies. The problem would be, however, that with such remedial legislation Chapter 13 would be left in a state of such Brobdingnagian complexity as to defy comprehension, much less mastery.

Given the broad application of Chapter 13, a subject explored in greater detail below, additional complexity seems hardly to be a proper answer to the generation-skipping tax problem. As Chapter 13 stands now, its complexity is among its most damning features.

Why is Chapter 13 So Complex?

Although the generation-skipping tax does not take up much room (only nine Internal Revenue Code sections), its concepts are so monumentally tortuous and complex as to have prompted an analogy by two commentators to the works of Rube Goldberg. See Stephens and Calfee, "Skip to M'Loo," 32 Tax L. Rev. 443, 447 (1977). Other commentators have described the tax variously as "incomprehensible" and "astonishingly complex and sophisticated." At a time when most Americans are interested in tax simplification, Chapter 13 veers dramatically in the other direction.

There are at least fourteen key defined terms to master under Chapter 13, as well as a handful of other terms not actually defined but, nevertheless, essential to the operation of the statute. As if this were not enough, the generation-skipping tax has no antecedent in prior law, meaning that an estate planner's comprehension of federal estate and gift tax concepts is of little value when grappling with Chapter 13.

Furthermore, significant portions of the law relating to generation-skipping transfer taxation are not in the statute and remain to be written. In particular, there are eight places on the face of Chapter 13 where important rule-making authority is delegated to the Secretary, and, for good measure, there is a ninth resort to the Secretary, this one for information as opposed to rule-making. As we speak today, none of these nine delegations has been discharged by issuance of final regulations, even though the first date upon which a taxable generation-skipping transfer may have occurred was June 12, 1976.

The tax applies to certain defined "transfers" even though many of the taxable events subject to the tax are not transfers at all. The tax is computed by reference to certain "transferors" who are only deemed to be so and who may have nothing at all to do with the "transfers" in question and whose identity is often hard to know or unknowable. The tax focuses on defined "beneficiaries," many of whom have no beneficial interest whatsoever. Indeed, as Professors Stephens and Calfee have so eloquently stated:

> Enter now the land of metaphor and make-believe. "Transfers" are found where in fact there are none; there are phantom "transferors" who are only deemed to be so; some trusts are only "trust equivalents;" and there are "beneficiaries" who in fact have no beneficial interests. Fiscal alchemy sometimes converts an "income" distribution into "corpus," en route to the distributee; and vice versa! And, mysteriously, several trusts sometimes crop up where in fact only one exists. Stephens and Calfee, op. cit., at 450.

Even with respect to the simple threshold question of whether the tax applies to a pre-existing trust, bizarre results obtain. Although Congress declared that the tax does not apply to a trust which was irrevocable on June 11, 1976, regulations have defined the word "irrevocable" in such a way that many trusts which were irrevocable on June 11, 1976, are deemed not to be irrevocable.

Why Is Complexity Such a Problem?

There are many complex provisions in the Internal Revenue Code, but perhaps none of such wide-ranging application as those relating to the generation-skipping tax. Admittedly, as an actuarial matter, the Chapter 13 tax may not be applicable with respect to most estate plans for the simple reason that most Americans intend ultimately to vest their property in the possession of takers who are no more than one generation removed from the transferor. But, the estate planner cannot be assured of such disposition when he or she drafts an estate planning instrument. Most estate plans make provision for the possibility of an unorderly sequence of deaths, so, for example, if a child dies before a stipulated vesting age (say, age thirty) that deceased child's children succeed to the property that would otherwise have been bound for the now dead parent. Because competent estate planning always takes this "gift over" matter into account, an estate planner is almost always forced to cope with the generation-skipping tax in the formulation of documents.

Many attorneys who would not hold themselves out as estate planning "experts" nevertheless from time to time undertake will and trust drafting assignments for clients. Indeed, such representation is, in the main, good for America, providing a great many people who would not otherwise get any assistance with their testamentary affairs the peace of mind and security of knowing that at death their estates and affairs have been put in order. But it is unrealistic to assume that these attorneys can ever attain the degree of competence required by a discrete and complicated statute like Chapter 13 and needed in order to plan properly for the generation-skipping tax implications of their will and trust drafting assignments. Our concern is that, as a result, these attorneys will fall into the many traps for the unwary created by Chapter 13 and may in time cease out of fear to provide the will and trust drafting services that so many of their clients desperately need.

Even as to the few attorneys who enjoy the status of "expert" in estate planning affairs, Chapter 13 presents difficulties which are insurmountable. As an example, according to a recent survey, my law firm has the largest estate planning department in the United States. About thirty of us do nothing but estate planning, and we have spent over 10,000 man-hours analyzing Chapter 13 and trying to develop proper planning approaches to this new tax. Even with all this effort, we realize that much of what we are doing amounts to nothing better than educated guessing. Furthermore, it is clear that, in much of our Chapter 13 planning, client preferences are being dramatically warped in reaction to this new tax and provisions are being introduced into documents that in their complexity far transcend the clients' ability to comprehend.

It is important to note that this question of complexity extends far beyond wills and trusts and those who prepare and sign them. Chapter 13 applies also to a broad range of so-called "trust equivalents," arrangements which, while not "generation-skipping trusts," are deemed to have "substantially the same effect as a generation-skipping trust." IRC §2611(d)(1). Practitioners were surprised to learn that in recently issued proposed regulations both estates and custodianships under Uniform Gifts to Minors Acts are considered by the Treasury Department to be among the "trust equivalent" arrangements to which Chapter 13 applies. These arrangements are so commonplace, so fixed in character, so finite in duration and so far removed from the sort of conduct to which Chapter 13 is directed that extension of the generation-skipping tax rules to these devices is sure to result in the uninformed failure to comply with Chapter 13 on a grand scale.

Threat to the Voluntary Compliance Tax System

The foregoing indicates to many a clear and present danger to this country's voluntary compliance tax system. On the one hand, many will fail to comply with the requirements of Chapter 13 out of simple ignorance. On the other hand, some will be encouraged to ignore Chapter 13 in the belief that it is impossible for the government effectively to enforce the tax and that, even in the event that a failure to comply is discovered, a plea of ignorance may appear to have sufficient validity to forestall the application of the penalty provisions.

This is a dangerous state of affairs about which we are certain that Congress has to be concerned. If we had any degree of confidence that remedial legislation could eliminate this potential disrespect for our voluntary compliance system, we would most certainly be recommending such legislation today. However, it is clear to us that this particular problem is inherent in Chapter 13 and cannot be expunged by any amount of "patch up." By its very nature, the complexity of this tax combined with its broad application foster the sort of undesirable behavior just described.

Can the Tax be Effectively Enforced?

Tentative regulations are in place indicating that the reporting of Chapter 13 tax liability on Form 706-B must begin on October 15 of this year. See Temp. Reg. §26a.2621-1(k). The initial due date for the preliminary Chapter 13 information returns [Forms 706-B(1) and (2)] is June 30, just twenty-five days away. Yet, none of these Forms is as yet available in final form.

The delay in the issuance of forms may be evidence of the basic enforcement problem confronting the federal government in the Chapter 13 area. The new tax does not have the predictability of the federal estate and gift taxes. The Chapter 13 taxable event may have nothing to do with an actual transfer or an individual's death. Indeed, an event as seemingly innocuous as a trustee's resignation or death is enough to trigger the tax.

If the federal government is to police the tax effectively, it must devise a system to keep track of all trust beneficiaries and all trustees under the hundreds of thousands of "generation-skipping trusts" in existence. It must know when each interest or power under each such trust terminates and when each trustee dies or leaves office. It must know when and how much property is added to all pre-existing trusts in order to determine the extent to which such trusts have become subject to Chapter 13. It must know when and in what fashion powers of appointment are exercised under generation-skipping trusts, and when interests or powers under such trusts are disclaimed or assigned.

In addition, the federal government must stockpile similar information as to the multiple of "trust equivalent" arrangements subject to the tax. Moreover, the federal government must acquire and store gift and estate tax information as to every person classified as a "deemed transferor" with respect to any "generation-skipping transfer" and must be prepared to supply that information to each Form 706-B tax return preparer upon request.

The incredible amount of information thus required would seem to be beyond the storage capacity of any known computer system. Even with active help from the taxpaying community, the collection and constant updating of the required data is an exercise the magnitude of which boggles the mind.

Proper staffing to administer and collect the generation-skipping tax would have to be immense. Given the complexity of Chapter 13, the training process alone seems overwhelming, and the number of civil servants needed to receive, analyze, store, sort and respond to the required Chapter 13 information would have to be staggering.

There are so many important matters now before the Treasury Department that it is difficult for us to conceive how Chapter 13 can be paid the requisite attention. And yet, even now, as Treasury continues to grapple with these very issues, we are only twenty-five days away from the time when the first Forms 706-B(1) and (2) must be filed, forms which as yet have not even been released.

Does Chapter 13 Serve Its Intended Purposes?

Chapter 13 was supposed to be "substantially equivalent to the estate or gift tax which would have been imposed if the property had actually been transferred outright to each successive generation." H.R. REP. at 20. But Chapter 13 involves anything but this sort of regular generation-by-generation transfer taxation. Indeed, the imposition of the tax may occur at irregular intervals not related to the expiration of generations of actual beneficiaries. Such imposition may occur with respect to the entire trust property even though a terminating interest or power may be in value only a small part of that property. The tax may be computed by reference to the tax rates of an individual, the "deemed transferor," who is totally dis-associated from the "transfer" in question.

There has been no attempt to build gift tax equivalence into Chapter 13. See in this regard, Friedman, "Corrective Legislation Needed for Transfers from Generation-Skipping Trusts," 116 Trusts & Estates 462-495 (1977). There is far from complete estate tax equivalence. See in this regard, Baetz, "Drafting for the Generation-Skipping Tax," 5 Notre Dame Estate Plan. Instit. 1053, 1093-1095 (1981).

Furthermore, Chapter 13's interaction with related parts of the Internal Revenue Code is far from satisfactory. For example, the interaction of Chapter 13 and the trust throwback tax rules may often result in combined tax as to a single event which exceeds the amount of trust property involved. A combined tax rate in excess of 100 percent is at the very least a rarity in our federal tax system.

Outright transfers to beneficiaries more than a generation younger than the transferor are not taxed under Chapter 13. Ironically, it is the wealthiest segment of our society which is in the best position to make such outright transfers to grandchildren and more remote descendants and which, thus, is in the best position to avoid the application of Chapter 13. Contrarily, it is the middle class which is most often not in a position to afford such outright transfers and which, therefore, is most often forced to contend with the intricacies of Chapter 13.

In the legislative history, there is a declaration that Congress "recognizes that there are many legitimate non-tax purposes for establishing trusts. However, [Congress] believes that the tax laws should be neutral and that there should be no tax advantage available in setting up trusts." H.R. REP., at 47. Other witnesses today are presenting testimony that suggests that Chapter 13 is anything but "neutral" with respect to trusts. Among other things, this tax creates onerous reporting requirements that represent a clear disincentive for anyone to accept appointment as a trustee. The tax creates trust administrative expenses that are substantial and disproportionate to any tax revenue collected. And, as mentioned above, the tax tends to drive the creators of trusts to warped estate planning schemes at odds with normal dispositive preferences.

Is the Policy Reason for Chapter 13 Sound?

Many would advance the argument that "generation-skipping" under trusts is more a chimera than Congress was led to believe in 1976. Most people do not intend their trusts to run for generations, but rather resort to trusts as protectors of property until children reach an age when they may be counted upon to use such property prudently. Even as to multi-generational trusts, property paid out to beneficiaries is, without Chapter 13, caught in the federal estate and gift tax systems and property over which beneficiaries have power substantially equivalent to outright ownership is, again without Chapter 13, caught in those same systems. Chapter 13 imposes tax even in a great many cases when a beneficiary whose "interest" or "power" terminates has never received a nickel from the generation-skipping trust in question, and many wonder what the abuse is in such circumstances that requires a Chapter 13 to correct.

The Chicago Bar Association does not intend to take a position on the policy reasons for Chapter 13. Rather, the Association by the foregoing remarks intends only to bring to Congress' attention the several problems presented by the generation-skipping tax, problems which, in the Association's view, are substantial, uncorrectable, and dangerous and which can only be remedied by the wholesale repeal of the tax on certain generation-skipping transfers.

Respectfully submitted,

W. Timothy Baetz

W. Timothy Baetz
For The Chicago Bar Association

ORAL TESTIMONY OF
RANDALL J. GINGISS
ON BEHALF OF
THE CORPORATE FIDUCIARIES ASSOCIATION OF ILLINOIS
ON
ESTATE AND THE GIFT TAX REFORM
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE

June 5, 1981

Mr. Chairman and the members of the committee:

My name is Randall J. Gingiss. I am here to represent the Corporate Fiduciaries Association of Illinois. I am a Second Vice President with the Continental Illinois National Bank and Trust Company of Chicago.

The Corporate Fiduciaries Association of Illinois is an unincorporated association, including among its membership some 55 state and national banks and a trust company who together administer more than 85% of the total trust assets in the state of Illinois. The association has been in existence for more than 60 years.

We have asked to testify today to be heard on S.404 which, if enacted, would repeal the Federal Estate Tax, the Federal Gift Tax, and the Federal Generation Skipping Transfer Tax. We take no position as to the repeal of the Estate or Gift Tax. We regard the issues involved in those taxes to be ones of political philosophy. To the extent one believes in having such taxes, the existing system works tolerably well.

Such is not the case with the Generation Skipping Transfer Tax. The purpose of the tax is to prevent the use of trusts or other entities for multiple generations to avoid the taxation that would have been otherwise imposed on the property at each generation. The tax that has been enacted not only fails to accomplish this objective, but has a complexity heretofore unknown in a tax of such broad application. The tax affects a significant number of areas which have no relationship to the purpose of the legislation and will have a deleterious effect on our self-assessment system. Significantly, through the use of sophisticated tax counsel, the very wealthy can avoid the main thrust of the tax while the middle class will have to bear its full burden of record maintenance and potential liability.

Some of these problems are covered by my colleagues, Tim Baetz, Bill Sutter, and Doug Kayt. I am familiar with their statements and endorse them without reservation. I will confine my comments to the latter two issues.

Transfer taxation in general has been aimed at preventing the passing of massive accumulations of wealth from generation to generation. Yet, with the help of sophisticated tax counsel, it is the very wealthy who have the ability to avoid the tax.

The Generation Skipping Transfer Tax does not tax outright distributions to generations more than one generation below that of the Grantor. All that is needed to avoid the tax is for intervening generations to have sufficient wealth not to be in need of all of the distributions or at least to provide separate trusts to the extent there is such a need.

One common device is called "layering". A Grantor will create one trust for his children, another trust for his grandchildren (in which children have no interest) and one for great grandchildren (in which neither children nor grandchildren have an interest). In this manner, after the death of the Grantor, all transfer taxes can be avoided for a number of generations, despite the intent of Chapter Thirteen.

Another technique is the so called "income only" trust which typically provides for distributions of income to grandchildren and more remote descendents. To the extent only income is distributed, there is no tax. With the extremely wealthy, it is unlikely that children will ever need the use of the funds. While the rich can avoid the tax, the middle class or the unwary will not. A typical situation where the unwary could be trapped is a custodianship under the Uniform Gifts to Minors Act. Such a custodianship is a creature of state law designed to avoid the difficulties of a court supervised guardianship where a minor is to receive assets. While there is disagreement as to whether custodianships were intended to be included as Generation Skipping Equivalents, proposed regulations indicate that if a custodian uses some of the money to satisfy a parent's obligation of support, there is a tax if the requisite number of generations including the custodian is present. Simply using funds to send a child to camp which the parent might not otherwise afford, and thereby providing food and shelter to the child for a few weeks, could generate a Generation Skipping Transfer, even if the amount of the account is only a few thousand dollars.

This example illustrates the effect on our self-assessment system. Custodianships are designed to avoid court supervision and costly legal fees. This law requires the custodian to know of the existence of a tax, understand the implications of use of funds, and the effect of payment in triggering the tax, and a filing requirement. The majority of attorneys, even those who do extensive estate planning, do not fully understand this tax. A fortiori, a non-lawyer custodian will have no concept of its implications. What will happen here as a practical matter is that the custodian is unlikely to file a return, the service will have no notice of a taxable event, and nothing is likely to ever be done about it other than the potential exposure to liability of the occasional custodian. This is at complete odds with our system of self-assessment.

The Generation Skipping Transfer Tax is overly complex, does not achieve its purpose, and cannot be salvaged by patchwork. The Corporate Fiduciary Association of Illinois urges its repeal.

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ISBA

ILLINOIS STATE BAR ASSOCIATION

SECTION ON FEDERAL TAXATION

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STATEMENT OF ILLINOIS STATE BAR ASSOCIATION
FOR JUNE 5, 1981 HEARING OF SUBCOMMITTEE ON
ESTATE AND GIFT TAXATION OF THE SENATE COMMITTEE ON FINANCE

The Illinois State Bar Association is pleased to have the opportunity to submit this written testimony in connection with the June 5, 1981 hearing of the Subcommittee on Estate and Gift Taxation of the Senate Committee on Finance on the estate and gift tax issues raised by various bills that have been introduced in the Senate in 1981. The Illinois State Bar Association generally supports most of the provisions in these bills.

The Federal Tax Section of the Illinois State Bar Association has been working to develop a comprehensive estate and gift tax revision bill since the summer of 1980. The goals of this legislative effort can be summarized as follows:

1. To make adjustments in the transfer tax provisions to mitigate the increasingly severe impact of these taxes that is caused by inflation;

2. To provide relief to small farms and family businesses that are being devastated by the estate tax; and,

3. To eliminate many technical problems and booby traps that Congress did not intend to impose on small farms and family businesses when it enacted certain estate tax relief provisions in 1976.

The Illinois State Bar Association's Board of Governors approved the Federal Tax Section's estate and gift tax proposed legislation on May 1, 1981. This proposed legislation has been called the Transfer Tax Reform Act of 1981. Congressman Madigan and other co-sponsors are introducing this estate and gift tax legislation in the House of Representatives, and Senators Percy and Dixon are sponsoring the legislation in the Senate.

The Transfer Tax Reform Act of 1981 contains many provisions that are identical or similar to many of the provisions in the bills that are the subject matter of the June 5 hearing. However, the Illinois State Bar Association believes that the Transfer Tax Reform Act of 1981 contains more comprehensive and better balanced provisions than the other bills, particularly in its revisions to the farm special use valuation law. To some extent the improvement in the special use valuation provisions is the result of the opportunity that the Federal Tax Section has had to review the other bills and consult with their draftsmen prior to the final drafting of the Transfer Tax Reform Act of 1981.

The following sections of this statement contain an explanation of the provisions of the Transfer Tax Reform Act of 1981.

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I. Increase In Unified Credit

The bill provides for a substantial increase in the unified credit available for estate and gift tax purposes. The increase is phased in over a period of four years. Reference to the increase in the unified credit exemption equivalent gives the best illustration of the proposed increase in the unified credit. Under present law, the unified credit exemption equivalent is approximately $175,000. Under the proposed increase in the unified credit, the exemption equivalent amounts would be $250,000 for 1982, $300,000 for 1983, $400,000 in 1984 and $500,000 in 1985 and thereafter. The inflation of the last several years that is still continuing has resulted in an increasing number of estates, many of them consisting largely of farms and small businesses, being subject to an increasingly heavy burden of estate tax. The increase in the unified credit will help limit the impact of the estate tax to estates that Congress felt were appropriate to tax back in 1976.

II. Increase in Annual Gift Tax Exclusion

The bill provides for an increase in the annual exclusion amount for gift tax purposes from $3,000 to $10,000. This provision would be effective for gifts made after 1981. The $10,000 amount has been made necessary by inflation. If the $3,000 amount was fully increased for the inflation that has occurred from the time that the $3,000 amount was initially established in the 1940's, the annual exclusion should be increased to $15,000. The $3,000 amount now does not allow a parent to give a child an American made car or even to pay for a year of college tuition at many schools without gift tax consequences! Imposing tax consequences on these common parental expenditures erodes the citizen's respect for the entire transfer tax system.

III. Estate Tax Treatment of Transfers Made Within Three Years of Death

The bill provides for a change in the valuation date for certain gifts made within the three year period prior to the decedent's death. Under present law, such gifts are to be revalued on the date of the decedent's death for purposes of including the gift in the donor's gross estate. Many times this presents a difficult tracing problem for the estate, because the donee may be unavailable or may have disposed of the asset prior to the decedent's death. The bill provides that the date of valuation of such gifts for estate tax purposes shall be the date of the gift rather than the date of death.

Under present law, certain gifts made by the decedent during the three years prior to his death must be included in his gross estate. However, the gross estate of a decedent does not include gifts made by the decedent during this period if no gift tax return was required to be filed by the decedent because the gifts were within the $3,000-per-donee annual exclusion. Gifts made by the donor and the donor's spouse may, with the consent of both, be treated as made one-half by each, and the full annual exclusion is allowed with respect to each spouse's one-half share of such gifts. Present law does not allow the exclusion of these "split-gifts" from the donor's gross estate if the gifts were made within three years of death. The pullback of these gifts is an unnecessary complexity for executors of decedents' estates. The bill excludes these "split-gifts" made within three years of the decedent's death from the decedent's estate if there was no gift tax liability with respect to the gifts.

This section of the bill would apply to gifts made after 1981.

IV. Election To Pay Gift Tax

The bill makes the application of the unified credit against gift tax elective rather than mandatory. The purpose of this change is to permit a donor to elect to pay gift tax by not utilizing any part or all of the available unified credit in order to have the value of the gift for tax purposes finally determined within three years from the time that the gift tax return reporting the gift must be filed. This provision also makes the valuation of the gift binding for estate tax purposes and generation skipping tax purposes, as well as for purposes of determining the tax on subsequent gifts. These corresponding changes are necessary under the unified transfer tax system that was enacted in 1976. This section of the bill would be applicable to gifts made after 1981.

V. Necessary Revisions In Estate Tax Special Use Valuation Provisions

The bill makes several amendments to Section 2032A of the Internal Revenue Code regarding the special use valuation of farms and other business real property for estate tax purposes.

A. Qualified Use Problem

The so-called "qualified use" problem is eliminated by providing that the farm does not have to be a trade or business with respect to the decedent on the date of death, as long as it is a trade or business with respect to the decedent or a member of the dececent's family for five of the eight years prior to the decedent's death. The qualified use problem under present law can best be illustrated by the IRS position that the estate of a retired farmer who was cash renting the farm to a neighbor at the time of death, even if the farm operation was a trade or business of the decedent or a family member for five of the eight years prior to death, cannot qualify for special use valuation. The bill resolves this problem by eliminating the requirement that the property must have been used in a qualified use on the exact date of the decedent's death. The property must have been used in a qualified use for five of the eight years prior to the decedent's death, but such qualified use may have been by either the decedent or a member of the decedent's family. This provision of the bill is effective for estates of decedents dying after December 31, 1976.

B. Material Participation Problems

The bill provides for exceptions to the material participation requirement during the eight-year period prior to the decedent's death. The bill would add three exceptions to Section 2032A(b). The first exception is for decedents who were retired or disabled at the time of their death. This exception provides that the date of retirement or the beginning of disability would be treated as the date of death for purposes of determining whether the five out of eight year material participation requirement has been met.

The second exception to the material participation requirement is for the estate of a decedent who inherited the farm from a spouse. The decedent may have difficulty, either because of lack of experience or poor health, in meeting the material participation requirement and there may be no member of her family available to operate the farm for her while she is living. The bill provides in these circumstances that the decedent who has received the property from a spouse need only be involved in the "active management" of the property, which means the making of the significant management decisions rather than participation in the daily operations of the farm or other business. It should be noted that if there are no qualified heirs of such a decedent involved in the farm management after the decedent's death, then the decedent's estate will not be able to permanently obtain the tax savings resulting from special use valuation.

The third exception to the material participation requirement is for the estates of woodland owners. Most privately owned timber operations do not require day-to-day management decisions and material participation by the owner. The bill provides that woodlands can qualify for special use valuation if the decedent or family member has actively managed the property, even if the material participation requirement is not satisfied.

These three exceptions to the material participation requirement do not remove the basic requirement of active family involvement both before and after the decedent's death in order to permanently obtain the tax savings from special use valuation. This provision of the bill is effective for estates of decedents dying after December 31, 1981.

C. Future and Partial Interests

The IRS has taken the position that if any interest in the property passes to a person other than a qualified heir, then even the interests in the property that pass to qualified heirs will not qualify for special use valuation. The bill provides that as long as the aggregate value of the interests in the property not passing to qualified heirs does not exceed 5% of the value of the property, the interests passing to qualified heirs will qualify for special use valuation. The interests passing to qualified heirs will qualify for special use valuation even if such interests are "future interests" for purposes of the gift tax law, either as a future interest in a trust that holds the property or as a legal remainder or reversionary interest in the property. This provision of the bill is effective for estates of decedents dying after December 31, 1981.

D. Recapture Provisions

The bill shortens the recapture period after the decedent's death from 15 years to 10 years. The current 15 year period is unduly long and the 10 year period is still sufficient to deter non-farm investors from acquiring farm land for estate tax shelter purposes. This subsection of the bill also eliminates the qualified use requirement of the bill for qualified heirs by providing that the qualified use can be by either the qualified heir or a member of the qualified heir's family after the decedent's death. This clarification of present law is required by the IRS interpretation that if a daughter receives an interest in a farm from her deceased father and cash rents her interest to her brother who operates the farm, then the daughter has ceased her qualified use because she personally is not at risk in the farm operation and must pay recapture tax.

The bill provides for limited exceptions to the material participation requirement for the qualified heir or family member after the decedent's death. A qualified heir who is a spouse of the decedent, a minor, a student or a disabled person would not have to materially participate in the farm management. Instead, such a qualified heir or his fiduciary or family member could elect to have the farm actively managed by such persons to preserve the tax savings obtained by special use valuation. This subsection also allows a qualified heir receiving an interest in woodlands to actively manage the property rather than satisfy the material participation requirement.

The bill clarifies the manner in which the amount of recapture tax is calculated when only a portion of the property which has been specially valued ceases to be used in a qualified use or is disposed of to a non-family member. This provision limits the amount of the recapture tax to the same proportion of the total potential recapture tax as the value of the property ceased to be used in a qualified use bears to the total value of all property specially valued. This provision of the bill is effective for estates of decedents dying after December 31, 1976.

E. Increase In Value Reduction Limitation

Present law provides that special valuation cannot reduce the estate tax value of the decedent's interest in qualifying property by more than $500,000. Special use valuation was intended to provide estate tax relief to small family farms and closely held business real estate. The total elimination of the value reduction limitation might tend to increase the concentration of land ownership in extremely large farming operations. However, the value reduction limitation should be increased to reflect the inflation that has occurred since 1976. The $500,000 limitation is increased by $100,000 for each of five consecutive years starting in 1982, so that for the estates of decedent's dying in 1986 and thereafter there will be a $1,000,000 reduction permitted. This provision of the bill is effective for estates of decedents dying after December 31, 1981.

F. Trades and Exchanges of Qualifying Property

One of the extremely unfair results under the present special use valuation law is that if there are trades of farm property either before the decedent's death or by the qualified heir after the decedent's death, special use valuation is denied to the decedent's estate or a recapture tax is payable after the decedent's death. The bill eliminates both of these problems by allowing qualified property to be traded prior to the decedent's death or after the decedent's death as long as other qualified property is received in exchange and retained in the family business.

The bill permits qualified real property which has been valued under Section 2032A of the Code to be exchanged in a capital gain-free Section 1031 transaction for other real property without triggering a recapture tax under Section 2032A. The real property received in the Section 1031 transaction would be subject to the same restrictions and potential recapture tax treatment as the qualified real property prior to the Section 1031 transaction. This provision of the bill is effective for estates of decedents dying after December 31, 1976.

The bill permits special valuation of real property that has been received in a Section 1031 exchange within the eight-year period prior to the death of the decedent. This provision permits the tacking of the ownership, qualified use and material participation periods with respect to the property transferred in a Section 1031 transaction to such periods with respect to the property received in the transaction. If only a portion of the property transferred in the transaction was qualified exchange property, then the tacking would be permitted with respect to only a portion of the real property received in the transaction. This provision of the bill is effective for estates of decedents dying after December 31, 1981.

G. Election Requirement Eliminated For Involuntary Conversions

The bill eliminates the requirement that qualified heirs make a special election to receive the benefits of Section 2032A(h) when an involuntary conversion occurs.

When specially valued property is involuntarily converted, the estate tax saved by special use valuation will not be recaptured as long as the proceeds of the involuntary conversion are reinvested in other qualified property and such property is used in the family business. This provision of the bill is effective for estates of decedents dying after December 31, 1976.

H. Valuation Methods Revised

Some of the more important changes in this bill are the revisions to the two special use valuation methods available under the present law. The first valuation method is for farms only, and is described as the cash rental formula. Under present law, there are serious problems in implementing this formula where most of the farms in the particular locality are rented on a crop share basis. Present law requires reference to comparable farms in the locality that are rented on a cash basis in order to utilize the cash rental formula. The bill eliminates this problem by specifying that rental value can be used in the formula, without specific reference to other comparable farms leased on either a crop share basis or a cash rent basis. This change would permit the rental value to be determined from specific comparables, from area-wide averages or by appraisal in a manner similar to the traditional fair market valuation method.

A new optional valuation method is provided for woodlands where the executor elects to utilize it. This optional method is similar to the revised rental value formula, but it permits the income factor in the formula to be based upon the current woodland use of the property which may not necessarily produce income annually. This optional method would permit the expected income over a reasonable period of time to be annualized for use as the income factor in the formula.

The other method of special use valuation under present law is a five-factor formula, which appears to be of very little use to either farms or other business real estate. This bill would eliminate the five-factor method and substitute in its place a 50% discount from fair market value for any qualifying farm or other business real estate where the real estate does not qualify for the rental formula method or where the executor elects not to use the rental formula method.

These changes in the valuation method should eliminate many problems under current law and make special use valuation available to a broader group of farms and small businesses, as was originally intended by Congress. The values produced by either of the new methods would still be subject to the value reduction limitation applicable to special use valuation.

Under present law, once the executor elects a particular method of special use valuation when the return is filed, the election is irrevocable. Because of disputes which may arise in audit about certain aspects of the valuation method, it may become desirable for the executor to elect a different valuation method. The bill permits an executor who has made an initial election on a return to later elect to use one of the other valuation methods at any time the statute of limitations for assessing additional estate tax is open. All of these changes in the valuation methods are effective for estates of decedents dying after December 31, 1981.

I. Elimination of Basis Penalty Upon Recapture

The bill provides that in the event that the estate tax that was initially saved by electing special use valuation is recaptured under the provisions of Section 2032A(c), then the qualified heir may elect to have his basis in the property increased under Section 1014 to what the qualified heir's basis in the property would have been if Section 2032A had not been elected. If the qualified heir does elect to receive the increase in basis, then interest on the recapture tax must be paid from the date on which the decedent's estate tax was due under Section 2001 to the date that the recapture tax is paid. Once the basis penalty under Section 2032A is eliminated, interest should be imposed for the period of deferral of the estate tax in the event that a recapture event occurs, in order to deter abusive special use valuation elections made merely to obtain interest-free deferral of estate tax payment. This provision of the bill is effective for estates of decedents dying after December 31, 1976.

J. "Family Member" Definition Revised

The bill expands the definition of family member for purposes of special use valuation to include relatives of the decedent's or qualified heir's spouse. This change will permit special use valuation of property left to a decedent's spouse when a brother of the decedent is the farm tenant on the property, for example. This expanded definition of family members is needed to make special use valuation applicable to many small family farming operations.

The bill also makes other significant changes in the definition of family membership. The family members of the decedent are defined more narrowly than under present law by including only the descendants of parents of the decedent, rather than the descendants of grandparents of the decedent. However, with respect to the qualified heir the family members include persons who are family members of the decedent, as well as family members of a qualified heir. This would result in maintaining approximately the same family membership definition with respect to a qualified heir as under present law in cases where the qualified heir is a descendant of the decedent. Finally, the bill provides that a change in the marital status of an in-law through death or divorce will not affect special use valuation eligiblity or cause a recapture event. This provision applies to estates of decedents dying after December 31, 1981, except that for purposes of the recapture tax the additional family members under the new definition will apply to estates of decedents dying after December 31, 1976.

K. Signing Agreement On Behalf of Minor or Disabled Person

One of the imporant technical problems under present law concerns the signing of the special use valuation agreement on behalf of a qualified heir who is a minor or disabled person. The bill provides that the agreement may be signed by the disabled person's legal representative, parent or attorney in fact (acting under a power of attorney valid under applicable state law). This provision would in many cases eliminate the expensive and cumbersome requirement that a guardian be appointed by a court to sign the agreement on behalf of a minor child or grandchild in circumstances where there is no other reason to have a guardian appointed by a court. This provision is effective for estates of decedents dying after December 31, 1976.

L. Special Use Valuation of Trust Property

The bill specifically provides that a beneficial interest in a trust that holds legal title to qualified real property shall qualify for special use valuation in the same manner as if the owner of the beneficial interest in the trust owned the interest directly in the property held by the trust. It is further specifically provided that this rule applies even if the beneficial interest in the trust is considered to be personal property under applicable state law. This provision is not a change in existing law, but is merely added to clarify existing law in the absence of regulations on this matter at the present time. This provision is effective for estates of decedents dying after December 31, 1976.

M. Certain Purchases By Qualified Heirs

The bill eliminates the questions about special use valuation eligibility under present law when a qualified heir exercises an option to purchase qualified real property from the decedent's estate or trust. This provision is also generally directed at other eligibility questions that have arisen under present law when a qualified heir purchases an interest in the qualified real property after the decedent's death. These questions are resolved by specifying that generally a qualified heir who purchases an interest in the qualified real property from the estate or a trust or who makes payments to other persons required by the Will or trust agreement as a condition for receiving the interest in the qualified real property shall be deemed to have acquired the interest from the decedent. This provision is effective for estates of decedents dying after December 31, 1976.

N. No Reduction of Mortgage or Other Lien Deduction Is Required

Under present law the Service has contended that where special use valuation is elected, the deduction permitted under section 2053 of the Code for mortgages or other liens on the specially valued property must be reduced in the same proportion that special use valuation reduces the estate tax value of the property. There is no statutory basis for the Service's position and such a reduction in the estate tax deduction for such liens was not intended by Congress when it provided estate tax relief through special use valuation in 1976. The bill adds specific language to section 2053 of the Code to provide that there shall be no reduction in the amount of the estate tax deduction for such liens where the underlying property is specially valued. This provision is effective for estates of decedents dying after December 31, 1976.

VI. Improvements To Installment Payment of Estate Tax Provisions

The Internal Revenue Code contains two separate elective provisions allowing the installment payment of estate taxes where a major portion of the estate consists of an interest in a closely held business (or interests in closely held businesses). These rules contain different payout periods, interest rates, and conditions under which payments are accelerated. The Code also contains a special rule under which a qualified redemption of stock to pay estate taxes, funeral expenses, and administration expenses would be taxed as capital gain, rather than ordinary income, even though a similar redemption during the decedent's lifetime would have been treated as a dividend.

In general, the bill revises the provision allowing the more liberal extended payment rules by expanding it to include all those cases where an estate would qualify for either of the extended payment rules under present law (and eliminates the less liberal provision). Consequently, under the bill, an estate in which the value of a closely held business (or businesses) included in the estate exceeds 35 percent of the value of the gross estate or 50 percent of the taxable estate would be eligible for payment of the estate tax over 15 years, with interest only payable over the first five years. Also, the rules relating to acceleration of deferred payments would be liberalized by increasing from 33 1/3 percent to 50 percent the amount of a business interest that could be withdrawn before payments would be accelerated. Furthermore, a late payment made within six months of the due date would not accelerate all payments; instead, a penalty of 5 percent per month would be imposed.

The bill also revises the special Code section relating to qualified stock redemptions to pay estate taxes, funeral expenses, and administration expenses to make it applicable if the value of the closely held business meets the 35-percent test or the 50-percent test. The rules relating to aggregation of two or more businesses are also conformed to those in the deferred payment provisions.

Under present law, the closely held business interest must be either a trade or business carried on by the decedent as a proprietor or an interest in a partnership or corporation which is engaged in carrying on a trade or business at the time of the decedent's death. If business is carried on by a decedent as a sole proprietor, the interest in a closely held business includes only the assets of the decedent which are actually utilized by him in the trade or business.

In a series of rulings, the IRS has set forth guidelines for determining what amounts to a trade or business for purposes of the extended payout sections. These guidelines set up a somewhat narrower definition of trade or business than the meaning given the phrase "trade or business" in other areas of the tax law. In general, these rulings do not treat the management of income-producing property as a trade or business. Consequently, the splitting of an owner's business between an operating corporation and his personal retention of the premises may prevent his estate from using installment payments for estate tax purposes. Thus, in one situation, a decedent incorporated his sole proprietorship but retained personal ownership of the land and building used in the business. Decedent leased the real property to the corporation which actually used it in the corporation's business. The IRS ruled that decedent's ownership of the real property did not qualify as a business interest and thus could not be taken into account in determining whether the estate met the percentage requirements for deferral of estate taxes.

Similarly, giving up active participation in farming because of age and health may result in the loss of the use of the installment payment provisions. In one situation a 96-year-old farmer gave his children the livestock used on his farm and leased the farm property to them on a rent-free basis. The farmer, who took no further interest in the management of the farm, died a year later. The IRS ruled that neither the livestock, which was included in his estate because the gift was made within three years of death, nor his real property qualified as an interest in a closely held business because he had not actively participated in carrying on the farm business.

These IRS positions indicate that the current rules are not adequate to allow estate tax deferral in many situations where the family is carrying on a trade or business on property even though the decedent is not personally doing so. Also, the rules should allow more flexibility so that, as long as the property is used in the trade or business, it does not have to be owned by the same entity that is engaged in the trade or business

The bill provides that a decedent's direct or indirect ownership in an asset or assets which are leased to or used by a family-owned business shall be deemed to be an interest in a closely held business carried on by the decedent. Generally, a family-owned business would qualify under this rule if a member of the decedent's family is engaged in the active management of a trade or business conducted by a proprietorship, a partnership, or a corporation, and the business is otherwise treated as a closely held business under the extended payout rules. The bill also provides that, in the case of property which is included in the decedent's estate because it was given away within three years of death, the time for testing as to whether the decedent was actually using such property in a closely held business is to be made as of the time immediately before the transfer (rather than immediately before death as is done for other property). This section of the bill is effective for estates of decedents dying after December 31, 1981.

VII. Revision of Disclaimer Rules

The bill amends the disclaimer provisions found in Section 2518 of the Internal Revenue Code by completely restating subsections (b) and (c). Disclaimer permits one to refuse an interest in property, so that it will be taxed as though it had never passed to him, if the disclaimant acts promptly after the interest becomes his and does nothing in the meantime to accept it. The amendment clarifies several important points in the application of the disclaimer rules to make the rules more intelligible to the average taxpayer and to insure that taxpayers who are similarly situated will be treated alike. The most important changes are: 1) to delay the running of the disclaimer period for contingent future interests until the disclaimant knows the full nature and extent of the interest he is to receive; 2) to permit disclaimer of any type of partial interests in any property, right or power; 3) to permit an interest in joint property acquired by right of survivorship to be disclaimed at the death of the first joint owner to die; 4) to permit a personal representative to disclaim if the disclaimant dies or becomes incompentent; and 5) to permit a disclaimer which complies with the federal rules to be effective for federal tax purposes even though it does not fully comply with all the technicalities of state law. This section of the bill would apply to all interests that become indefeasibly vested in the disclaimant after December 31, 1981.

SUMMARY OF STATEMENT OF MALCOLM A. MOORE
Davis, Wright, Todd, Riese & Jones
Seattle, Washington

HEARINGS HELD BY SUBCOMMITTEE ON ESTATE AND GIFT
TAXATION OF SENATE FINANCE COMMITTEE
June 5, 1981

I. IN GENERAL

The estate and gift tax laws should not apply to the majority of U.S. citizens and their estates because of the intrusiveness and hardship to those estates caused by the law's application, without significant offsetting benefit.

II. REPEAL OF THE ESTATE AND GIFT TAX LAWS

While no position is taken with respect to the total repeal of the estate and gift tax laws to all estates, they should be repealed in terms of their application to the great majority of U.S. citizens' estates.

III. UNIFIED CREDIT AND RATES

The unified credit should be increased substantially, partly to keep up with inflation, and partly to remove the bulk of U.S. estates from the system. The rates should also be adjusted downward if an increase in unified credit will not have the desired result.

IV. INTERSPOUSAL TRANSFERS

Any kind of interspousal transfers, be they outright, or in trust, or otherwise, should be exempt from estate and gift taxation, and the exemption should be unlimited. Such a "qualitative" and a "quantitative" change should apply to transfers both during life and at death.

V. GENERATION SKIPPING TAX

The generation skipping tax should be repealed.

VI. THE GIFT TAX ANNUAL EXCLUSION

The gift tax annual exclusion should be substantially increased.

VII. OTHER MATTERS

Rules relating to taxation of joint tenancies should be vastly simplified, Sections 2035 through 2038 should in large part be eliminated, the orphan's deduction should be applied without condition or if this does not happen, it should be repealed, and Sections 2032A, 6166 and 6166A should be combined into a single broad statute simply providing for deferral of estate tax in those cases which Congress believes require special treatment.

VIII. CONCLUSION

What is needed is not more "reform" which has brought complexity, but rather elimination of the application of the estate and gift tax laws to the great majority of U.S. citizens and their estates, which would be real reform in terms of the simplicity it would bring to the system.

STATEMENT OF MALCOLM A. MOORE
Davis, Wright, Todd, Riese & Jones
Seattle, Washington

HEARINGS HELD BY SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF SENATE FINANCE COMMITTEE
June 5, 1981

I. In General.

The touchstone of my position with respect to various proposals now pending before Congress for reform of the estate and gift tax laws is my belief that those laws should not apply to the great majority of U.S. citizens. It is my position, derived from nearly nineteen years of experience as a practising trusts and estates lawyer, and from extensive contact, on a national basis, with other lawyers having similar practices, that the intrusiveness and hardship caused by the application of the estate and gift tax laws to the vast majority of estates far outweighs any benefit, in the form of revenue or otherwise, to be derived from the application of those laws. The costs of applying and enforcing the estate and gift tax laws to most taxpayers is not only calculated in terms of the Internal Revenue Service payroll, but much more importantly, in terms of the monetary and psychological cost to our citizens, including distortions in normal living patterns, in planning for, and coping with, the application of those laws.

The lawyers in this country whose practice in large part involves trust and estate matters (which includes my own) know that their clients worry a great deal about how much of their estates will be taken in taxes, whether there will be enough left for their families to enjoy the fruits of their labors, and whether their assets (be they business enterprises, farms, securities, or other forms of investment) will have to be sold over a short period of time in order to meet those taxes.

II. Repeal of the Estate and Gift Tax Laws.

I do not take a position with respect to total repeal of the estate and gift tax laws because I consider that question essentially a political one related primarily to public policy as to concentrations of wealth vis-a-vis the encouragement of private capital development; my expertise and experience (and the reason for my desire to participate in these hearings) relates only to the problems of both lawyers and clients in coping with these laws over the years. From that perspective, however, I do endorse repeal of the estate and gift tax laws as they apply to those situations where the overall cost and intrusiveness resulting from the tax outweighs the assumed benefits (both fiscal and social) of collecting it. I believe that such is the case with the overwhelming number of estates in this country now subject to the estate and gift tax laws.

III. The Unified Credit and Rates.

I believe that the unified credit should be increased substantially over its present level. Part of the basis for believing that such an increase is essential is due to the seemingly constant inflation which has become a part of this country's economics. J. Thomas Eubank, Jr., former chairman of the Section of Real Property, Probate and Trust Law of the American Bar Association, graphically illustrated the effects of inflation on a modest estate, in his testimony in 1980 before the Subcommittee on Taxation and Management of the U.S. Senate Committee on Finance:

> If we consider a $250,000 estate on January 1, 1977, when the current rates became effective, and look at that same estate seven years later on January 1, 1984, assuming that the inflationary rate during each of those seven years is 10 percent and that no change in value has occurred except an increase commensurate with inflation, that $250,000 estate will be a $500,000 estate in 1984 with no real increase in value. The tax on that estate will increase from $24,800 in 1977 to $108,000 in 1984. To produce an accurate measure of the effect of inflation alone, a unified credit of $47,000 can be used in all calculations, even though the credit was less than that in 1977. If we measure the tax increase in constant 1977 dollars, the $108,800 tax is halved to $54,000. The tax increase in constant dollars is thus from $23,800 to $54,400, which is, most would agree, an alarming increase that Congress probably did not intend in 1976 when it enacted the present rates.
>
> If similar calculations are performed in 1977 estates ranging from $250,000 in value to $2,500,000 in value, an interesting pattern develops. With constant 1977 dollars, the tax increase for a $2,500,000 estate is 28 percent. This percentage tax increase drops as the estate size is lowered, until it reaches 22 percent for 1977 estates of $1,250,000 and $1,500,000, then it starts increasing dramatically as the estate size is lowered further. In the case of a 1977 estate of $500,000, the percentage tax increase is 37 percent. In the case of a 1977 estate of $250,000, the percentage tax increase is an alarming 129 percent. Stated

differently, the tax on that estate increases from 10 percent of the estate to 22 percent of the estate, without any real increase in the size of the estate.

These calculations lead to several important conclusions. The combination of inflation and rate progressivity creates problems calling for downward adjustments in rates throughout the schedule, if the basic level of taxation set in 1976 is to be maintained. Second, the unified credit that will reach $47,000 in 1981 is in need of adjustment upward, because its static character relative to inflation and rate progressivity produces the dramatic increases at the lower end. Third, the need for adjustments is greatest in the case of estates shown at the lower end, specifically, estates between $175,625 and about $500,000. Fourth, inflation has had and increasingly will have the effect of moving many 1977 nontaxable estates, those below $175,625, into the taxable category, thus taxing a great number of estates Congress did not intend in 1976 to tax.

I am not prepared to suggest a precise amount for the increased unified credit, or of an exemption equivalent. However, the level should be high enough so that the net revenue benefits of imposing and collecting the tax are not outweighed by the burdens and dislocations, both of property and planning, caused to the decedent's estate and family by reason of the tax. If Congress is not willing to raise the unified credit enough so that it alone will remove the burden and hardship of the tax's imposition on the great bulk of estates, the tax rates should be reduced so that, taken in conjunction with the amount of the unified credit, the relief I feel to be appropriate will be achieved. A reconsideration of the rate structure is also suggested by the fact that, once the unified credit is taken into account, the starting tax rate applicable to the portion of a person's estate in excess of the exemption equivalent is 32%. Hence, at present, the first $1 of wealth subject to tax is taxed at 32%.

Some combination of unified credit and rate structure similar to the proposals contained in S.395 would come close to achieving the balance between those burdens and benefits just mentioned.

IV. <u>Interspousal Transfers</u>.

A. <u>In General</u>.

Among those citizens who, as pointed out earlier, worry a great deal about what estate and gift taxes will do to their families, married couples in particular feel threatened by, and are fearful of, the estate tax. Present problems they face under present law are threefold:

> First, only $250,000 or one-half of a spouse's separate property, whichever is greater, can be left tax free to the surviving spouse; the death taxes which are imposed on the balance substantially reduce the amounts left available for the surviving spouse's benefit, which is perhaps the primary reason for the apprehension of married taxpayers.
>
> Second, there are needlessly technical and complex rules (particularly the so-called "terminable interest"

rule) which must be followed with great precision in order to "qualify" that portion of a spouse's property passing to the survivor which can be deducted; if these requirements are not satisfied, no deduction is allowed, even though the property intended for deduction in many cases ends up taxable in the surviving spouse's estate.

Third, in order to avoid having to pay estate tax at the second spouse's death on property already taxed at the first death, part or all of that property is often directed to be held in trust for the surviving spouse's benefit, even if neither of the spouses see any utility to such a trust (e.g., in terms of management or protection for the surviving spouse).

Should it really be the policy of the United States that the existence of arbitrary rules and the imposition of taxes on transfers between spouses should result in depriving spouses who have worked, and in many cases, struggled to produce that property, of its full and unfettered enjoyment?

B. Qualifying Property Transfers for Deduction.

I believe that the present complex rules for the qualification of property for the gift and estate tax marital deduction which, among other things, deny any deduction for a simple life estate in property given to the surviving or donee spouse, should be eliminated so that all forms of property transferred during life and at death from one spouse to another will "qualify" for the marital deduction. Even though there are a great number of spouses who make tranfers to the surviving or donee spouse in outright form, there are those who are legitimately concerned that the surviving or donee spouse (in many cases a spouse by a second marriage) might later redirect the property's ultimate disposition to persons outside the transferor's family -- such as to a new spouse or to the second spouse's children. Those who have this concern want to insure, insofar as possible, that after the surviving or donee spouse's death some property remains for the transferor's children.

Under present law, since a marital deduction can only be obtained for property which is either transferred outright to the surviving or donee spouse, or transferred in such manner that such spouse is granted complete lifetime, or at least testamentary, control over the property's ultimate disposition, such assurance is not possible. If a person wishes his spouse to have the full use of the property during such spouse's life, but also wishes his children to benefit from it after the spouse's death, should the law deny him a deduction from transfer tax for such a disposition, when such a deduction is granted for other types of transfers?

A qualitative expansion of the marital deduction for both testamentary and lifetime interspousal transfers need not result in the exclusion of such transferred property from both spouses' estates. If the property qualifies for deduction in the transferor's estate, or for gift tax purposes, then that property should be includable, to the extent it is extant at the surviving or donee spouse's death, in such spouse's estate. Where the nature of the property interest involved would not cause its inclusion in the spouse's estate, such inclusion could be accomplished by an election by the transferor to have such transferred property (i) qualify for a current deduction (as a qualified interspousal transfer) and (ii) be subject to inclusion in the spouse's estate with the increase in tax caused by such inclusion being paid from such property if the spouse does not direct otherwise. If the transferor makes no such election, then the surviving or donee spouse could make the election, in which event the increase in tax caused by such inclusion would be paid by such spouse's estate in the usual manner.

C. Transfers at Death.

I further believe that there should be an unlimited deduction for all transfers at death between spouses, so that if 100% of a spouse's property is left to or for the benefit of the surviving spouse, there would be no tax. Regardless of how the legal ownership of property is recorded, most spouses do not regard the property as "mine" or "yours" but rather as "ours" (at least insofar as its use is concerned) and, consistent with this perception, a great number of planned and unplanned deathtime transfers of property between spouses occur, which transfers should not be subject to estate tax. Many couples feel that their properties should be wholly available for the surviving spouse's use and their testamentary planning reflects this desire, either by an outright disposition to the spouse or by a disposition in trust for the spouse's benefit. Unplanned transfers at death take place all the time because of the common practice of holding property in joint tenancy with right of survivorship (e.g., real estate, stocks, bank accunts, etc.) which means that, at the death of the first spouse, all such property passes outright to the surviving spouse.

Under present law, since only the greater of $250,000 or one-half of property transferred to a surviving spouse in qualifying form is deductible in the first estate, part of the property in many cases ends up being taxed twice -- one-half is taxed in the first estate, and all in the second estate. This has led to the practice of creating a trust for the surviving spouse's benefit of the property subject to tax at the first death, so that it will not be taxed again at the second spouse's death, even if the spouses would prefer not to have such a trust. Providing a deduction in the first decedent's estate for all interspousal transfers would eliminate this unfair second tax on the presently nondeductible portion of the first spouse's estate currently payable if there is no such trust, and allow dispositive decisions to be made on the basis of what the couple deems best for them, not on the basis of the tax consequences. In particular, such a change in law would give relief to those estates which are essentially unplanned, and become overtaxed, by reason of titling in joint tenancy. Citizens should not be penalized in terms of taxation, as they now are, if all of their property is held in such joint tenancy fashion.

D. Transfers During Life.

I also believe that, as with transfers at death, no transfer tax should be payable in connection with the many planned and unplanned transfers of property which take place between spouses during life. Often such planned transfers occur simply because of the desire to give a spouse a more secure feeling that the property involved is really "ours" -- both legally and actually. Even though, as a practical matter, the income from property owned by one of the spouses is usually available to, and utilized by, both spouses during the marriage, such equal access to income in many cases does not satisfy the psychological need of a spouse to be an "owner" or "co-owner" of the property.

Another reason for planned lifetime interspousal transfers is that the spouse with the property desires to insure against the impecunious spouse dying first with the resultant loss of that spouse's unified credit. If community property is involved, there is an automatic sharing (and ownership) so that the exemption equivalent and unified credit will not be wasted with respect to such property. However, there are presently only eight community property jurisdictions and it is natural that as to separate property (which is the dominant property interest in the other forty-two states) spouses want to (and should) have, and by lifetime transfers insure against losing, that same advantage, without paying a tax penalty.

Unplanned lifetime interspousal transfers also take place with great frequency. For example, these transfers occur when assets are placed in joint name (stocks and bonds, business interests, cash, etc.) which spouses are also advised, and desire to do. Similarly, when a married couple moves from a separate property state to a community property state and uses one spouse's separate property to buy a house which is thereafter held as community property, an unplanned taxable transfer occurs, unless state law imposes a right of reimbursement from the community property to the separate property.

The result of such planned and unplanned transfers, if the amount involved exceeds $3,000, is imposition of the federal gift tax law which, even if no tax is payable by reason of the transfer being under $100,000 or by reason of the unified credit shielding such transfers from tax, still requires the filing of gift tax returns. Since most spouses have no idea that these transfers may result in taxable gifts, they end up not filing the required returns. At worst, this makes them law breakers, and at best it muddies the waters with respect to ownership; the failure to comply with the gift tax law can also create real problems upon the death of either spouse. Any tax system that thus intrudes upon normal dealings between spouses during life is inappropriate. Planned and unplanned interspousal lifetime transfers will continue to take place among the great majority of the population and the law should allow all such transfers to be made free of gift tax.

E. Considerations Common to Both Lifetime and Death Transfers.

Provision for a qualitative expansion of the forms of property disposition between spouses which would qualify for deduction, coupled with removal of the amount which could be deducted, would also in large part solve the very difficult and unnecessary problems caused by the application of the estate and gift tax laws to the creation and severance of joint tenancies between spouses. Under such changed law, creations and severances of joint tenancies between spouses would not be subject to any transfer tax, nor would deemed transfers of such joint property upon death from one spouse to the survivor result in taxation. Such changes in the tax laws, coupled with an increased exemption equivalent and rate reduction, would also serve to relieve liquidity and other problems now faced by owners of farms, closely held businesses and other illiquid assets.

Providing for the complete exemption from tax for interspousal transfers in any form is consistent with my belief that federal transfer tax laws should not apply in a manner which unnecessarily intrudes into the decisions of taxpayers (as they currently do) in terms of artificially limiting either how or what they might transfer to spouses. It would also eliminate the necessity which now exists for maintenance by spouses of complicated bookkeeping and accounting records relating to property transfer and ownership. There is also great merit (and common sense) in taking completely honest tax payers out of the "law breaker" category in which many of them now find themselves (albeit unknowingly and innocently) because of the complex and limiting requirements with respect to the present gift and estate tax marital deduction. The qualitative expansion, coupled with an unlimited deduction in amount for interspousal transfers, would also allow the removal of much of the complexity now present in many spouse's wills by reasons of the conditions and limitations imposed by the current interspousal transfer tax laws, and the artificial "push" in many cases to create trusts.

V. Generation Skipping Tax.

I believe that the present law imposing tax on generation skipping transfers should be repealed. Again, the primary reason for my position is my belief that the tax creates an unreasonable intrusion upon a citizen's financial affairs, and the planning necessitated by the law results in a cost far in excess of any possible benefits. The law is extremely complex in its provisions and operation. Now, five years after the law's enactment, the taxpayers and their advisers have yet to see any final regulations dealing with the law's major provisions, and proposed regulations have been issued on only a few of the law's many complex features. One can only conclude that this delay is in part attributable to difficulties that the Treasury and the Internal Revenue Service are having understanding and interpreting the law. The law requires extensive record keeping, both by the Internal Revenue Service and by trustees and beneficiaries, to deal with what apparently was perceived to be widespread utilization by taxpayers of transfers in trust designed to avoid death taxes at several generational levels. In fact, in my experience, prior to 1976 such long term trusts for tax avoidance purposes were few in number and affected only a very small percentage of taxpayers. Enactment of the law was clearly an overreaction to a "nonproblem". The comment made by J. Thomas Eubank, Jr. in the 1980 hearings before the Subcommittee on Taxation and Debt Management, when he was commenting on disclaimers, seems particularly apt here:

> It would be nice if someone took away their [i.e., the tax technicians'] blunderbusses and issued them small bore rifles along with safety instructions and common sense.

As will be pointed out in the next several paragraphs, the generation skipping tax in fact applies to a wide segment of our citizens, who, along with their advisers, must plan for and cope with tax a that was never intended to apply to them.

For example, the tax now applies in such a broad fashion that it catches, and, subjects to tax as though it were a part of a child's estate, property which was never designed to be held for the child's life for the purpose of avoiding tax at the child's death. A typical illustration of this is a trust created for a child which will terminate at age 25 and which provides that if the child dies before age 25 leaving surviving children, they are to receive the trust property. If, in fact, the child dies before age 25, the trust property will be subject to the generation skipping tax (that is, it will be taxed as though it were included in the child's taxable estate) unless the property passes to the child's children in outright form or otherwise "vests" in those grandchildren for tax purposes in a highly technical sense that disqualifies many transfers on the basis of insubstantial distinctions and even then the exclusion from the child's estate is limited to $250,000. That kind of a trust was never designed to escape death taxes upon the child's death, but rather to provide a reasonable means for managing property for the child's benefit until the child reached what the transferor considered an age at which the child should be able to manage the property. Why should lawyers and their clients be forced to insert basically "unnatural" provisions (e.g., "vesting" provisions insuring inclusion of property in grandchildren's estates in order to qualify for the $250,000 grandchildren's exclusion) into completely natural dispositions directing that property be held for a child until age 25 or 30? The families of those clients whose wills do not contain the "magic" vesting language end up paying a tax which could have been avoided by the inclusion of certain technical provisions (although perhaps unwise and undesired) and that result is unfair to the client who has not engaged counsel expert in the intricacies and unexpected application of this new and confusing law.

Another example of the law's unfair and unplanned application involves the case where a person gives property to a person in a younger generation to hold for an even younger generation beneficiary. For example, assume that an uncle leaves property with his nephew as trustee to hold for the benefit of his grandnieces and grandnephews. Upon the death of the nephew while the trust is still extant, the value of the trust property will, in effect, be included in the nephew's estate as a generation skipping transfer even though he never had any enjoyment or beneficial interest in the property. The same result occurs if the transfer is not in trust, but to the very commonly used custodianship under the Uniform Gifts to Minors Acts of many states. The law should not apply to fiduciaries who have no beneficial interest in the trust property. The presence of that provision in the law puts individual fiduciaries under a great disadvantage vis-a-vis corporate fiduciaries to whom the transfer tax does not apply. Individual fudiciaries are also at a disadvantage when it comes to complying with the new law; corporate fiduciaries are having a difficult enough time dealing with the law (and are making increased charges to the trusts they administer because of its presence). In many cases individual fiduciaries simply will not know enough to know when and how to comply with the law. Here is another example of citizens being made lawbreakers by the presence of intrusive and overreaching laws which are complex and apply with much too broad a brush.

The generation skipping tax applies in so many instances to so many trusts that it is difficult today to create a trust with any kind of non tax-motivated flexibility without running afoul of the tax. For example, a garden variety "sprinkling" trust which provides present benefits for children as well as the surviving spouse, but which also provides benefits for children of a deceased child) is a generation skipping trust with possible transfer taxes payable merely by reason of the death of a child while the trust is still in existence. However, to add further complexity, the tax will probably not be due until the trust's termination, which could be many years after that child's death. What this means is that records with respect to that child's estate's assets will have to be maintained (even if they are not large enough to require an estate tax return) in order to ascertain at what bracket the property subject to the generation skipping tax will be reported and taxed.

The vast majority of testators or donors simply do not create trusts for their children with the idea of saving or eliminating death taxes upon a child's death. The trusts are set up for good and understandable reasons, such as holding property until the beneficiary is deemed mature enough to deal with it, or placing property in a trust for a child's benefit rather than giving it to him outright, perhaps to protect the child (in this day of so many broken marriages) against a spouse's access to such funds. Why should donors and transferors not be allowed to make these transfers without having to be mindful of complex, intrusive, and costly (both in terms of planning and collection) tax laws?

VI. The Gift Tax Annual Exclusion.

I believe that the gift tax annual exclusion should be substantially increased. It has been at its present level since

1942. I do not propose particular figures for the exclusion, but it should be high enough to deal with those everyday "non gift" transfers which we find our clients making but which are, in the absence of a substantial increase, caught by the gift tax law's application. For example, the exclusion should be large enough so that a parent's payment of tuition and related expenses for his child attending college would be outside the ambit of the gift tax. It is certainly the case today that virtually no taxpayers file gift tax returns in connection with payments made for such college expenses, yet there is no exclusion from the gift tax for such clearly "non gift" transfers. Almost all taxpayers would find it amusing and probably offensive that such expenditures which drain the family pocketbook should be taxable as gifts. In the same category are payments by adult children for support of elderly parents which are treated as gifts if, under state law, the child does not have an obligation to support the parent. Likewise, in most cases an automobile cannot be given to a young adult by his parents without exceeding the present exclusion limits. There is simply no reason that the gift tax laws should have any effect or impact on such transfers.

The gift tax exclusion was enacted to take _de minimus_ transfers out of the gift tax system. If $3,000 was considered _de minimus_ in 1942, surely a much greater amount would be considered so in 1981, and the laws should be changed to reflect this reality.

As was mentioned in the section of the paper dealing with interspousal transfers, a significantly large increase in the gift tax exclusion would also remove honest taxpayers from the "law breaker" category. Transfers of property which most tax payers today regard as insubstantial are made all the time among families, in both the education and support category, and in the "pure" gift category, and it is inappropriate to require taxpayers making such transfers to file gift tax returns in connection with them.

VII. Other Matters.

There are a number of other sections in the Internal Revenue Code which are addressed by various tax bills now in Congress. It is not my intent at this point to become any more specific in this regard than to point out the following: The rules with respect to taxation of joint tenancy interests are still a morass of complexity, and should be vastly simplified; the need for such laws, however, would be largely obviated by an increased exemption equivalent and an unlimited interspousal transfer provision. In the context of a unified transfer tax structure, Sections 2035 through 2038, of the Internal Revenue Code are inappropriate and unnecessarily complex, and should be drastically revised and simplified and some provisions can be wholly eliminated. While having a laudable purpose, the orphan's deduction, because of its complex and restrictive qualification requirements, creates such tremendous distortions and unwarranted risks in drafting property dispositions for any person having a child under age 21 that I believe it either should be applied without any conditions or should be repealed. Finally, Section 2032A, Section 6166, and Section 6166A should be considered as a package, with the same threshhold percentage requirements being applied in all cases covered by such sections and with greatly reduced complexity or, better yet, those provisions should be combined into a single broad statute simply providing for deferral of estate tax in those cases which Congress may believe require special treatment, as is currently the case with certain closely held businesses and farms.

VIII. Conclusion.

Since 1969 three Tax Reform Acts have dealt with the problems of taxaton of gifts and estates: the 1969 Act dealing with charitable gifts, the 1976 Act dealing with unification of rates and substantive reforms including carryover basis and generation skipping provisions, and the 1978 Act dealing with the repeal of carryover basis and other corrections to the 1976 Act. What has been enacted in the name of reform has introduced complex concepts into estate planning so that even the Internal Revenue Service is having difficulty drafting regulations. Curiously vested remainders, which lawyers have avoided for centuries, now become tax saving devices. The new concepts introduced in these so-called reform acts have no relationship to the realities of estate planning in the real world. No one will ever know how much time, effort and expense has been incurred, or will be incurred in the future, by the American public because of the new complexities introduced in estate planning and death taxation in the name of reform. However, on a daily basis in estate planning and estate administration, I believe that burden has been and is too expensive and unfair to the American taxpayer.

We do not need more "reform" which adds complexity to a system which is already so complex that few lawyers, let alone the general public, understands it. What we do need is to simply eliminate, along the lines set forth in this paper, the estate and gift tax as it applies to the great majority of U.S. citizens.

STATEMENT OF WILLIAM P. SUTTER
PAST PRESIDENT, ON BEHALF OF THE ILLINOIS
STATE BAR ASSOCIATION, ON ESTATE AND GIFT
TAX REFORM, BEFORE THE SUBCOMMITTEE ON ESTATE AND
TAXATION, COMMITTEE ON FINANCE, UNITED STATES SENATE

June 5, 1981

Mr. Chairman, members of the Committee, my name is William P. Sutter. I am appearing here on behalf of the 25,000 members of the Illinois State Bar Association, of which I am a past President. I have been chairman of the Probate Practice Committee of the Chicago Bar Association and chairman of the Committee on Income Taxation of Estates and Trusts of the American Bar Association Section of Taxation. I am a member of the Board of Regents and of the Estate and Gift Tax Committee of the American College of Probate Counsel. I am a partner in Hopkins & Sutter in Chicago.

It is with a sense of deja vue that I appear here this morning because it was a little over 8 years ago that I appeared before the House Ways and Means Committee at the 1973 Hearings on Estate and Gift Tax Revision to advance the same arguments which I present today.

In 1973 I stressed to the House Committee that there is often a dichotomy between simplicity and what is intended to be equity. I pointed out that, in Illinois, there are a great many practitioners who are not technical tax experts, and that they feel strongly that, unless an inequity is so gross and so apparent as to be obvious to all members of the Committee and all Members of the Congress, simplicity in taxation rather than an elusive concept of equity is to be preferred. I also pointed out that this is particularly true where the alleged inequity results from a tax provision which has existed for many, many years without change.

At that time, I was addressing and opposing a proposal for constructive realization of capital gains at death, an alternative proposal for carryover of basis at death, and a proposed tax on generation-skipping transfers. Unfortunately, a few years later, both carryover basis and the generation-skipping tax were enacted. However, it was shortly demonstrated so conclusively that carryover basis is totally unworkable because of both legal and factual complexities that its repeal was accomplished almost without opposition. Today, I join with numerous other witnesses in urging that the generation-skipping tax be relegated to the same limbo to which the well-intentioned, but friendless, carryover basis has already been consigned.

Statements filed with this Committee, which I have read and with which I am in complete agreement, demonstrate conclusively that the generation-skipping tax is unquestionably the most complex piece of legislation with which large numbers of individuals, fiduciaries and attorneys have ever been asked

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to deal. When a tax is so complex that only a very few of the most expert tax practitioners know when it applies, to whom it applies, and how best to avoid or minimize its consequences, it is a tax which will be widely ignored by taxpayers, which cannot be enforced by revenue agents other than the most sophisticated, and which, when enforced, will be enforced chiefly against those without high-priced and skilled counsel. Indeed, the Treasury Department has not even yet been able to draft workable regulations and forms interpreting the Code provisions. Proposed regulations recently issued were so deficient that they provoked 58 pages of single-space comments by the Trust Division of the American Bankers Association, together with elaborate suggested revisions. The comments of the Section of Taxation of the American Bar Association ran to a mere 136 pages. Such a tax makes a mockery of our self-assessment system, lowers the respect of the tax-paying public for such system, raises little or no revenue, and, in short, is an evil far worse than any perceived inequity which it is intended to correct.

It is not my intention to discuss in detail these complexities, but I hope to give a few simple illustrations as to why the tax is unfair, incomprehensible and unworthy of retention.

Section 2613(b)(6) provides that the $250,000 grandchild exclusion from the generation-skipping tax is to be applied to transfers in the order in which they occur. Assume a generation-skipping trust of $1,000,000 where principal may be distributed to grandchildren only for specified purposes, any such distribution being treated as an advancement of the recipient's share in the trust. A corporate trustee distributes $250,000 to grandchild A for such a purpose, for example, investment in his business. Thereafter, the child of the grantor who is the parent of the grandchildren and is the deemed transferor of the trust dies, the remaining $750,000 becoming distributable equally to grandchildren B, C and D. The death of the child is a taxable termination, and a generation-skipping tax is payable from the trust assets. The distribution to A, however, was not a taxable distribution, because of the availability of the $250,000 grandchild exclusion. Thus, A receives $250,000 unreduced by tax. If the deceased child had no taxable estate whatever, a most unlikely case, the tax on the $750,000 remaining in the trust would be $201,300; each of B, C, and D would receive $67,100 less than A. A tax which operates in such an arbitrary fashion is not one which can expect to command either support or respect.

The generation-skipping trust which truly skips a generation, i.e., the trust which benefits only grandchildren of the grantor, is not subject to a generation-skipping tax.

Thus, families of great wealth can avoid the tax, whereas those whose children require assistance may be subject to it. The tax fails to deal properly with the problem it was intended to solve. Even worse, the tax can lead to extremely poor family planning. Assume that G has an estate of $1,250,000 after taxes, and that G's son, S, has no assets of his own. If G leaves $1,250,000 outright to S, on S's death the estate tax on this amount will be $401,300. If the $1,250,000 is left in a generation-skipping trust for S's life, with remainder to S's children, the $250,000 grandchild exclusion causes the generation-skipping tax to be imposed on $1,000,000, rather than $1,250,000. The tax will be reduced to $298,800, a saving of $102,500. However, if the generation-skipping trust is cut to $750,000, and $500,000 is placed in a trust for the sole benefit of G's grandchildren in which S has no interest, the tax will be only $108,800, because the grandchildren's trust will not be taxed.

Example

Estate tax on $1,250,000	$401,300
Generation-skipping tax on $1,000,000	298,800
Saving	$102,500
Generation-skipping tax on $500,000	108,800
Added saving	190,000
Total saving possible	$292,500

To begin with, only if G has access to a sophisticated tax planner, will G comprehend the possibility of such saving.

The creation of two trusts, one in which S will have an interest and one in which S will have no interest, is contrary to all ordinary notions of family estate planning, and is purely a tax avoidance device. Secondly, if G has expert tax advice, and learns of the chance to save $292,500, how can G be expected to resist? Yet, if G succumbs, S, with no other assets, is left to rely on a trust of $750,000, not a large sum in today's world, because S may not be given any interest whatever in the $500,000 trust for grandchildren. Indeed, S cannot even be given an unrestricted right to withdraw the principal of his own $750,000 trust, because such a right will cause that trust to be subject to the estate tax, rather than the generation-skipping tax and the benefit of the $250,000 grandchild exclusion will be lost at a cost of $92,500 in additional tax. The generation-skipping tax is both arcane and conducive to unwise planning in the name of tax avoidance.

If a generation-skipping transfer occurs at the same time as or within 9 months after, the death of the deemed transferor, for purposes of section 2056, section 2602(c)(5)(A) provides that the value of the gross estate of the deemed transferor is deemed to be increased by the amount of the generation-skipping transfer. Assume that H has an actual adjusted gross estate of $1,000,000 and he is the deemed transferor of a generation-skipping transfer of another $1,000,000. His adjusted gross estate is $2,000,000 and his maximum marital deduction is $1,000,000. Since the marital trust created by H's will can only be funded out of H's own property, his entire probate estate will be used to fund such trust. If the beneficiaries of H's residuary estate are his children by a second marriage, whereas the transferees of the generation-skipping trust created by H's father are H's children by a first marriage, the children of the second marriage will receive nothing, except to the extent that they collect in a malpractice suit against H's attorney for failing to deal with the situation.

Of course, where H's attorney knows of this effect of the generation-skipping tax provisions, H's will can be so drafted as to contain a provision that, in computing the size of the marital trust, the value of H's adjusted gross estate will not be increased by the value of any generation-skipping transfer of which H is the deemed transferor. If this were done, H's marital deduction would be limited to $500,000, and H's estate tax would be $108,800. This would be paid out of the residuary estate, leaving $391,200 for the children of the second marriage. For generation-skipping tax purposes, assuming a $250,000 grandchild exclusion, the taxable estate would be $1,250,000; total taxes would be $401,300, of which $292,500 would be paid out of the generation-skipping trust. The children of the first marriage would receive $707,500, and W-2 would get $500,000.

If H was only married once, however, and his children were the beneficiaries of both the residuary estate and the generation-skipping trust, H's will should <u>require</u> that the value of the trust be taken into account in determining the size of the marital trust. In such case, total taxes would be $201,300, $200,000 less than if the marital deduction were not so increased. The children would receive $798,700 and W would receive $1,000,000, whereas if the generation-skipping transfer were not taken into account, the children would receive $1,098,7000 ($300,000 more), but their mother would receive $500,000 less. In such case, it might well be mother who would expect the will draftsman to make her whole.

One final example illustrates the crazy quilt which has been embroidered in the generation-skipping tax provisions. Assume a trust created by G, born in 1907, for his life-long impecunious friend, F, born in 1910, and F's descendants. F has four children, A, born in 1940; B, born 1944; C, born in 1947; and D, born in 1950. The corporate trustee has power to distribute income or principal to F or F's descendants, with distribution on the death of F to his descendants, <u>per stirpes</u>. F will be assigned to the same generation as G, because they were born within 12-1/2 years of each other. A and B are in the first generation below G, because they were born more than 12-1/2 years but not more than 37-1/2 years after G. However, C and D are in the second generation below G, since they were born more than 37-1/2 years after G, even though they are actually in the same generation as A and B. Thus, the trust is a generation-skipping trust, and upon the death of F, if all four children survive him, the distributions to A and B will not be taxable distributions, but there will be a taxable termination with respect to C and D, since there was a present interest in two generations below that of G. Similarly, prior to F's death, distributions to C and D would be taxable distributions, but distributions to A and B would be tax-free.

Even more ridiculous is the fact that, if C had a child, GC, born in 1968, GC would be in the second generation below G, since GC would have been born more than 37-1/2 years but not more than 62-1/2 years after G. Thus, GC and GC's parent, C, would be in the same generation. On the other hand, if A had a child, GC-2, born in 1971, GC-2 would be in the third generation below G, even though A was only in the first generation below G.

It would be possible to continue ad nauseum with like examples of the peculiar, utterly unforeseeable results which the generation-skipping tax provisions of the Code produce. It is unnecessary to do so. The tax is not a significant revenue producer and will never be such; it is unavoidably complex; it is unfair; it is unenforceable. It should be repealed.

[Whereupon, at 1:07 p.m., the hearing adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF SENATOR SAM NUNN

Mr. Chairman, I am pleased to have this opportunity to present my views to the Committee on estate tax reform, a critical issue to millions of small business owners and family farmers.

Estate tax laws were originally conceived to prevent huge aggregations of wealth that could have adverse effects on society. But the estate tax law of today increasingly imperils the transfer of family business and farms from one generation to another.

In 1976, the Congress increased the estate tax exemption from $60,000 to $175,000 and the marital deduction was increased to $ 250,000 or one-half of the estate, whichever is greater. That was the first estate tax reform since 1942 and an important step toward improving business continuity. I am hopeful that Congress will soon take another step in that direction and that we will not have to wait for another 35 years for further estate tax relief.

Earlier this year, I joined in introducing S. 360, the Omnibus Small Business Capital Formation Act of 1981. That comprehensive measure contains estate tax provisions which would give additional protection from inflation and high taxes to the estates and lifelong work of millions of Americans. That bill would:

-- Raise the present estate tax provision so that up to $600,000 of an estate can be passed on tax-free to a descendant's children;

-- Provide for an unlimited gift and estate tax marital deduction so that an entire estate can be passed on tax-free to a surviving spouse;

-- Increase the annual gift tax exclusion to $6,000 per donee;

-- Make certain changes in the special use valuation rules for closely held businesses and farms;

-- Set the value of gifts made within 3 years of a descendant's death at the value at the time of gift rather than at the time of death; and

-- Permit the 5-year deferral/10 year installment election for payment of estate taxes, provided that at least 35 percent of gross estate, or alternatively, 50 percent of the taxable estate is a closely held business.

Mr. Chairman, runaway inflation and outmoded federal estate taxes now threaten the very existence of a whole generation of family enterprises. Inflation is artificially distorting the value of estates by making them appear more and more valuable while taxes in turn are taking away a bigger and bigger piece of the estate.

Since 1970, the average value of an operating farm in Georgia has increased by 232 percent. The value of an acre of farmland in the State has increased by nearly 300 percent. Similar increases in the values of small businesses and homes throughout the nation has taken place.

The time is ripe to give additional protection to the estates of small business owners and family farmers. After a lifetime of building their businesses for their children, their heirs should not be forced to sell the business or farm to pay the estate taxes.

The estate tax reforms proposed in the Omnibus Small Business Capital Formation Act would make significant and necessary changes in the law. I encourage the Committee to act expeditiously to adopt the badly needed estate tax reform and I commend the Committee for holding hearings on this vital issue.

<u>SUMMARY STATEMENT</u>

<u>JOHN H. FITCH, JR.</u>

<u>VICE PRESIDENT-GOVERNMENT RELATIONS</u>

<u>NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS</u>

<u>COMMITTEE ON FINANCE</u>

<u>SUBCOMMITTEE ON ESTATE AND GIFT TAXATION</u>

June 5, 1981

<u>SUMMARY</u>

Mr. Chairman, on behalf of NAW's 119 national commodity line associations and their 45,000 wholesaler-distributor members, I would like to commend this Subcommittee for the efforts it has undertaken to reform the estate tax laws.

There is a "crisis of perpetuation" for the small, family-owned wholesaler-distributor. Each succeeding year, it becomes harder and harder to continue the independence of the business and keep it within the family structure under today's estate tax laws.

Unless efforts such as yours here today are successful, the entrepreneurial uniqueness of America's free enterprise system will wither and die, and with it will go much of the competitive and innovative nature of our economy.

The National Association of Wholesaler-Distributors supports the outright repeal of the estate tax laws or, in the alternate, the following legislative initiatives which would significantly reform the current estate tax laws:

1. increase the estate tax exemption to include an unlimited deduction for the passing of a closely held business to a spouse or to children;

2. revise current estate tax brackets to counter "bracket creep" that has occurred as a result of inflation;

3. increase the time allowed for filing and payment of estate taxes;

4. reduce the requirement for a decendent's interest in a closely held business to 20% of gross estate or 35% of taxable estate, which would allow for use of ESOPs in closely held business estate tax valuation.

FULL STATEMENT

Mr. Chairman, Members of the Subcommittee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW.

Mr. Chairman, before I get into the substance of my statement, I would like to commend your efforts and those of the Subcommittee to address the crisis of perpetuation. For the small, family-owned wholesaler-distributor, it is difficult to continue the independence of the operation and keep it within the family structure.

Unless the estate tax laws are changed, the entrepreneurial uniqueness of America's free enterprise system will wither and die, and with it will go much of the competitive and innovative nature of our economy.

NAW

The National Association of Wholesaler-Distributors is a federation of 119 national wholesale distribution associations1/ which have an

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1/ Appendix A, is in official Committee files.

aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business.

The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 2.5 million, of the 4 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

The Industry

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 4 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

Industry sales totaled approximately $955 billion in 1980 and are expected to reach over $1 trillion in 1981, according to United States Commerce Department estimates.

A 1980 profile of the wholesale trade, as compiled by the U. S. Department of Commerce from Census Bureau figures, shows the following:

SIC CODES: 50-51	
Sales (million $)	955,175
Employment (000)	5,280
Number of establishments (1977)	307,264
Compound annual rate of change, 1975-80:	
Sales (percent)	12.3
Employment (percent)	3.6
Payroll (million $)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

ESTATE TAXATION AND THE WHOLESALE DISTRIBUTION INDUSTRY

Business Perpetuation in the Wholesale Distribution Industry

In 1973, NAW initiated a broad study to gain a precise understanding of the actual ownership and perpetuation status of wholesaler-distributors2/.

The survey involved 38 commodity line associations and was distributed to 18,000 firms. An astounding 5,000 responses were received, of which 4,700 were usable for the computerized analysis.

2/ A copy of the full study is appended to this statement.*
* In official Committee files.

The study was conducted by Robert C. Bansik, Ph.D., and Harold Squire, Ph.D., of the Capital University Graduate School of Business Administration in Columbus, Ohio. Data collected through the study revealed much about the individual wholesale distribution business and its ability to exist in its present form beyond one generation. The following typical ownership profile was determined from the survey results:

1) The firm has a net worth of between $250,000 and $499,000.

2) The Chief Executive Officer (CEO) himself owns from 51 to 74 percent of the firm's outstanding stock.

3) The CEO is between 50 and 59 years of age.

4) The CEO's personal maximum federal tax bracket is in the range of 35 to 49 percent.

5) His ownership in the company represents from 51 to 74 percent of the CEO's personal net worth.

6) Less than $100,000 in life insurance on the CEO is owned by the corporation, and payable to it upon his death.

Although the study was conducted in 1973, its conclusions remain valid today. Indeed, the situation has even more urgency associated with it due to mortality figures and due to inflation since 1976, when the law was last revised.

Based upon the determination of the typical ownership profile, the NAW Perpetuation Survey sought to answer the following question: "What is the likelihood that this firm can be perpetuated beyond the life of the present chief executive officer, in its present form?" The researchers concluded that: "In fact, given the present situation of U. S. inheritance/estate taxation and valuation, perpetuation in its present form may be highly unlikely."

The urgency of this problem cannot be emphasized strongly enough. Standard mortality tables, accurate to within a fraction of a percent, permit a very realistic projection of how many people, in various age groups, will die during any future specified period. Based on the "Commissioners' Standard Ordinary Table of Mortality," in conjunction with age data provided by the NAW Perpetuation Survey respondents, it was determined that at least 61 of the almost 4,700 owners replying would die by the end of 1975. Chief executive officers of the firms surveyed are dying at the rate of at least one per week.

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Table 1

AGE DISTRIBUTION AND MORTALITY

Expected Deaths by 1985

Age Reported	Number Reporting	Actuarial Age	Deaths by 1985
Under 40	423	40	22.0
40-49	1235	45	147.1
50-59	1817	55	359.1
60+	1266	60	364.4
			892.6

Source: NAW Perpetuation Survey, 1975.

Moreover, the study also showed that nearly 8 percent -- or 363 -- of the owners responding would die before 1980. As Table 1 shows, 19 percent, or 893, will have died before 1985. The figures may be morbid, but they are clear: one in every five chief executive officers of wholesaling firms faces death before 1985. The statistical figures shown are for general mortality; we would expect data for stressed businessmen to be higher -- accelerating the death rates for the respondents of the survey.

Over the years, the problem of perpetuation has gained in prominence for the owner or chief executive officer of a wholesale distribution concern as he plans for the disposition of his estate upon his death. The tax crunch resulting from present estate taxes becomes a major concern to everyone faced with this problem. The tremendous estate tax liabilities, which are certain to come due upon the death of a principal owner of the small wholesale distribution business, leave the heirs of the estate with few options -- pay up with cash on hand, or sell or merge the business to generate the needed amount of cash.

Payment of the estate tax, regardless of which methods are employed, will adversely affect the economic health of the small business community -- by reducing the funds available to the smaller business for continued growth, or by outright extinction of the small business firm through sale or merger.

Public policy has a tremendous impact on the preservation of a viable small business community in our nation, and on the unique needs and problems of the small business community. This has been recognized by the Congress, as is evidenced by the creation of the Small Business Administration, whose sole purpose is the preservation of a viable small business sector in the economy; the establishment of Small Business Committees in both the House and the Senate; the enactment of various small business oriented statutes; and the introduction each year of numerous legislative and regulatory measures specifically designed to aid small businesses.

Despite this recognition and awareness on the part of the federal government, nothing can protect large numbers of small businesses from dying a gradual death unless reform measures are enacted to mitigate the impact of estate taxation on small business. We recognize the fact that the estate tax system was never intended by the Congress to impact in any adverse manner on the small business community. However, the application of the law in today's economy has in fact done so -- a consequence completely at variance with the intent of the Congress.

Repeal of Estate Taxes

While we recognize the validity of the original purposes for the enactment of the estate tax laws: (1) as a revenue source; (2) to increase mobility and redistribute wealth; and (3) to enhance the progressivity of the overall tax system, these purposes have lost most, if not all, of their validity.

As a source of revenue to the Treasury, estate taxes provide precious little contribution; 1977 Treasury statistics show that estate taxes provided only 1.4 percent of total federal revenue in 1977.

As a tool for social reform, it is my opinion that since the enactment of the Tax Reform Act of 1916 when the present tax was first imposed, the number and percentage of those actively participating in the economic system has substantially increased. Moreover, Treasury figures show that the quality of that participation has also increased over the broad scope of our social spectrum. Thus, the necessity to prevent large accumulations of wealth from being passed along untouched by taxes to succeeding generations consequently reducing the mobility of other segments of society is passed. The goal has been achieved.

With the advent of this affluence came an increase in personal spending and a reduction in savings and investment, which have been exacerbated by inflation and government disincentives such as estate taxes and taxes on interest and dividends. The obvious result of that collective environment is the current disastrous economic situation in which our members find themselves today.

A barrier to savings, estate tax runs counter to what the Administration and Congress are trying to accomplish with the recent budget cuts, tax reform and regulatory reform. It is clear that the social goals have changed from mobility and redistribution of wealth to savings, investment, and preservation of independent family farms and closely held businesses.

Finally, estate taxes distort normal processes which small businesses' owners and others would otherwise use in the distribution of their estates upon death.

In our opinion, the evidence, as outlined above, is overwhelmingly in favor of the total abolition of estate taxes.

If, in fact, the repeal of estate tax laws is not feasible at this time, NAW would urge the following significant reforms to them:

Estate Tax Exemption

The burden of estate taxation has fallen increasingly on small businessmen and other middle-income taxpayers in recent years. The basic cause for this has been the long-term inflationary trend in our economy. No one needs to be reminded of the tremendous erosion which has occurred in the value of the dollar over the years. To illustrate the debilitating effect of inflation on the wholesale distribution industry, the Distribution Research and Education Foundation commissioned a study3/ by the senior faculty at the Graduate School of Business of the University of Michigan. The results of that study clearly reflect the need to take immediate steps such as estate tax reform, to alleviate this critical problem. Inherent in this inflationary trend is the fact that the cost of dying has also increased. Changes in the income tax exemption have been made numerous times over the years to account for the rising cost of living, but the corresponding changes made in the level of the estate tax exemption have not kept pace.

Therefore, NAW recommends that the specific exemption be increased to reflect the current inflationary value of estates since 1976.

We fully recognize that, should the exemption figure be increased, the impact on the revenue derived from estate taxes could be sizable.

3/ Copies of this study, Inflation in Wholesale Distribution have been provided to the Committee.

Therefore, if economic conditions and budget considerations should preclude this immediate increase in the specific exemption, NAW would not be adverse to adoption of a "phased-in" method of increasing the exemption, as was done in the Tax Reform Act of 1976.

However, it must be remembered that total revenues from estate and gift taxation represent a small percentage of total federal revenues. When considering the total economic impact of this proposal, this fact should be kept in mind.

This inflationary erosion of the estate tax exemption has led to serious structural changes in the free market system. That is, smaller businesses, because of the current estate tax laws, have less opportunity to remain independent and grow into medium-sized or even larger businesses.

Estate Tax Rates

Another aspect of estate taxation which requires examination is the rate structure. This structure is clearly a highly progressive tax, with marginal tax rates spanning from 18 to 70 percent. However, a close examination of the tax rates shows the sharpest rise in progressivity occurs in the lower rate brackets, while the upper brackets increase only mildly.

Clearly, the impact of the estate tax on the lower brackets seems unfairly severe.

A clear example of this can be seen when one examines the tax rate on $500,000 -- 32 percent. Yet, the rate on twice that amount -- $1 million -- is only 37 percent. It can easily be seen that inflation has severely distorted the rate structure, resulting in an effective rate of taxation completely foreign to that originally enacted. Thus, in practice, the marginal tax rates have also been raised due to inflation; i.e., estate tax bracket creep.

In the interest of returning parity to the estate tax structure, NAW recommends that Congress revise the tax brackets to obviate bracket creep generated by inflation using the same approach recommended by the Administration in reducing the individual tax rates as proposed in HR 2400 or S 683.

Table 2 presents an analysis of the effects of this "bracket creep" phenomenon on the average wholesale distribution firm.

The heirs of a family-owned distribution firm will naturally look to the business to pay the estate taxes attributable to the business. In our example, we have considered the business asset as representing the entire estate (this allows for the application of the full exemption and the lowest possible rate of estate taxation).

Table 2 shows the average asset size and net income for the typical wholesale distribution firm in the $250,000 to $500,000 asset grouping, as derived from the Treasury Department's Statistics of Income Series, the latest year for which data are available.

Table 2

IMPACT OF ESTATE TAXES ON TYPICAL WHOLESALE DISTRIBUTION FIRM ASSET SIZE CLASS

Asset Size	$250,000-500,000
Average Asset	$359,031
Less Exemption	$175,625
Taxable Estate	$183,606
Estate Tax	$ 49,553
Net Income After Tax	$ 16,792
Ratio of Estate Tax Liability to Asset Earnings	2.95

Source: Derived from applicable estate tax rates (Guide to Federal Estate Gift Taxation).

The typical firm in the $250,000 - $500,000 asset category has $359,031 in assets which would represent a $183,606 taxable estate with estate taxes due of $49,553 -- and an earning capacity of $16,792. The ratio of estate tax liability to asset earnings is almost 3 to 1!

The estate tax burden and the liability of the heirs and the executor of the estate to pay this tax seriously threaten the continued existence of this firm.

Clearly, inflation and the rate structure of the estate tax have had a tremendous adverse impact over the years, but most specifically, this impact has been felt to a greater degree by the relatively small estate.

We have illustrated the tremendous tax liabilities which fall due upon the death of a principal owner of a small, closely held business. However, this problem is compounded when one considers the nature and liquidity of the assets which comprise the estate consisting mainly of an interest in a closely held business. Closely held stock is highly illiquid, as there is not a ready market for the stock and such stock is not easily salable. In addition, it is highly unlikely that a prospective buyer of closely held stock would be interested in obtaining only a minority interest in the firm, thereby allowing the heirs of the estate to continue control of the family interest in the business. One must also consider the tremendous problems encountered in valuation of the closely held stock, as there are no truly objective standards employed in the IRS valuation of the closely held stock for estate tax purposes.

The preceding discussion clearly demonstrates the problems which face the small, closely held business upon the death of a principal owner. The future of that business can be very directly affected by the ability of the heirs to pay the estate tax. Inability to generate a sufficient amount of cash to satisfy the estate tax liabilities may force the heirs to sell their interest in the closely held business for this purpose.

It must be understood that the closely held business which has lost its principal owner is already in a precarious position, notwithstanding the additional burden of estate taxes. A difficult transition period takes place, during which time the individual(s) charged with directing the business must seek to compensate for the loss of valuable management skill and leadership which the principal owner had furnished over the years. Customers and suppliers must be assured that the business will continue to provide goods and services in an efficient manner, that existing financial obligations will not be neglected for any reason, and that future profitability will not be adversely hampered.

The problems and concerns of the closely held business stated above are by no means all-inclusive. The fact remains that the closely held business will face a period of uncertainty and remain particularly vulnerable to a variety of situations when faced with the death of a principal owner, who was most likely the chief executive officer.

At the same time, however, the heirs of the business must also be concerned with the payment of estate taxes. When the estate consists largely of an interest in a closely held business, heirs have few options open to them with regard to payment of the estate tax: pay with cash on hand (usually not a viable option); pay with cash obtained through a loan; pay on an extended basis in yearly installments; or pay with cash obtained through sale or merger of the firm.

Extension of additional credit at this time is highly questionable. Indeed, the contrary is likely to happen as the principal owner is also the chief executive officer, the one looked to by the bank to manage the business in such a way that the bank will be repaid its already outstanding loans to the closely held business. When the closely held business loses its chief executive officer, the bank is very likely to recall a portion of the loan or decline to extend additional credit or renew current loans until the future of the business is more certain.

Section 6166 - Extension of Time for Payment in the Case of a Closely Held Business

In the case of an estate consisting largely of an interest in a closely held business (i.e., where such an interest comprises 25 percent of the value of the gross estate or 50 percent of the taxable estate), the executor of the estate may elect to pay that portion of the estate tax attributable to the business interest in not more than five years, with payment on a yearly basis. The Code defines "closely held business" as: a) a proprietorship; b) a partnership having no more than 15 partners or one in which the business interest is at least 20 percent; or c) a corporation having no more than 15 shareholders or one in which the decedent held at least 20 percent of the voting stock.

This option has been included in the tax code in an effort to provide a measure of relief and protection to the closely held business. In practice, such provisions which grant an extension of time for payment of taxes are largely ineffective, mainly because of the stringent criteria set down in the Code. NAW firmly believes the effectiveness of Section 6166 would be enhanced greatly if the requirements were eased -- by reducing the percentage requirements for the decedent's interest in the closely held business from the present 25 percent of gross estate or 50 percent of taxable estate to 20 percent of gross estate or 35 percent of taxable estate.

In this regard, one must also consider the impact of Employee Stock Ownership Plans (ESOPs) on the ability of the closely held firm to elect to pay that portion of the decedent's estate tax attributable to the business interest in installments. The Congress has, on many occasions, endorsed the concept and utilization of ESOPs. However, if the closely held business determines that an ESOP should be established within that firm, the resulting increase in the closely held business's number of shareholders (and decrease in the percentage of voting stock held by the previous stockholders) could prohibit that firm from paying the tax in installments upon the death of a principal owner. The decision to establish an ESOP within a closely held business may therefore be tempered by considerations of the estate tax consequences.

The enactment of liberalized provisions for payment of estate taxes attributable to an interest in a closely held business would do much to enhance the perpetuation prospects of those businesses. Further, the revenue considerations involved in any liberalization of payment of these taxes would be small. Payment in full -- plus interest -- will be made; we are not advocating a forgiveness of any portion of the tax.

Unlimited Marital Deduction

Additionally, we observe that many legislative proposals dealing with estate tax reform also would provide for an unlimited estate tax marital deduction. NAW strongly endorses this concept and would go even further by providing a separate unlimited children's deduction or expanding the marital deduction into an unlimited family deduction.

CONCLUSION

Mr. Chairman, in closing I wish to express NAW's strong support for your bill S 404 to repeal the estate tax laws and, in the alternative, other bills which would address the substantive changes in the estate tax laws which I have outlined in my statement.

Without some immediate and substantial estate tax relief for the small family-owned wholesaler-distributors, the independent entrepreneur will slowly atrophy, and with that atrophy will go the unique characteristic that separates the American free enterprise system from any other economic system in the world.

Can we afford that kind of desecration?

Statement of Edward Andersen
Master of The National Grange

Mr. Chairman and Members of the Committee:

On behalf of the National Grange and its 450,000 members in 41 states, I am pleased to offer our views on the important subject of estate and gift taxation involving family farms and other small family enterprises. I wish to thank you, Mr. Chairman, and the Members of this Subcommittee, for your interest in this issue. Clearly, your concern for equity in the generational transfer of farms and businesses is of great importance to many Americans.

The National Grange has a long and proud tradition of service to family farmers and ranchers dating back to 1867. In those times, there was a need for rural Americans to band together in an economic and political union to draw attention to problems peculiar to rural life. Today, the need for the strong leadership of the Grange is just as great, given the fact that less than 3 percent of the U.S. population now resides in rural areas. Since its beginning, the Grange has championed the value of family agriculture. It is in this tradition that I offer our views on estate and gift taxation.

It must be recognized that taxes are not necessarily levied for the sole purpose of financing government. Taxes can be a useful tool for implementing public policy and addressing public concerns. The Grange has worked in concert with other groups to establish as public policy the need to preserve and protect farmla for our future needs and to encourage family-sized farms and ranches to furnish food and fiber for domestic needs and international trade. The Grange is alarmed at the rate at which this country is losing its farmland and the decreasing number of families deriving their income from agriculture.

Increasingly, America's production agriculture is being concentrated in the hands of fewer individuals.

The concerns of our organization for the future of family agriculture involve the issues of resource conservation and farm structure, and both can be addressed through estate and gift taxation. Estate and gift taxation must be placed in the broader context of agricultural and land use policy. Simply stated, estate and gift taxes significantly affect farm structure. Changes are needed to allow agriculture to continue to be a feasible vocation for the sons and daughters of those in the agricultural industry today. By facilitating the means by which farm estates can be passed on intact to heirs who desire to remain on the farm, efficient-sized agricultural operations will be assured for the future. Much of the decrease in the number of farm families can be attributed to the changes in agricultural production methods and technological improvements within agriculture. There are, however, limits to economies of scale, and farms should not be encouraged to expand beyond these limits.

The Grange feels strongly that the total repeal of estate and gift taxation will encourage farms to grow at the expense of family farmers and U.S. consumers. For the good of the agricultural industry and of the nation, there must be some means of assuring that farmland ownership does not become limited to a small proportion of the citizenry -- a "landed gentry". The Grange believes estate taxes are based on a sound premise, but the present exemption level is unrealistically low. Congress should act to raise the exemption levels to more accurately reflect the increased value of farmland. We recommend a $500,000 exemption to the adjusted gross estate value and an increase in the annual gift tax exclusion to $6,000.

The marital deduction must also be examined. The Grange believes the present estate and gift tax provisions fail to recognize the contribution of women in the operation of farm or ranch. We recommend an unlimited gift and estate marital deduction, as a proper way to recognize the economic rights of women. Marriage is an economic partnership, and the present tax provisions fail to recognize that fact. The Grange has a long and proud history of upholding the rights of women, and we urge Congress to address the serious inequity of present estate tax law.

Estate and gift tax laws can be a tool for implementing a public policy favoring the retention of farmland in agricultural production. Too much good, productive farmland is being lost to uses of less strategic importance to this country. Unless policy makers at all levels act to check present land use trends, our agricultural industry, the envy of the world, will be seriously affected. Farmland preservation for future generations must become a top priority of U.S. agricultural and tax policy.

When Congress enacted the Tax Reform Act of 1976, its intent was to allow farms and other small businesses to be valued, for estate tax purposes, on their current use rather than on the market value. This was a wise and proper decision. But certain subsequent decisions and interpretations seem to conflict with the original Congressional intent. The special use valuation provisions of the Internal Revenue Code need to be revised to enhance the future of family agriculture in America.

The National Grange strongly advocates the following changes in the special use valuation procedure outlined in Section 2032 A of the Internal Revenue Code: (1) Allow crop share rentals to be used for estate valuation purposes; (2) Substitute the "date of disability or retirement" for the date of death in qualifying under the "material participation" test; (3) Substitute "active management" for "material participation" if the property is inherited from a spouse who otherwise qualifies; (4) Place a reasonable total dollar limit on qualifying for special use valuation; (5) retain the current percentage-of-estate requirement in order to qualify for the special use valuation; and (6) retain the current 15-year recapture period.

The Grange believes that with the provisions outlined above, estate and gift taxes can be an effective tool for implementing a positive federal policy in behal of agriculture. These changes will provide assurances that family farms and ranches can be passed along through generations without encouraging the enormous accumulation of farmland holdings that have the signs of an eventual agricultural cartel. We believe these to be fair and equitable recommendations, and we urge their adoption.

Respectfully submitted

Edward Andersen

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*OHIO BAR ONLY

June 5, 1981

The Honorable Steven D. Symms
Chairman, Estate and Gift
Taxation Subcommittee
United States Senate
Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Symms:

The Specialty Advertising Association International, by its attorneys, hereby submits its views on S.395 and other bills which seek to revise the estate and gift tax laws and minimize the burden on small and moderate size estates. So that our views can be considered in their proper perspective, we shall begin with a brief description of our association client and the industry it represents.

The Specialty Advertising Industry

The Specialty Advertising Association International is the trade association that represents the specialty advertising industry. Its 2,400 member firms, located in virtually all states, manufacture or distribute specialty advertising products. Specialty advertising is an advertising medium that uses useful but inexpensive products to carry an advertising message. Examples of such products are ballpoint pens, key chains and calendars, which are custom-imprinted with the name, logo or other message of the advertiser and distributed free of charge for their promotional value.

By any definition, specialty advertising is a small business industry. It is composed primarily of two types of businesses: manufacturers that produce and/or imprint products and distributor firms that sell them. There are from 800 to 1,000 manufacturers of products used for specialty advertising purposes, most of which have specialty advertising sales of less than $500,000. Of the 4,000 distributor firms in the industry, more than 70 percent are estimated to have sales of less than $250,000.

Specialty advertising firms face all of the tax and other economic disadvantages of all small business companies. In addition, however, they have the problem of being in constant and direct competition with other advertising media composed primarily of large firms that do not have these disadvantages. These media consist of television, radio, newspaper and magazine publishing companies.

Views On Proposed Legislation

Mr. Chairman, we commend you and the members of your subcommittee for your in-depth consideration of this subject of vital interest to our industry and to taxpayers generally. Much has been said about the tax and other economic inequities faced by small business owners and we shall not elaborate on them here. We do wish to point out, however, that we believe these inequities impinge most heavily on specialty advertising firms because they have the additional burden of competing vigorously with large and, in some cases, huge companies.

We note that the subcommittee's hearings have dealt with various bills, including S.404, S.395, S.858, S.574, S.23, and S.557. We further note that some of these measures, particularly S.395, seek to provide estate and gift tax relief for family enterprises, including small businesses, in addition to providing relief for taxpayers generally.

Our Association has examined the provisions of S.395, the measure entitled the "Family Enterprise Estate and Gift Equity Act." We believe that this bill deals with a number of inequities in a realistic manner and that it would provide much needed benefits to our industry. We, therefore, strongly support its enactment.

The proposed reduction in the estate tax rates contained in S.395 is long overdue and we approve it, although we believe an even greater reduction is justified. We also strongly support provisions in S.395 which would increase the unified credit from $47,000 to $124,000, increase the present estate tax exemption from $175,000 to $600,000, increase the annual gift tax exclusion from $3,000 to $10,000, and provide an unlimited marital tax deduction.

We also believe that the repeal of the $500,000 limitation in the valuation of qualified real property excluded from the gross estate under Section 2032A of the Internal Revenue Code is highly appropriate. The present exclusion of $500,000 is outdated and inadequate.

Finally, it is exceedingly important to the specialty advertising industry to provide for extensions of time for payment of estate tax where the estate consists largely of interests in a closely held business. S.395 addresses this point adequately and we support it. In addition, however, we would urge consideration of a provision which would exclude from the value of an estate for tax purposes all small business property if a certain percent (e.g., 60 percent) or more of the estate consists of such property.

We respectfully request that this letter be made part of the record of the subcommittee's hearings on estate and gift tax proposals.

Sincerely,

Malcolm D. MacArthur

Malcolm D. MacArthur
General Counsel
Specialty Advertising Association
International

cc: Robert E. Lighthizer, Esquire (5 copies)
Chief Counsel
Committee on Finance
Dirksen Senate Office Building, Rm. 2227
Washington, D. C. 20510

SOCIETY OF AMERICAN FORESTERS 5400 GROSVENOR LANE • WASHINGTON, D. C. 20014 • (301) 897-8720

Statement of the Society of American Foresters

Submitted to the Subcommittee on Estate & Gift Taxation
Committee on Finance
United States Senate
June 5, 1981

Re: S. 395, To amend the Internal Revenue Code of 1954 to provide estate and gift tax equity for family enterprises, and for other purposes.

Mr. Chairman,

This statement is presented on behalf of the 21,000 members of the Society of American Foresters, a national organization representing all segments of the forestry profession of the United States. Membership includes public and private practitioners, researchers, administrators, and students.

Our statement is offered in support of the objectives and purposes of S. 395 with regard to provisions relating to tax rates and credits, and the "material participation" rule.

Forest taxation policies should encourage forest conservation and stable land ownership patterns. Current federal estate tax laws impose double taxation on inherited property, since private owners pay on both appreciation of the asset and income from it.

Estate tax liabilities often necessitate drastic harvesting, provided that markets make this option feasible. Even when feasible, however, such harvesting often constitutes bad forestry and disrupts established management programs. It may also disrupt the local market situation, reducing prices. Therefore, the executor may be forced into a sale of all or part of the forestland to a large company or to a developer. Such action is detrimental to the established social

Approved by the President and Executive Vice President of the Society of American Foresters on June 1, 1981, in accord with section II-B(2) of the SAF Bylaws. A position of the Society of American Foresters expires three years after the date of its adoption unless, after thorough review, its continuance is approved.

premise of maintaining a balance of ownerships between the industrial and non-industrial sector.

Congress was evidently concerned about such occurences and included special provisions for family farmers and timberlands, and certain closely held businesses in the estate tax portion of the 1976 Tax Reform Act.

These provisions are two-fold. First, a special rule permits certain managed woodlands to be valued for estate taxes on the basis of current use rather than at fair market (speculative) value. Second, payment over a 10-year period of that portion of the tax attributable to the forestland is now automatic in certain cases. In some situations, the first payment may be deferred for five years and the remainder made from the sixth through the fifteenth years.

In practice, a number of prerequisites and restrictions will severely limit use of these options. Three of the most burdensome are as follows. First, those assets qualifying for use-valuation must, at fair market value, comprise at least 50 percent of the total estate. Thus, the heirs of a forest owner who also had substantial other assets--large amounts of life insurance, for example--could very easily be precluded from utilizing the use-value provision. Second, in order for a property to qualify for use-valuation, the decedent or a member of his family must have materially participated in the management of the property, and such material participation by a family member must continue after probate. Regulations issued by the Internal Revenue Service with respect to this stipulation virtually exclude land managed by a forestry consultant or under lease to industry. Third, in order to qualify for the 10- to 15-year tax payment extension, the forest property must have been a "closely held business" under the strict definition of the Internal Revenue Code for this purpose.

Thus, estate tax problems with respect to forest properties will in all probability continue despite the 1976 Tax Reform Act's increase in credits and deductions that apply generally to all estates. The very restrictive nature of the special requirements pertaining to farms and woodlands suggest actual benefits will be extremely limited. Congress was obviously convinced that a problem existed, but its intentions seem not to be served by the legislation as it exists today.

Therefore, the Society of American Foresters supports the objectives and purposes of those provisions of S. 395 relating to estate taxation rates and credits, and the "material participation" rule.

Mr. Chairman, we appreciate this opportunity to submit our views for your consideration.

Wayne G. Seylar
PUBLIC ACCOUNTANT
328 ROXBURY ROAD
SHIPPENSBURG, PA. 17257
PHONE: 532-6473

May 11, 1981

Robert E. Lightizer, Chief Counsel
Committee on Finance, Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Re: Estate and Gift Tax Legislative Proposals

Dear Sir:

It has come to our attention that hearings are being held by your committee on changes to the Estate and Gift Tax law. We support efforts in this direction. We feel the estate and gift tax laws in their present form are excessive and out of date. It puts excessive financial strains on small family business, and is an invasion of the interests between husband and wife, mostly in later years, not to mention the difficulty of passing on hard earned monies to close family members.

Most funds subject to these taxes were earned over a life time, and on which taxes have already been paid many times. In addition, inflation in recent years has increased estate values far out of proportion to the value of the purchasing power of the money which created the estate. We would strongly support the repeal of this law, or at least increase the marital deduction to much higher limits, and expand this to other family members as well.

We have read that President Reagan supports legislation along this line. We do encourage your committee to recommend these changes. Inflation is mainly the result of government action. These taxes are compounding this situation, which is almost out of control.

Very truly yours,

Wayne G. Seylar

Wayne G. Seylar

Affiliated With American Agri-Women

ILLINOIS WOMEN FOR AGRICULTURE

We've a Story To Tell

Route #1
Tamaroa, Illinois
May 11, 1981

Robert E. Lighthizer, Chief Council
Committee on Finance
Room 2227, Dirksen Senate Building
Washington, D.C. 20510

Dear Sir:

I wish to support S-395, legislation which will eliminate the "widow's tax" when estates are settled.

The transfer of property valued up to $600,000, tax free, is a more realistic figure than the present $175,625. figure. In keeping with inflation the gift exemption of $10,000 is not unreasonable.

Farmers and ranchers need to be nurtured and protected, not penalized for being diligent and successful during a lifetime of hard work.

I have a friend whose farm has been divided in order to settle an estate. In less than 100 years, one million dollars in taxes have been paid on the same 160 acres!

Estate taxes have a deleterious effect on the economy. Money taken from the private sector decreases the supply available for increased production and investments in business. More production creates more jobs which generate more income and taxes.

Sincerely yours,

Jean Ibendahl

Jean Ibendahl, Adviser
ILLINOIS WOMEN FOR AGRICULTURE

J. PHILIP ROBBINS
BOX 1633
FORT STOCKTON, TEXAS
79735

May 4, 1981

Mr. Robert E. Lightizer, Chief Counsel
Honorable members, Senate Finance Committee
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Sirs:

I would like to share a few thoughts with you regarding taxes and our national economy. Perhaps my point of view from nearing retirement age might be one that had not occured to you.

First, I would strongly support a substantial decrease in the federal income tax rates. With the steeply graduated rates as they are now, very few people, no matter how efficient and productive they may be, can accumulate any significant amount of savings. I recognize that a large tax cut may, in the short run, be inflationary. However, I would point out that two or three large tax cuts in our national history were followed, within eighteen months, by a substantial reduction in the rate of inflation.

Second, and perhaps more important for our national economy, I believe a drastic reduction or a complete abolishment of the federal estate tax would prove very productive for the economy. It would have the immediate effect of countering the inflationary effect of a reduction in income tax.

During our early and middle productive years, our prime incentive is to provide a good standard of living for ourselves and our families, and to provide some security for our retirement years. However, from that point on, and during the most productive period for many, our incentives center increasingly around passing something on to our children and grandchildren.

Most of us would prefer to pass our savings on to our children in the form of a family business or as investments in good American industry. In this way, our savings would continue to produce income for us as long as we live, and then pass to our children with little or no interruption in the productive function of our accumulation. This should take some of the pressure off the social security program, and at the same time keep capital productive in the national economy.

However, with estate tax rates as they are, it is natural and inescapable that a couple in their declining years will consider putting a large part of their savings into tax shelters, tax havens, foreign investments, collectables, gem stones, precious metals, or some other part of what is commonly referred to as the invisible economy, in the hope of passing their savings on without having the government confiscate a large part of them. The I.R.S. probably considers many of these methods immoral or illegal. However, many people, when they seriously think about the estate tax, consider it an immoral tax, and have little moral compunction against avoiding it any way they can. After all, they paid income tax on those savings as they earned them. It is probably true that disrespect for some law breeds disrespect for all law, particularly all tax law.

All moral and tax considerations aside, the estate tax seems to me to be counter-productive for the economy as well as for the many individuals involved. I have read that, even at present levels, the estate tax brings in only a relatively small per cent of total tax revenue. I believe that the loss of this relatively small amount of revenue would very quickly be recouped through a more productive economy for the nation. The abolishment of the estate tax would provide a strong incentive to save and invest a part of earnings rather to spend them on consumer goods, or to hord them or spend them on non-productive collectables. This would be counter-inflationary, both from the short and the long view. It would rapidly put savings to work in American industry to create more jobs and a higher standard of living for all.

I hope that you can agree with my reasoning, and I strongly urge you to work for the reduction, or preferably the total abolishment of the federal estate tax.

Respectfully yours,

Philip Robbins

Philip Robbins

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TELEPHONE 216/861-0930

May 6, 1981

Robert E. Lightizer
Chief Counsel
Committee on Finance
Room 2227, Dirksen Senate Office Building
Washington, D.C., 20510

Dear Sir:

The undersigned is an attorney dealing with estates, estate planning and has served as a public official for over eighteen years and as such is familiar with the growing distrust of the American Taxing Establishment and with the tax rising discontent of overburdened citizens.

First of all, there should be no taxing consequences arising out of transactions between husband and wife. In our society they are one unit and should not be compelled to think in terms of mine and thine.

The low $3,000.00 deduction for exemption from gift tax is ridiculous in this day and age. It should be an absolute minimum of $100,000.00 and should be free of Estate Tax consequences. The present law is --well--"obscene" is the only word I can know of. It is unworkable and unrealistic to give a "tax credit" for a lifetime of giving and again at death.

The I.R.S. regulations are incomprehensible, drawn so as to confound, unfair, and a disgrace. Realistic enforcement is impossible and the cost, unrelated to efficient over all operation.

I note the the growing anger and frustration of all having to deal with the overwhelming verbosity of I.R.S. regulations, memos, treasury letters, rulings and other printers diahorea arising out of confusion. The morass of forms must be eliminated.

Unless a sane tax and tax policy is adopted there will be a growing rebellion among the abused and mistreated taxpayers which can lead to most harmful, long term problems.

Sincerely,

Robert M Wurzman

Robert M. Wurzman,
Councilman, City of Beachwood

EDISON KADERLY

ATTORNEY-AT-LAW

682-5262
AREA CODE 417

P. O. BOX 459
116 WEST 10TH
LAMAR, MISSOURI 64759

May 5, 1981

Mr. Robert E. Lightizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20515

Dear Mr. Lightizer:

This letter is written in connection with the Senate Finance Sub Committee Hearings on Estate and Gift Taxation.

I first wish to comment that I have been a member of the Missouri Bar for approximately 30 years, 12 years of which were devoted to service as a Probate Judge, and the remainder devoted to the private practice of law wherein much of my practice has been confined to probate practice and estate planning.

I live in a small rural area where farmers have become wealthy because of inflated land values. However, they are not wealthy from the standpoint of cash flow, cash available for the payment of expenses and debts. As a result, there is never any cash with which to pay the federal estate tax. The same situation also generally exists with respect to the small business man who has a small business which he wishes to pass on to his children.

The present exclusion of $3,000 for gift tax purposes has been around for approximately 40 years. If this exclusion had kept up with inflation, the annual exclusion should probably amount to about $40,000 per year. Certainly, there should be an extensive increase in the annual exclusion.

My main concern arises from the area of contribution of the spouse. It is my feeling there should be unlimited transfer of property between husband and wife without any tax consequences. This matter of proof of contribution actually makes a liar out of most practicing attorneys wherein they attempt to prove contribution with no idea as to what the eventual outcome will be when questioned by Internal Revenue Service upon the death of the first spouse. It is my feeling that husband and wife should have an absolute right to hold their property jointly and to be relieved of the problem of contribution. If they want to split the property and hold the property as tenants in common to take advantage of various trust arrangements, there should be no tax consequences or no problem involved in the splitting of the property. I would request you please give us something we can work with which is somewhat simple and which can guarantee to the taxpayer that he will not be questioned about his decisions concerning his property when the first spouse dies. In other words, he must have some assurance that what he does will not be questioned when he dies.

I am sure you realize it is common practice to hold property in joint ownership. This certainly escapes the problems of excessive attorney fees and excessive court costs and assures one spouse that the other spouse will become the owner of the property when the first one dies. However, joint ownership is the worst possible type of ownership when it comes to effective estate planning. It would appear that you could surely simply remove the problem of contribution and permit husband and wife to have full flexibility in the transfer and exchange of property between spouses without any complications.

Over the years, I have attended so many seminars on estate planning, and I have heard the very wise experts lecture on the various aspects of estate planning, but they all will admit that the final and bottom line represents at best an educated guess which will be seriously questioned by Internal Revenue Service upon the death of the first spouse. This is not fair to the taxpayer and it should be eliminated because of the high-handed activities of the Internal Revenue Service. In some manner, give us some simple method whereby husband and wife can transfer property, hold property as they so choose, not worry about contribution and in the end result each spouse could own one-half of the entire estate as his sole and separate property without being taxed by Internal Revenue Service. Naturally, one-half would then be taxed by Internal Revenue Service.

Naturally, it goes without saying that the exclusion should be greatly increased and certainly an unlimited marital deduction would help greatly.

Finally, I would hope you might in some manner simplify the procedure whereby you could help the practicing attorney work with the available tools and give him some assurance that what he does will not be questioned by Internal Revenue Service. It seems as though every tax measure results in more complications and very seldom is there any movement towards simplification.

Sincerely yours,

Edison Kaderly

Edison Kaderly

EK/lh

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WILLIAM B. SKELTON
1871-1964
HAROLD N. SKELTON
1900-1979

May 6, 1981

Robert E. Lightizer, Chief Counsel
Committee on Finance, Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lightizer:

Subcommittee on Estate and Gift Taxation Hearings

I support repeal of the estate and gift tax, as proposed by S.404. Given the nominal amount of revenues they raise, and the tremendous burden imposed on a few taxpayers in complying with them, these two taxes ought to be eliminated. Also well known is the tremendous administrative burden and cost in collection and enforcement of these taxes.

My practice focuses substantially on estate planning, particularly estate and gift tax planning, so I do not make these remarks lightly.

Certainly a substantial increase in the unified credit and an unlimited marital deduction, as proposed by S.395, would make good sense, if total repeal is not possible.

Sincerely yours,

Bryan M. Dench

BMD/jjb

R#1, Box 59B
Arbuckle, CA 95912
April 29, 1981

Robert E. Lighthizer, Chief Council
Committee on Finance
Washington, D.C.

Dear Mr. Lighthizer:

Re: Estate and Gift Tax (for printed testimony)

Yesterday my husband and I visited a tax attorney regarding our estate. Needless to say we were astounded at the federal estate tax which would be mandatory at the death of either of us.

Due to inflation, ranch property we purchased 16 years ago at $180,000 is now worth $1,000,000! The same land raising the same products! This does not mean we would ever realize that much money on a sale, particularly a forced sale and of course we do not wish to sell.

Now for the tax: at the death of one of us, the other would have to pay almost $100,000. At the second death $232,000 would be due.

Because crop payments have not risen with the inflation rate, at our ages the cost of insurance to pay the tax is prohibitive. Ours is not an isolated problem but is the same for farmers and small businessmen. Our worth is only on paper.

Also, a gift of $3000 per person in our area would be a gift of less than 1 acre. You could not even build a house on it as in our county you cannot build on less than 10 acres. Reforms are needed in this area also.

Please consider all this as you deal with the estate and gift tax issue. Thank you.

Yours ...,

Ruth Lohman

Ruth Lohman

Phone 485-2171

H. B. MELLOTT ESTATE, INC.

Concrete and Mortar Sand — Transit Mix Concrete
Crushed Stone — Agricultural Lime

McCONNELLSBURG, PA., 17233

May 7, 1981

Robert E. Lightizer, Chief Counsel
Committee On Finance Room 2227
Dirksen Senate Office Building
Washington, DC 20510

Re: Estate and Gift Tax Legislative Proposals

Dear Sir:

It has come to our attention that hearings are being held by your committee on changes to the Estate and Gift Tax law. We support efforts in this direction. We feel the estate and gift tax laws in their present form are excessive and out of date. It puts excessive financial strains on small family business, and is an invasion of the interests between husband and wife, mostly in later years, not to mention the difficulty of passing on hard earned monies to close family members.

Most funds subject to these taxes were earned over a life time, and on which taxes have already been paid many times. In addition, inflation in recent years has increased estate values far out of proportion to the value of the purchasing power of the money which created the estate. We would strongly support the repeal of this law, or at least increase the marital deduction to much higher limits, and expand this to other family members as well.

We have read that President Reagan supports legislation along this line. We do encourage your committee to recommend these changes. Inflation is mainly the result of government action. These taxes are compounding this situation, which is almost out of control.

Very truly yours,
H. B. MELLOTT ESTATE, INC.

Paul C. Mellott

Paul C. Mellott
President

OREGON SMALL WOODLANDS ASSOCIATION

President:
Lee O. Hunt
Star Rt. Box 216-C
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George Schroeder
Rt.4 Box 253
Sherwood, OR 97140
(625-6069)

May 8, 1981

Mr. Robert E. Lighthizer
Chief Counsel, Committe on Finance
Rm. 2227 Dirkson Senate Office Bldg.
Washinton D.C. 20510

Dear Mr. Lightthiser:

The Oregon Small Woodland Association has sponsored and supported during the past few years estate planning programs for its members.

The Wallop Bill (S 395), Family Enterprise Estate and Gift Tax Equity Act, is a positive step in the right direction. Our Association officers, directors and members strongly support this Bill and urge its enactment.

The need was brought forcibly to my attention recently when an elderly friend died leaving a large ranch to his widow. She was required to raise over $100,000 for estate taxes. The ranch had no prospect of that kind of immediate cash, nor could the money be borrowed. The family had to harvest a large amonnt of young growth timber at a considerable financial sacrifice to meet the obligation. Imagine the result when the children, who now operate the ranch, inherit the property without the marital deduction available on the first estate.

I am faced with the same kind of a situation in trying to provide for the continuity of our family tree farm.

Thus, I wish to add my personal plea for favorable action on the proposed legislation (Wallop Bill).

Sincerely yours,
Lee O. Hunt
Lee O. Hunt, President

COMMENTS OF THE AMERICAN ASSOCIATION OF NURSERYMEN TO THE SENATE FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION ON SENATE BILLS S. 404, S. 395, S. 858 and S. 574

The American Association of Nurserymen ("AAN") is an organization of approximately 3,100 nursery owners located throughout the United States. The Association functions as the principal trade association of the nursery industry, representing firms engaged in the growing and the wholesale and retail distribution of ornamental plants and related landscaping products and services.

AAN strongly supports many of the proposals made in the Bills now being considered by this Subcommittee. We feel that prompt action must be taken to reduce the present estate and gift tax burden on U.S. taxpayers.

The vast majority of AAN's members are small, family owned businesses. The use of relatively large amounts of land is an integral part of most nursery growers' businesses and the value of the land is now dramatically increasing. In addition to the increases due to the inflation that is affecting most real estate values, many nursery businesses, which were established many years ago in relatively rural areas, are now experiencing drastic increases in the value of their real estate because they are now located in the paths of growing suburban areas. Many nursery owners' land would now be worth much more as a housing subdivision or shopping mall.

This increase in real estate values, plus the present estate tax system has made it increasingly difficult for a nursery owner to pass his or her business on to other family members at the owner's death. Many nursery businesses must be liquidated in order to pay estate taxes. It should be noted that although the value of many nursery businesses appear large on paper because of inflated land values, these businesses generally do not produce an amount of income that would allow the owner to accumulate sufficient liquid assets, outside the business, with which to meet the tax liability at his or her death. In the past, a nursery owner could obtain life insurance, the proceeds of which could be used to provide cash to pay estate taxes at his or her death. However, because of increased land values and the resulting estate tax liabilities, most nursery owners cannot afford to pay the premiums on the amount of insurance that would be needed to meet those tax liabilities.

Even the special provisions of IRC § 2032A, which provides, on a limited basis, for a special valuation of nursery land based upon its value for that use, as opposed to its use as a shopping center or housing subdivision, cannot provide adequate relief from the estate tax burden. The present tax rates and structure themselves are the ultimate source of the nursery owner's concerns.

AAN and its members feel that the destruction of small, family-owned business, because of large federal estate tax burdens, should not be tolerated in our free enterprise system. The knowledge that one's business may not survive one's death, is a disincentive for many owners to build and expand the family business.

The Bills presently before this Subcommittee are welcome signs that Congress shares our concerns about the effects of the present estate tax system on this country's small businesses. It appears clear to us that one of the original goals of the tax, the prevention of large accumulations of wealth in a few families, is not the present focus of the tax. It now affects a large and increasing segment of estates and forces the liquidation of many small businesses, the assets of which must be used to meet estate tax liabilities.

AAN asks this Subcommittee to carefully examine this issue now and recommend the changes in the present estate and gift tax system which must be made to lift this increasing burden on U.S. taxpayers and its small business. We set out several proposals for your consideration.

I. Eliminate the Federal Estate, Gift and Generation-Skipping Taxes.

It is clear that the repeal of the present estate, gift and generation-skipping taxes would eliminate the concerns of nursery owners stated above. The small business owner could feel confident in building and expanding his or her business, knowing that it could pass intact to family members who may wish to continue the operation, without fear that taxes at death would destroy his or her major asset.

AAN and its member nurseries would support S. 404 as introduced by Senator Symms. However, inflation and rapidly growing suburban areas and land values, are making the problem of overwhelming estate taxes an obstacle which is increasingly difficult for the small nursery owner to avoid. The need for reform is urgent, and the total abolition of these taxes would, we believe, prompt extensive study and debate. AAN would support solutions short of the total repeal proposed in S. 404 as prompt changes in the taxes could alleviate the present problems of many nursery owners.

II. Modify the Lifetime Credit, Tax Rates, and Deferral Provisions.

Under present estate tax provisions, the estates of many nursery owners can use the special valuation provision, § 2032A, to reduce estate taxes inflated by the high values of the land used in the nursery business. However, the provision is extremely complicated and does not apply to all estates, even though a particular estate might be the type Congress had in mind when § 2032A was adopted. Even with the special use valuation, estate tax rates are high and apply to more and more estates as the value of assets increase with inflation.

AAN contends that a modification of the present tax structure and rates, and an improvement in the present tax deferral provisions would result in a more equitable distribution of the tax burden on all estates and make "special taxpayer" sections like § 2032A less important in preserving the small business at the death of its owner.

A. <u>The Lifetime Credit and Tax Rates.</u>

AAN first proposes an increase in the unified credit which would result in an exemption equivalent above the present $176,625. Both S. 858 and S. 395 propose such an increase and both would establish an exemption equivalent of $600,000.

We support these proposed changes in the unified credit. It is clear that an individual with an estate of $600,000 is not unusual today. The protection of such an estate would not be contrary to the original social purpose of the tax, the prevention of large accumulations of wealth, given today's property values and inflation over the past several years.

In addition to a modification of the unified credit, S. 395 proposes changes in the present estate and gift tax rates. AAN supports the proposed reduction of rates and widening of tax brackets. The change of the present maximum rate of 70% for taxable estates over $5,000,000 to a 60% maximum rate would be a step in the proper direction.

However, we suggest that a further reduction, to a 50% maximum rate, would be reasonable. Such a rate would compare to the existing 50% income tax rate on earned income and current proposals to set 50% as the maximum rate on other types of income, and it would make the total tax liability for an estate with small business assets easier to meet, and the necessity of liquidation of business assets less likely.

In order to insure the continued effectiveness of the above proposals, AAN would support the indexing of the unified credit and tax tables for annual increases in inflation. Unless such an indexing system is adopted, inflation would subject a greater number of estates to the tax at higher effective tax rates.

B. Simplify the Estate Tax Deferral Provisions

In addition to the changes in the unified credit and estate and gift tax rates, AAN believes that modifications in the present estate tax deferral provisions are crucial. Modifications of those provisions would make it easier for estates with businesses that constitute a large portion of total assets to meet the estate tax burden over an extended time period and avoid the alternative, the liquidation of business assets to pay estate taxes nine months after the date of death.

Present estate tax deferral provisions are included in IRC §§ 6161, 6166 and 6166A. Section 6161 allows the Internal Revenue Service to extend the time for payment of estate taxes "for reasonable cause," "for a reasonable period." The provision is discretionary and is available in special circumstances that vary widely. In comparison, Sections 6166 and 6166A provide options for estates which meet specific statutory requirements, largely depending upon the percentage of the taxable estate which consists of closely-held businesses, to pay estate taxes on an installment basis over a ten to fifteen year period. The installment payments allow an estate to collect cash to pay the taxes, possibly from the income of the business itself.

We believe that § 6161 provides the Service with the necessary discretion to grant extensions under special circumstances. However, AAN proposes that changes be made in the deferral provisions of §§ 6166 and 6166A. They are now, we believe, unnecessarily complicated, making it difficult for nursery owners or other small business owners to include the potential benefits of deferral as a part of their estate planning. AAN supports the proposal included in S. 395 to consolidate the two deferral sections by eliminating § 6166A, the ten year deferral provision, while transferring many of its beneficial aspects to § 6166.

This modification would allow estates with closely-held business interests which constitute over 35% of the value of the gross estate or 50% of the taxable estate to qualify for a uniform deferral of up to 15 years. In addition to the simplification such changes would mean to estate planners and administrators and the significant simplification of the Code, the amended § 6166 would make it easier for more estates to qualify for the longer deferral period, thereby increasing the possibility that a small business could meet the tax installments out of annual business income, without the need for asset liquidation.

AAN also strongly supports the changes in "acceleration" standards. With the consolidation, only one set of actions would prompt acceleration and the requirement of immediate tax payment. Presently, the two sections differ and can create enormous planning and administrative problems. The proposed increase in the amount of the business interest which can be disposed of without causing acceleration of the tax payments would make conducting the business easier during the installment payment period. This asset disposal would include, for example, the redemption of shares in the business, if necessary to pay other estate administration and tax liabilities, under § 303 which includes favorable income tax provisions for such redemptions. S. 395 simplifies the procedure further by setting the same threshold standards for the favorable § 303 redemptions as would exist for deferral under § 6166.

In addition to the present complexities of §§ 6166 and 6166A, another difficulty in administering an estate with a deferral of tax payments is the fluctuating interest rate on the outstanding tax balance. Although a 4% fixed rate is now available for a small amount of deferred tax, the interest on the remainder floats with the prevailing IRS rate, presently 12%. In addition to the planning difficulties this fluctuating interest can present, in times of high inflation the higher interest rate imposed by the IRS can make it impossible for a small business to meet payments out of current income or through the sale of limited business assets. The proposal in S. 858 which would limit the interest on deferred taxes to 6% or 90% of the fluctuating IRS rate, whichever is lower, is strongly supported as a measure which will help more estates take advantage of the deferral provisions.

AAN urges the Subcommittee to take this, and all other steps proposed in the Bill, so that the process of estate tax deferral will be one that can be more readily planned for and used in those cases where closely-held businesses constitute a large part of an estate. We also suggest an additional provision which relates to the interest on deferred taxes.

At present, the interest on deferred taxes is allowed as a deduction as an administration expense for federal estate tax purposes, and can decrease the total estate tax due by reducing the taxable estate. The IRS will not now allow that deduction for interest on an estimated basis which would cover the entire deferral period. Instead, for each year the tax is deferred and interest paid, the IRS requires a "supplemental return" which claims the interest paid as a deduction and recalculates the total tax due. This recalculation will reduce the tax due, reduce the installment amounts and remaining tax to be paid, and will reduce the interest to be paid. After each such recalculation it will be found that prior interest and tax payments were overpaid and the Service suggests that the estate request a refund of those amounts only after all taxes have been paid.

In addition to this cumbersome "supplemental return" system which could require up to 15 returns, and the complex calculations, best made with the aid of a computer, which must be made for each such return, such a filing and payment procedure requires estates which have serious liquidity problems to produce, in the earlier years of deferral, more tax and interest than would be actually due if all interest deductions were included in the initial return on an estimated basis.

AAN proposes that Congress provide for the deduction of interest payments on deferred taxes on an estimated basis on the initial return of an estate choosing to use § 6166. The fixed interest rate proposed in S. 858 would make such estimates easier to make. In any event, a provision could be included which would require the payment of higher interest or tax amounts should the interest rate change or acceleration of the tax occur, thereby eliminating part of the planned interest payments.

This is a serious problem for planning or administering an estate with the tax deferral option. We believe Congress should address it so that deferral can be a viable tool in preventing the liquidation of small businesses at the death of their owners.

III. Modify Special Use Valuation § 2032A.

Because the values of their businesses comprise a large part of their assets, the estates of many nursery owners are now potential beneficiaries of the special use valuation provisions of § 2032A, whereby farm land or other land used in a trade or business is valued for estate tax purposes, not at its "highest and best use", but for the use for which it was held by the decedent. This can reduce the taxable estate and thereby reduce total estate taxes. However, the special use valuation provision is extraordinarily complicated and often does not apply to an estate which may meet the "spirit" of the law, but fails to qualify under one of the many threshhold provisions of the section.

Should the changes supported in Parts II.A. and II.B. be implemented, the special use valuation provision would be needed by far fewer estates. However, there will remain those estates to which § 2032A valuation could mean the difference between the destruction of the family business, or the passing of it to the nursery owner's spouse or children. AAN believes that some changes must be made to increase the effectiveness of § 2032A. Unfortunately, it appears that little can be done to minimize much of the provision's onerous complexity.

The first critical modification of § 2032A must be the elimination of the present $500,000 limit on the reduction of a decedent's gross estate due to the special valuation. There should be no ceiling placed upon the amount of value reduction available as a result of the special use valuation and AAN supports the provisions in both S. 858 and S. 395 which eliminate the present $500,000 ceiling. It is clear to us that if a qualified business is in need of a special use valuation, the present limitation could defeat the purpose of the statute by limiting the reduction in the asset's value.

The second set of needed changes which we support is also included in both S. 858 and S. 395 and would modify, in some circumstances, the present requirements of "material participation" by the decedent or his heirs. Changes in the participation requirements are proposed for those situations in which it would be normal for less involvement to exist, but where it is still reasonable, and desirable, to allow special use valuation. Under both bills, the material participation requirement for the decedent need be met only until the date on which the decedent retired or became disabled, as defined. A decedent need only meet an "active management" test if the decedent, a nursery owner's wife, for example, inherited the property from her husband and the property had qualified under § 2032A at his death. The same reduced involvement is provided for the "qualified heir" requirement if that heir is a spouse or a minor child.

AAN fully supports these proposed modifications as reflections of frequently occuring situations where "material participation" should not be required.

Additional modifications of § 2032A are proposed in S. 858 and S. 395, which, although adding to the complexity of the bill, should make qualification and administration of the section easier for a nursery owner's estate. Among the changes, AAN notes that the reduction of the recapture provision from 15 to 10 years, is a good step toward reducing the overall complexity of § 2032A and its use, and the modified valuation procedure included in the Bills should help make the special valuation a much easier and uniform process.

IV. Miscellaneous Exclusions and Deductions.

In addition to the estate and gift tax modifications discussed in Parts II and III above, AAN supports several other provisions under consideration by the Subcommittee: the increase in the annual gift tax exclusion from $3,000 to $10,000 and the unlimited marital deduction for both estate and gift taxes.

We believe that the present gift tax exclusion of $3,000, established in 1943 should be increased as proposed in S. 395. The real value of the exemption has been greatly reduced by inflation since its establishment and Congress should update that value to compensate. AAN proposes that the annual exclusion also be indexed to the annual rate of inflation so that its real value will not be reduced in the future.

AAN also supports the proposed unlimited estate and gift tax deduction for marital transfers set out in S. 395. Such an unlimited deduction would codify the present attitudes of many married couples who regard their assets as being earned and held together by both spouses. Such a deduction would also eliminate the estate and gift tax problems which occur when married couples acquire and hold property jointly.

V. Conclusions

The American Association of Nurserymen and its members are convinced of the need for immediate changes in the present estate and gift tax structure. The most basic changes must occur in the level of the unified credit, the present tax rates, and the structure of the estate tax deferral provisions. The adoption of changes proposed here in those areas could reduce the present onerous estate tax burden on small businesses and allow the nursery grower to pass on his or her business to other family members without destructive estate tax impact.

There will be a continued need for the special provisions of § 2032A. However, the proposals we have discussed here should better reflect the original intent of Congress in including the provision.

We urge this Subcommittee to carefully consider the Bills now before it and act promptly to reduce the present estate and gift tax burden that now so adversely affects this nation's small businesses.

May 15, 1981

Minnesota Farm Bureau Federation
1976 Wooddale Dr., P.O. Box 43370, St. Paul, Minnesota 55164/(612)739-7200

FEDERAL ESTATE AND GIFT TAX LAWS

Statement

of the

Minnesota Farm Bureau Federation

to the

Subcommittee on Estate and Gift Taxation

Senate Committee on Finance

Washington, D.C.

May 11, 1981

The Minnesota Farm Bureau Federation is a general farm organization, with 35,000 member families in 83 organized county units. We appreciate the opportunity to present written comments on estate and gift tax laws as well as on a number of legislative proposals designed to repeal or amend current statutes. We respectfully request that this statement be incorporated as part of the Subcommittee's hearing record.

Farm Bureau has a long involvement in the federal estate and gift tax area because of the effect that these taxes have upon family farms and other family businesses. Farm Bureau was active in its support for estate tax relief in the Tax Reform Act of 1976 and the Revenue Act of 1978. The continuing interest of our membership, in Minnesota and nationwide, is reflected in the following policy which was adopted by the voting delegates of the member State Farm Bureaus at the American Farm Bureau Federation's annual meeting in January 1981:

> "We favor a phase-out of the federal estate tax. Until this phase-out is accomplished, we will continue to support legislation to reduce the impact of the federal estate tax on the orderly transfer of property and an exemption for property on which an estate tax has been paid within 15 years prior to the death of the second decedent.
>
> "We favor indexing of the federal estate tax to compensate for inflation.
>
> "We favor recognition of the equal contribution of the spouse to a farming enterprise in estate settlements.
>
> "We believe both crop share and cash rentals should qualify in determining the special use valuation of farmland under Section 2032A of the Internal Revenue Service Code.
>
> "We favor special use valuation of agricultural land for gift tax purposes similar to the special use valuation of such property for estate tax purposes under Section 2032A of the Internal Revenue Service Code.
>
> "We encourage a reasonable and flexible interpretation by the Internal Revenue Service of the 'material participation requirements' for the special use valuation of farmland under Section 2032A of the Internal Revenue Service Code.

"We recommend an immediate increase in the estate tax exemption to $500,000 and an increase in the annual gift tax exclusion to $10,000 per year."

All taxes are painful. In addition, some are unfair in the financial burden they impose. Among the cruelest and most injust of all are estate taxes, which annually destroy countless thousands of farms and family businesses.

In keeping with a basic American tradition, many persons work a lifetime in such enterprises with the hope of passing them on to their children. Yet far too often, under present law, the heirs are forced to sell out just to pay exhorbitant inheritance taxes.

Although specific figures are elusive, there is no question in our mind that estate taxes have been an important factor in reducing the number of U.S. farms and in reducing the number of small businesses.

One of Farm Bureau's legislative priorities in the 97th Congress is repeal of the federal estate tax. We allow, of course, that estate tax reform in 1976 and 1978 afforded some meaningful relief from the economic and administrative burdens associated with the estate tax. However, such reform provided no permanent remedy for the increasingly heavy taxation of farm estates, major asset of which is highly inflated land.

As a result of inflation, numerous small and moderate size estates are today subject to the estate tax. The $47,000 unified credit adopted in 1976 is no longer of significant benefit to most farm estates. Looked upon at the time as the answer to estate tax problems for agriculture, the special use valuation has become such a hapless victim of the regulatory efforts of the Internal Revenue Service (IRS) that some estates choose to forego its application. With regard to material participation requirements and valuation procedures, they are so restrictive that they nullify a law intended to benefit farms and other small businesses.

In terms of revenue to the U.S. Treasury, it has been well established that estate and gift taxes are one of the smallest sources. These taxes in 1979 constituted 1.2 percent of all federal tax revenues for a total of $5.5 billion. We do not argue but what repeal would mean a loss of revenue. What we do say is that there are numerous other opportunities to further reduce federal spending to compensate for this relatively small tax revenue loss.

As to the suggestion by some that estate tax repeal would cause a tidal wave of nonfarm investors who would find farmland an attractive investment opportunity, we submit that such would not be the case. A business in which return on investment historically has averaged no more than four percent a year, and in which farmers themselves of necessity must expand their production base to meet ever-increasing costs, is unlikely to be a boon to nonfarm investors on the strength of estate tax repeal. The reverse, in fact, is often the case; the presence of the estate tax has caused many farm heirs in the past to sell a portion of the estate to pay the estate taxes.

Additionally, we see the estate tax as a disincentive to save, invest and produce. It is an instrument tailor made for those who would use tax policy to achieve the redistribution of wealth. So that profitability in agriculture might be maintained, the size of farming operations often increases. Since as farmers we cannot pass our costs to consumers through increased commodity prices, we have no other alternative but to enlarge upon our production base. To us, it is fundamentally wrong, under the capitalistic private competitive enterprise system, to penalize heirs for efforts of decedents to establish profitable businesses.

As we mentioned at the outset, Farm Bureau is four-square behind repeal of the estate tax and will strive to accomplish this objective through the endorsement of S. 404, a bill designed and intended to eliminate estate and gift taxes.

Based on member-adopted policy also, Farm Bureau proposes herein to address provisions contained in other legislation the Subcommittee has under consideration, viz., S. 395, S. 574 and S. 858--the latter a measure whose chief author is Minnesota Senator David Durenberger. While none of these bills calls for total repeal of the federal estate tax, they do allow a greater measure of tax relief for farm families. Therefore, we lend our support to them as steps in phasing out the estate tax.

Our major concerns relative to these three (3) bills are directed to the following areas:

Unified Credit, Rate Reduction

The effects of inflation on the value of farm estates are well known by the Subcommittee membership. As a matter of equity, farm families--faced with spiraling production costs, depressed commodity prices and rapidly appreciating land values because of inflation--are entitled to an adjustment in the unified credit against estate and gift taxes and a reduction in tax rates. Specifically, Farm Bureau supports modification of the unified credit to increase the equivalent estate tax exemption to no less than $500,000.

Marital Deduction/Family Deduction

The use of an unlimited marital deduction would permit the transfer of farm property from one spouse to the other without estate or gift tax liability. Although careful estate planning is essential to realize maximum benefit for the estates of both spouses, an unlimited marital deduction could reduce significantly the amount of taxes due on the estate of the first decedent. Such reduction in estate taxes would promote the continuation of family businesses. What is more, it would recognize the contribution of the surviving spouse to the farming operation. Likewise, a deduction with respect to interests passing to qualified heirs of the decedent other than the spouse is desirable.

Annual Gift Tax Exclusion

The transfer of farm property by gift is common among farm families. The making of gift transfers assets from the parent generation of farmers to the children. This not only reduces the size of the parents' estate, but promotes continuation of the family farm as well. Because inflation, which had dictated an increase in the unified estate and gift tax credit, has caused the present $3,000 per year/per donee to become obsolete, Farm Bureau supports an annual gift tax exclusion of $10,000 per year/per donee.

Special Use Valuation

On the issue of special use valuation under Section 2032A of the Internal Revenue Service Code, we support the IRS and its efforts to prevent abuses in the special use valuation of farm real estate. We are concerned, however, that the restrictive aspect of the proposed definition of material participation may work to the detriment of many farmers and their heirs. The regulations should maintain the flexibility needed to reflect the intent of Congress to encourage the preservation of family farms.

The proposed regulations could work to the disadvantage of farmers in two respects.

First, the restrictive definition of "material participation" can discourage a decedent -to-be and his or her heir from engaging a non-family farm management specialist or firm to operate the farm, even though business or family considerations might warrant such services. Employing a non-family member could risk losing the farm's special use valuation.

In the area of special use valuation of farmland also, we support legislation allowing the use of crop shares as well as cash rentals. The IRS definition of gross cash rentals part of proposed regulations published on July 19, 1978, permitted crop share rentals if no actual cash rentals of comparable real property were available in the locality. However, this option was withdrawn in proposed regulations published on September 10, 1979.

As a consequence of the withdrawal, farmers in certain areas of the country where crop share arrangements are prevalent, find it impossible to take advantage of the special use valuation under 2032A (e) (7); the only alternative is a more cumbersome valuation procedure under 2032A (e) (8).

Since the option to substitute crop share figures for cash rent figures is essential in sectors where rental operations are conducted primarily under crop share arrangements, Farm Bureau continues to urge the Internal Revenue Service (IRS) to re-examine its decision to eliminate the use of crop share rentals.

In conclusion, let us emphasize that as far as farm families are concerned, special use valuation benefits can be realized only if guidelines for methods of valuation and requirements for material participation are reasonable. To date, however, the Internal Revenue Service (IRS) has not proposed workable guidelines.

Therefore, Farm Bureau supports amendments to the Internal Revenue Service Code, such as those contained in S. 395 and S. 878, that would set forth realistic requirements to qualify for special use valuation. In particular, we support provisions that address the interaction of Social Security benefits and special use valuation. In addition, we support provisions that would accommodate questions of material participation or active management as they affect individuals such as spouses or minor children who inherit property from a decedent who qualified for special use valuation.

We commend the Subcommittee for its consideration of estate and gift tax laws. Again, Farm Bureau reiterates its commitment to repeal.

Estate tax reform is merely an effort to manage the problem.

Repeal is the solution.

Robert Lighthizer

Chief Council,Comm.on Finance

Room 227,Dirksen Senate Office

Washington D.C. 20510

Dear Sirs:

My husband and I farm 850 acres-500 are owned by his parents who farmed for 38 years before retiring.They have been spending some of those retirment years struggling with the problems of estate planning.

As I observe their battle against unfair laws that will rob them of their land and of the right to pass it on to their four children,I cringe at the thought of us going through the same thing in the future.

It is a sad commentary on our times when families that have spent a lifetime building a future for their loved ones must,in the end,give it to the government.

It is sad too,for people to spend the last part of their lives working with lawyers and devising legal plans,at great expense,to hold on to what is theirs.

Even more cruel is the "widow's tax".For years audiences at movies have booed the villain who tries to foreclose on the mortgage and take the poor old widow's farm-the sad fact is that the villain turns out to be the U.S. government.

The present estate tax laws are punitive and out of step with reality.The current value of the farm property that is allowed to pass taxfree has not kept up with inflation.

The gift tax exemption hasn't been raised in 35 years.

I urge support for Senate Bill 395 which would make dramatic and needed improvements in the estate tax policies in the nation.

Politicians are always extolling the virtues of the hard-working American taxpayer, the way our nation has been built through the efforts of people,like farmers,who spend a lifetime following all the rules and are loyal to the end.

But the end has come and the hard-working American taxpayer can't hold on any longer against out-dated,unfair laws that threaten his way of life. Now the politicians need to put their words to use and work for the people.

Please support legislation to up-date the estate laws-the time has come for a change.

Sincerely,

Debra Harford

Route 1,Mazon,Il.60444

STATEMENT ON ESTATE AND GIFT TAXATION

TO: SENATE FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

FROM: PETER J. OSTROWSKI, JR. ATTORNEY
EUREKA, SOUTH DAKOTA 57437

DATE: May 10, 1981

GENTLEMEN:

I am a practicing attorney in a small rural community in north central South Dakota. There are approximately 1300 people in Eureka. We are a farming community. Eighty percent of my practice is devoted to income tax and estate work.

MAIN COMMENT:

The effective estate tax rate of 32% is not a tax but a confiscation. This combined with the high rate of income tax is paralyzing the peaceful and orderly transfer of family farms to younger generations. Redistribution of wealth is opposed to the national interest in the area of farming. We must keep livestock, machinery and land in the families. These people are the only ones who know how to farm. The skill and experience has been handed down for generations.

Eureka is a small community of 1300 people. We serve the farm family with supplies, elevators and a railroad. We provide a place to retire to for older farm families.

The average farm unit is between 800 to 1200 acres. It usually consists of a small grain and stock-cow operation. There is some dairy in the area. The main small grain crop is spring wheat. Oats and barley, along with corn, are mainly feed crops.

The average net worth of a farm unit is between $350,000 and $500,000.

The predominant nationality of our citizens is German-Russian. A people who migrated from Germany in the late 1700's to the Baltic area of Russia. Catherine the Great promised them land and promised not to interfere with their culture should they come to Russia, break the sod and raise food for the country.

The late 1800's saw a change in Russian leadership. It wanted to confiscate the lands and enlist the Germans into the Russian armies. It wanted to send people to Russian schools and Russianify their culture. They chose to leave Russia for America.

These people came to America in the late 1800's and early 1900's for the same reasons they left Germany for Russia one hundred years earlier: the promise of land ownership and non-interference with their culture and property.

Now, one hundred years later, I'm sure they have to ask themselves if things are any different under our present income and estate tax system than they were in Russia. If these people want to bring a family member into the farm, their tax advisors will tell them it is difficult or impossible. Even the initial cost of machinery and livestock prohibits a member of the younger generation from starting in farming. His only hope is a low interest loan from Farmers Home Administration. The economic times practically prohibit him from doing it on his own, and the income and estate tax rates effectively prohibit him from taking over from his father.

It is hard enough to get into farming, make a profit, have something left after taxes; yet, under present estate tax laws, it can be impossible to pass this operation to the next generation. The new special use evaluation status helps, but have you ever tried to explain to a 70-year old farmer what kind of rental agreement he must have with his son so that the government does not take 32% over exemptions when he dies. He doesn't understand why he cannot have whatever arrangement he wants with his son. He is providing food for a nation. Why cannot the nation leave him alone?

Even if "I" can understand the complexities of 2032A, and, even if I can explain it so that he can understand it, this man will probably say he wants none of it.

Thirty years ago land values in our area were $20 to $30 per acre. A person could own 1000 acres and only be worth 20 to 30 thousand dollars. Machinery was less complicated and less expensive. The gift and estate tax exemptions were $60,000 each. A man could do what he wanted with his property by way of gift or devise.

The older generation cannot understand why this is not the same today. Why is the tax so high? It is scary for a family who never considered itself rich, who never indulged in extravagances, to be presented with an estate tax worksheet that shows on the death of the survivor, the family will have to pay $80-$100,000 in estate taxes.

Most of the estate planning work we do is for farm families where the father is between 55 and 63. Some of them have a son who is working into the operation. Many do not. For many, the children have spread themselves around the country with little or no desire to return to the Eureka area.

What do we do to plan these estates so to allow the family to preserve the most property? Mainly, we use marital deduction formula wills, or make use of the marital deduction gift exemption to put land in the wife's name so that the wills can exchange life estates in land with remainder to the children.

Even with these planning tools, it is virtually impossible to plan the sale or devise of a farm to family members without some attrition. You have to hope that the parents will live long enough to be able to give the land or sell it over a long period of time. The best estate plan seems to be to delay dying as long as you can. This is true. Most families with longevity have eventually moved off the farm to town. The eldest son has gradually worked himself into the farm either by buying or by a series of gifts, or a sale for less than full consideration.

The people who are in real trouble with the present tax is the family who lost the father in an accident or to cancer or a heart attack in his early years. By early years, I mean in his late 40's or early 50's.

In this case, there is probably no will. We have a one-third/two-third split. If the operation is large, there is not enough marital deduction. If the operation is smaller, the children usually deed back their share to the widow. She then owns it all with a $175,000 credit equivalent. When she dies, the government wants 32% of the excess.

In this case, a son usually takes over. He and a young wife get an operating loan from FHmA or Production Credit Association. The mother puts the land up for security. If they work hard, get rain and have some luck, they might make it. In the meantime, if the widow dies, and they have been paying her cash rent, there is no special use. The ogvernment takes 32% of the value of property over $175,000.00.

My point is that this first estate bracket is too high. It is not a tax, but a confiscation. With the escalation in the value of land and machinery over the years, the exemption amounts do nothing to help a farm family work in the younger generation or pass this property to the younger generation.

I favor the recent proposals that would exempt $600,000 to $700,000 from estate tax. This would sure make it easy. It would be more like the 1950's and 1960's where the exemptions exceeded the value of the family farm. But this is not enough. The increase in exemption must be coupled with a reduction in the rate of tax. A beginning rate of 32% is too high.

Statistically, the estate tax is not a revenue measure. I believe it raised only five billion dollars in 1980, five billion out of a 750 billion federal budget.

Who pays the substantial portion of these estate taxes? I believe it is those who do not get estate planning. And, who are those? They are probably the second or third generation immigrant family who has normally kept to itself, worked hard and put their money back into the farm.

It is not in the national interest to take from these people the property that they need to produce the nations food.

To date, we have not seen any wholesale confiscations in our area. But it is only a matter of time; a matter of two to five years, we will have a widow or widower pass away who has not operated his property to qualify for special use valuation. The government will want one-third of his property in excess of $175,000.00.

This confiscation will keep people from lawyers, accountants and estate planners. Transactions will become very private. Clear title to real estate will be confused by the family handling these things privately, by not probating estates.

Just as our population fled Russia when threatened with land confiscation, so will it clandestinely flee the government tax reaper today.

It will not do so to commit fraud on the government. It will do so in order to be able to work their lands and livestock 18 to 20 hours a day, to preserve their farm, to be slaves to the soil, as the fathers and grandfathers were before.

Something must be done to prevent this.

I see the same trends in the field of agriculture that are present in areas of American industry. That trend is interference, overseeing and regulation by the government agencies that prevents and inhibits human initiative and experimentation, that drive the creative individuals into other areas of endeavor.

Today, farming is so costly that only those who get government aid can get in it or stay in it. The government programs are tailored to help the young and the marginal farm operation. The good, efficient operator is at a disadvantage when applying for drought or disaster loans. The marginal, less experienced farmer has it easier. What is the result of this? Government programs are encouraging the less able, and the less able are becoming subject to close government scrutiny and supervision through the loan programs. The government becomes their partner.

There seems little difference in this trend in farming than the trend in the railroad and auto industries, where government has stepped in and the creative and hardworking people got out.

The present estate and gift and income tax situation, relative to the establishment, maintenance and devolution of the family farm, further insures that the most efficient and dedicated will be prevented from passing the tools and implements of production to the younger generation. Something must be done to change this.

Any consideration you may give to the comments in this grass-roots statement will be greatly appreciated.

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AREA CODE 515
732-3796

April 15, 1981

Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

RE: Final regulations under Code Section 2032A

Dear Mr. Lighthizer:

As a practicing attorney I am deeply concerned by the final regulations adopted with regard to Section 2032A I.R.C. It was our understanding at the time that "special use valuation" was intended as an aid to the preservation of the concept of the "family farm". Successive interpretations of the law by poorly informed Internal Revenue Service personnel have stripped the law of much of its benefit.

I make specific reference to the new concept of "qualified use". By instituting the artificial "economic risk" (which by the way has no foundation in the law as passed by Congress) and by further requiring, again without legislative basis, that this test be met in five out of eight years they have virtually emasculated the law as far as the typical Iowa farm family is concerned.

In setting up the "economic risk" test the IRS has also knowingly or unknowingly created a Catch 22. They are requiring that income figures on comparable land must be taken from cash rent situations and they will no longer accept crop-share rental data. With all of the farmers having to turn to crop-share rental agreements there will soon be no cash rental information left from which to provide the data now required in the special use valuation formula.

If I were asked to give a short interpretation of the IRS regulations regarding special use value I would be reminded of the story of the black man who went into the polling place in Alabama back in the days when the literacy test was still a requirement to vote. He was handed a sheet of paper written entirely in Chinese and asked if he could read it. He replied that of course he could read it and said "it says that black people don't vote in Alabama. " Paraphrasing this gentleman I would say, "there ain't no such animal as special use value."

Sincerely,
DUNKELBERG, McKINLEY & FOLKERS
By: [signature]

KAM:sg
cc: Mr. Orville W. Bloethe
Professor Neil Harl

William M. Alexander
ATTORNEY AT LAW
123 NORTH THIRD STREET
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(712) 845-2681

April 14, 1981

Mr. Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227
Dirksen Senate Office Bldg.
Washington, DC 20510

RE: Code Section 2032A

Dear Mr. Lighthizer:

This letter is written in the hope that at some point in time something beneficial will be done for the family farm business.

I presently am assisting a family in the probate of an estate in northwest Iowa. The father passed away in March of 1979. He passed away owning approximately 200 acres of real estate—farmland in northwest Iowa. He had retired approximately 10 years before and had been cash renting the farm to his son. It was done under a written farm cash lease.

When dad died, he left part of the farm to his surviving spouse in a life estate and part of it to her outright utilizing the usual marital deduction features and attempting to exclude half of the property from taxation twice by utilization of the life estate.

A family meeting was held at which the pros and cons were discussed of electing to value the farmland under the special use formula-rent minus taxes divided by Federal Land Bank rates. That is, the average five-year cash rental in the community minus the average taxes for a five year period divided the Federal Land Bank interest in effect during the year of death. It was explained to the family that the election of special use valuation would lower their income tax cost basis in the farm. In this instance, there is one son and two daughters and in all probability, the son will purchase his sisters' shares in the farm after mom has passed away.

By electing to value the farm under the special use formula, it went into the estate at approximately $714 per acre. Current fair market value would have put it into the estate at approximately $2,200 per acre. The net result for the widow by electing special use is a tax savings of approximately $22,000. In this instance, the kids decided to help mom and worry about their tax consequences later. There is very little cash in this particular estate.

In December of 1979, the estate tax return was filed and all heirs elected special use valuation. An early audit was requested. In June 1980, I was notified that the estate was going to be audited.

The audit went well until September of 1980 when temporary or proposed regulations were issued by the Internal Revenue Service with respect to interpretation of Section 2032A as it dealt with the matter of cash rent among family members. All seminars that I had attended prior to the issuance of those proposed regulations had generally followed an interpretation that cash rent among family members was of no consequence because of the technical language of the law required that the land or the asset in question had to be utilized by the decedent or a member of his family. There appeared to be no question that rental between strangers would have to be on a crop-share basis to involve material participation but that within the family a cash rent arrangement would certainly be appropriate because of a family member utilizing the asset.

The regulations, as I'm sure you are aware, issued in September of 1980 reversed all of that thinking and all of the planning that I'm sure has been accomplished for many many farm families in the country. In any event, the regulations issued in September of 1980, have turned my family situation into a turmoil creating a considerable amount of strain and difficulty on the family members as to how to handle a $22,000 federal estate tax bill if, if fact, the regulations are made permanent.

I trust that this matter has already seen litigation over the interpretation. I for one am totally amazed that any arrangement between father and son would be subject to scrutiny as long as its arms length. That is, I can't see how a cash rent arrangement between father and son is questionable when the language in the statute indicates that as long as the asset, here a farm, is utilized by the decedent or a member of the family.

The intent of Congress seems clear to me that it was trying to help the family farm only to have the "interpretative authority of the Internal Revenue Service" to have its intentions thwarted through arbitrary regulations.

I trust that this matter will be discussed at the hearings on April 27. I also trust that you will receive thousands of letters like mine protesting the particular aspect of the regulations regarding Section 2032A.

One last note: I believe that if the Internal Revenue Service auditors themselves were asked their opinion with respect to the regulations, the chief administrators at the policy setting level would be amazed. My experience in the field has been that most auditors--off the record--are against the regulation and feel that it does impose a burden that they don't really want to enforce.

I will obviously be looking forward to seeing the results of the hearings on the 27th especially as they pertain to the matters set forth in this letter.

Sincerely,

Bill Alexander

William M. Alexander

WMA:nbh

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FLOYD M. MELTON, JR.
KEITH A. GRAGSON

May 4, 1981

Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227
Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Final Regulations under Code §2032A

Dear Mr. Lighthizer:

I am writing to you to express my concern to the Senate Finance Sub-Committee on Oversight of the Internal Revenue Service regarding the final regulation at §20.2032A-3(b)(1) under Code §2032A of the Internal Revenue Code. Part of this regulation interprets the term "qualified use" as used in the statute at §2032A(b)(2) and this regulation states in part that "all specially valued property must be used in a trade or business.... The mere passive rental of property will not qualify. The decedent must own an equity interest in the farm operation". The Internal Revenue Service in its application of this regulation has taken the position that an estate does not qualify for the election under §2032A where the decedent was "passively" renting the property to a qualified heir at the date of death. The Revenue Service has in substance stated that the decedent must be "at risk" in the farming operation at the date of death. Apparently the Internal Revenue Service has relied on excerpts from the legislative history for §2032A found in the Committee Report on §2032A for its interpretation of these regulations; however, upon examination of the Committee Report, it appears that the regulations take the statements in the legislative history out of context since the legislative history states "the mere passive rental of property will not qualify. However, where a related party leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. For example, if A the decedent owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C each had a one- third interest in profits and capital, the real property could qualify for special use valuation. However, if the property is used in a trade or business in which neither the decedent <u>nor</u> a member of his family materially participates, the property would not qualify".

It is interesting to note that prior to the issuance of these final regulations, the Internal Revenue Service issued letter ruling 8014022, December 27, 1979, which sets forth facts wherein non-family members had rented the decedent's farm land for the year immediately preceeding the decedent's death and the ruling determined that the property was used for a qualified use at the decedent's date of death, where property had been owned by the decedent or a family member and was used in a farming operation in which a family member materially participated for periods aggregating five of the last eight years ending on the decedent's date of death.

Our office is currently representing or associated with five estates being audited by the Internal Revenue Service and the decedent in each of these estates had been cash renting to a "qualified heir" family member at the date of death due to some infirmity of old age or other health problem and the special use valuation election under §2032A was made on each estate tax return filed for these estates. The Internal Revenue Service has maintained the position in the audit of each estate that the estate does not qualify for the election where the decedent was "passively" renting the property to a qualified heir at the date of death based upon the authority of the regulations at §20.2032A-3(b)(1), although the Service admits that the "material participation" test under the statute has been met. Thus apparently the decedent would have to be driving the farm tractor on the date of death to qualify under the regulations imposed by the Internal Revenue Service. I believe that Congress intended that passive rental to a relative would qualify the estate for §2032A Valuation as long as the other conditions of that section are met. I have recently received a copy of the Bill H.R. 2783 introduced by Congressman Bedell of Iowa which addresses this problem and would clarify Congress' intent that nothing in §2032A shall be construed to prevent otherwise qualified real property from being treated as qualified real property by reason of the rental of such property by the decedent to a member of the decedent's family. The Internal Revenue Service's restrictive interpretation of §2032A severely limits the benefits intended under this statute for the family farm operation since it is a very common practice in this area for farmers when they retire or have health problems to cash rent the family farm to their children.

I am writing the Mississippi members of congress to make them aware of this problem and to encourage their support of legislation which would reinterate Congress' intent concerning this aspect of §2032A. I appreciate the opportunity to express this comment to the Senate Finance Sub-Committee.

Sincerely,

Keith A. Gragson

Keith A. Gragson
KAG:gf

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Respond To:
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May 8, 1981

Mr. Robert E. Lighthizer, Esq.
Chief Counsel
Committee on Finance
Room 2227 - Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Lighthizer:

I am writing to express my formal opposition to proposed IRS regulations under Sections 482 and 483 which would, basically, impute interest on loans between commonly controlled trades or businesses at a rate of twelve percent and would impute unstated interest in other transactions at a rate of nine or ten percent.

I practice law in a rural law office in Barnesville, Minnesota, a community of approximately 2,300 people. A substantial portion of my real estate business revolves around farmland and a good portion of that revolves around transactions between family members.

In recent years, of course, farmland has increased substantially in value, usually through no fault of the small family farmer. The vast majority of these people have no desire to sell their property to outsiders, but to continually transfer it to relatives, in most cases, children. Of course, the estate and gift tax problems have been reduced somewhat in recent years, however, these benefits do not generally extend to parties who wish to sell their farmland to relatives.

In a good faith effort to reflect legitimate values on these sales, the sellers have been receiving higher and higher prices per acre over the last few years, and thus incurring substantial capital gain tax liabilities. Because of extensive audit pressures over the last few years (which I presume have been triggered by increased land values) these good faith efforts are necessary. We must reflect the true value in our sales or an audit will trigger substantial gift tax liability in many cases.

Now these proposed regulations bring about additional tax liabilities. Not only in these sales must we be sure to reflect the accurate value of the land, and therefore incur unexpected capital gain responsibilities, we must now also charge at least 11% because if we do not, 12% will be imputed by the IRS.

This makes no sense. In many of these cases the annual payments made on these contracts are somewhat small and investment of the proceeds would yield a rate of five or six percent, similar to passbook savings. Why require the taxpayer to charge such a high rate from a family member when they could not collect that rate from a commercial bank or savings and loan through passbook savings?

When counselling clients, it is difficult enough trying to explain the estate and gift tax consequences of certain actions. These acts of Congress are very difficult to explain. These farmers have owned their farms for many, many years, in many cases barely making a living, and now they are told that because the property is so valuable they must sell it for an exorbitant price to their loved ones or face gift tax possibilities, and that they must charge at least 11% or face additional ordinary income tax liabilities.

I note that these written comments to you are to be not more than 25 double-spaced pages in length, and I feel that I could go on for that long reciting examples of how ridiculous these proposals actually are. However, I also note that the comments are due no later than May 11, 1981 and therefore, I must get this in the mail right away.

Thank you for your consideration.

Very truly yours,

Michael J. Hanhaher

MJH/ss
cc: Honorable Arlan Stangeland
Honorable Rudy Boschwitz
Honorable David Durenberger

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May 11, 1981

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Comments on Proposed Final Regulations §2032A

Dear Mr. Lighthizer:

Pursuant to several public announcements requesting comments from the public concerning the proposed final regulations under §2032A, I respectfully submit my comments concerning these regulations. My comments will be addressed solely to the issue of whether the Treasury Department's definition of "qualified use" correctly implements the law when applied to cash leases by the decedent to family members.

In the official publication entitled "II. Current Use Valuation (Section 2032A), A. Legislative History and Background," it is correctly stated that:

> [a]lthough the Code requries that the property be used in a trade or business, it does not indicate who must be engaged in that trade or business. The Treasury Regulations [§20.2032A-3(b)] interpret the trade or business requirement to mean that the decedent-owner (rather than the family member that materially participates in the operation of the trade or business) must be engaged in the trade or business.

It is noted in the official explanation that the Treasury's interpretation is supported by statements in the legislative history that special use valuation was not intended for a use that was a "mere passive rental."

I. WHETHER THE TREASURY'S INTERPRETATION IS CONSISTENT WITH THE STATUTE?

Section 2032A(b)(1) provides:

> IN GENERAL. -- For purposes of this section, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use, but only if --
>
> > ... during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which --
> >
> > > (i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use, and
> > >
> > > (ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other busines, and ....

Section 2032A(b)(2) defines "qualified use" as follows:

> QUALIFIED USE. -- For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:
>
> > (A) use as a farm for farming purposes, or
> >
> > (B) use in a trade or business other than the trade or business of farming. ...

The statutory language does not clearly specify who must use the real property for a qualified use; however, an examination of the statute as a whole indicates that the decedent <u>or</u> a member of decedent's family must use the real property <u>in</u> a qualified use. This conclusion is more probable than the interpretation advanced by the Treasury Department in the regulations. For example, §2032A(b)(1)(C) provides:

(C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which --

(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use, and

(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business, and .... (emphasis added).

This language requires the real property to be owned by the decedent or a member of decedent's family and used for a qualified use for 5 of the 8 years immediately preceding the decedent's death. I submit that this language permits the reasonable interpretation that the subject land could have been owned by a member of decedent's family and farmed by a member of decedent's family for a part of the requisite period and still qualify for special use valuation.

Second, the statute clearly permits a member of the decedent's family to be the material participant; this aspect of the statute must necessarily contemplate that the member of decedent's family who is also the material participant may also be the only person who actively participates in the trade or business.

The Treasury's interpretation as embodied in the Regulations, §20.2032A-3(b), confuses two separate points, namely:

(i) that the land must be used in an active trade or business; and

(ii) that this active trade or business must be conducted by decedent or by a member of decedent's family.

The active component of the trade or business requirement is a justified and proper interpretation by the Treasury and is supported by the statute and the legislative history. However, the requirement that the decedent must be engaged in an active trade or business is contrary to the entire statutory scheme.

I would, therefore, conclude that the language in the statute does not support the Treasury's interpretation that the decedent must be engaged in an active trade or business; in fact, the statute is subject to a more compelling interpretation to the contrary.

II. WHETHER THE TREASURY'S INTERPRETATION IS SUPPORTED BY THE LEGISLTIVE HISTORY?

The Treasury has justified its interpretation based upon legislative history, more specifically upon H.R. Rep. No. 94-1380 (94th Cong., 2d Sess.) p. 23. However, a careful examination of the language relied on by the Treasury justifies the opposite conclusion; for example:

> "Qualifying real property. -- Real property may qualify for special use valuation if it is located in the United States and if it is devoted to either (1) use as a farm for farming purposes, or (2) use in a trade or business other than farming. In the case of either of these qualifying uses, your committee intends that there must be a trade or business use. The mere passive rental of property will not qualify. However, where a related party leases the property and conducts farming or other business activities on the property, the real proeprty may qualify for special use valuation. For example, if A, the decedent, owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C had a one-third interest in profits and capital, the real property could qualify for special use valuation. However, if the property is used in a trade or business in which neither the decedent nor a member of his family materially participates, the property would not qualify. (Emphasis added)"

Clearly this language contemplates that the decedent or a member of decedent's family may use the property in a trade or business. The Treasury's insistence in requiring that only the decedent must be engaged in a trade or business is not consistent with the legislative history. The above quoted language is echoed in the Joint Committee Explanation. See, e.g., Joint Committee Explanation, 1976-3 C.B. 548,550.

III. CONCLUSION.

Based upon the foregoing analysis, I respectfully submit that the Treasury's interpretation on the active trade or business requirement is not supported by the statutory language nor by the legislative history. It is obvious that the Treasury has magnified a sentence taken out of context from the legislative history to justify its distorted interpretation of the statute. The legislative history more clearly indicates that the decedent-owner or a family member that materially participates in the operation of the trade or business must be engaged in the trade or business. A contrary interpretation would make certain activities permitted by the statute (material participation by a family member instead of the decedent) superfluous.

I would also state that the regulation, §20.2032A-3(b), as presently drawn is confusing and ambiguous. Even if the Treasury's position is sustained, it would be helpful if that position could be more clearly presented. It is unclear what the regulation attempts to focus upon, since it contains so many unrelated statements.

I trust the foregoing comments will be helpful to the Senate Finance Committee's Subcommittee on Oversight of the Internal Revenue Service in correcting the distorted and burdensome interpretation of Section 2032A. I feel that the position advanced in this letter is more consistent with the statute, the legislative history and with the overall spirit of the subject legislation; I hope my comments have persuaded the committee to take corrective action.

Very truly yours,

Allan J. Wade

AJW:A7013:djc

Summary of Family Enterprise

Estate and Gift Tax Equity and Reduction Act

The Family Enterprise Estate and Gift Tax Equity and Reduction Act would make significant changes in the estate and gift tax rules. In general, these changes would reduce the Federal estate and gift tax burdens and would make it much easier for a farm or small business to be transferred from the owner to other members of his family.

The bill would reduce the estate and gift tax rates very substantially over a three-year period beginning in 1981. These rates currently range from 18 percent to 70 percent. Under the bill, the rates would range from 8 percent to 50 percent in 1981, from 7 percent to 40 percent in 1982, and from 5 percent to 30 percent in 1983 and thereafter.

The bill also increases the unified credit against estate and gift taxes from $47,000 to $61,875 over a four-year period beginning in 1982. This means that an estate would incur no estate tax liability if the taxable estate (including prior taxable gifts) was no more than $300,000 in 1982, $400,000 in 1983, $500,000 in 1984, and $600,000 in 1985 and thereafter.

Under the bill, all of the present dollar and percentage limitations on the gift tax and estate tax marital deductions would be repealed, and the marital deduction would be allowed on an elective basis for certain gifts or bequests of a life estate or other terminable interest (but, in such cases, the property would be included in the surviving spouse's estate). In addition, the annual $3,000 per donee gift tax exclusion would be increased to $10,000.

The bill would make a number of changes in the provisions allowing special use valuation of real property used in farming or other closely held businesses. Among the most significant of these changes are the repeal of the $500,000 limitation on the reduction in value due to special use valuation, expansion of the provision to cover woodlands, and revisions in the rules for valuing eligible property. The bill also would revise a number of statutory provisions and administrative interpretations which have resulted in the unavailability of special use valuation in a number of situations.

The bill would add to the tax law a new special valuation provision for interests in closely held businesses. Under this new provision, the executor of an estate could elect to value an interest in a closely held business at 50 percent of its fair market value. If decedent's heirs dispose of their interest in the business or it is merged into a widely held company within 10 years after the decedent's death, the benefits of this special valuation would be recaptured. This provision would not be available to an estate if real property used in the business is valued under the provisions allowing special use valuation of real property used in farming or other closely held businesses.

The tax law currently contains provisions allowing an extended period of time to pay estate taxes and favorable income tax treatment of stock redemptions to pay estate taxes where a large portion of the estate consists of an interest in a closely held business. The bill would coordinate, liberalize and simplify these provisions. It would also make it easier for control of a closely held business to be transferred from one generation to another by liberalizing the rules governing when the proceeds of stock redemptions are entitled to capital gains treatment (rather than dividend treatment) and by allowing a closely held corporation to accumulate funds during the lifetime of a shareholder (without application of the accumulated earnings tax) for the purpose of redeeming stock from the shareholder's estate (rather then being forced to accumulate funds only after the shareholder's death).

The bill would make several other changes to simplify the administration of the estate and gift tax laws and provide more certainty for taxpayers. For example, gifts made within three years of death are valued as of the date of the gift for estate tax purposes rather than as of the date of the decedent's death. Also, gifts made within three years of death which were not taxable when made by reason of the annual per donee exclusion and the rule allowing one half of the gift to be treated as made by the donor's spouse would not be included in the decedent's estate. Another provision would allow the value of a gift to be determined (even though it would not normally be taxable by reason of the unified credit) by allowing the taxpayer to forgo the immediate use of the unified credit and pay gift taxes. (This rule would assure that a reevaluation of the gift after the donor's death could not affect the estate tax liability of his estate.) Finally, the bill would recognize the effectiveness of a disclaimer which meets the standards of the tax law even if State law does not treat it as a disclaimer.

Analysis of H.R.

"Family Enterprise Estate and Gift Tax Equity and Reduction Act"

I. In General

This bill would make major changes in the Federal estate and gift tax rules. These changes are designed to lower the burden of these taxes and make it easier for farmers and small businessmen to transfer family farms and other businesses to their families (rather than breaking up the farms or businesses to pay estate taxes).

II. Reductions in Rates and Increases in Unified Credit

Under present law, the tax rates applicable to taxable gifts and estates under the unified tax rates range from 18 percent of the first $10,000 of taxable transfers to 70 percent of the amount over $5,000,000.

Also, under present law, the unified credit (which reduces liability for estate and gift taxes) is $47,000 for estates of decedents dying in 1981 and thereafter. This means that if a decedent leaves a taxable estate which, coupled with prior taxable gifts, exceeds approximately $175,000, the estate will incur an estate tax liability. Also, any estate with gross assets in excess of $175,000 would be required to file a Federal estate tax return.

<u>Problem</u> The inflation of the last several years has resulted in an increasing number of estates, many of them consisting largely of small businesses, being subject to estate taxes. Also, these taxes have become an increasing burden on estates because many estates have been pushed into higher estate tax brackets. The high marginal rates of these taxes have also served as a disincentive to savings (and accumulation of wealth) and have placed an undue premium on sophisticated estate planning.

<u>Solution</u> The bill provides for an across-the-board reduction in rates. The rate schedule for 1981 will range from 8 percent on the first $25,000 to 50 percent on amounts in excess of $5,000,000. The bill provides further reductions in rates in 1982 and 1983. Under the proposed new rate schedules, rates would range from 7 percent to 40 percent in 1982 and from 5 percent to 30 percent in 1983 and thereafter.

The bill also increases the unified credit to $61,875 over a period of four years. Under this phase-in, there will be no tax liability if the taxable estate is less than $175,000 for decedents dying in 1981, $300,000 for decedents dying in 1982, $400,000 for decedents dying in 1983, $500,000 for decedents dying in 1984, and $600,000 for decedents dying in 1985 and thereafter. Similarly, if the gross estate of a decedent dying in 1982 does not exceed $300,000, no estate tax return would have to be filed. This $300,000 amount is increased to $400,000 for 1983, $500,000 for 1984, and $600,000 for 1985 and thereafter.

III. Unlimited Marital Deduction

Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first $100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of the interspousal lifetime transfers in excess of $200,000.

In addition, an estate tax marital deduction equal to the greater of $250,000 or one half of the decedent's adjusted gross estate is allowed for the value of property passing from a decedent to the surviving spouse. This amount is adjusted by the excess of the amount of unlimited marital gift tax deduction over one half of the lifetime gifts to the surviving spouse.

1. <u>Problem</u> The present rules relating to the inclusion of jointly owned property in the estate of the first to die often create hardships for the survivor, particularly where the survivor is the decedent's spouse. This is especially true where contributions of property or services have been made by the surviving spouse to a business enterprise which is treated as owned by the decedent for estate tax purposes.

<u>Solution</u> The bill provides an unlimited marital deduction for both gift and estate tax purposes.

2. <u>Problem</u> Under present law, a gift or transfer at death does not qualify for the marital deduction if the spouse receives only a life estate or other terminable interest. Thus, an individual cannot obtain a marital deduction with respect to property in which his spouse receives only a life estate (or other interest which terminates on the death of the spouse).

To obtain a marital deduction for property left in trust, the spouse ordinarily must receive a general power of appointment (i.e., a power to transfer the property to anyone) in addition to the spouse's lifetime interest. These rules present a problem in certain cases, such as situations where both spouses have children from previous marriages. In such cases, one spouse frequently wishes to provide for the other during the surviving spouse's lifetime but does not wish to give the surviving spouse a general power of appointment over the property.

Solution The bill allows the executor of an estate or the donor of a gift to elect the marital deduction with respect to any interest in property (or portion of an interest) in which the spouse is given a terminable interest. If such an election is made, however, the property will be included in the spouse's estate upon death to the same extent as if such spouse had a general power of appointment.

These new marital deduction provisions are elective because, in many situations, making these provisions mandatory would result in all property in the decedent's estate being subject to the marital deduction and then all being included in the surviving spouse's estate -- thus preventing the spouses from obtaining the advantages of estate-splitting (as they can do under present law).

IV. Increase in Annual Gift Tax Exclusion

Under present law, an annual exclusion of $3,000 per donee is allowed with respect to gifts of present interests in property (Code sec. 2503(b)).

The annual exclusion has been $3,000 since January 1, 1943.

A gift made by a husband or wife may, with the consent of both, be treated for gift tax purposes as made one half by each. The full annual exclusion is allowed with respect to each spouse's one-half share of gifts of present interests in property. Thus, if both spouses consent, a married donor may make up to $6,000 in excludable transfers to a donee during a calendar year.

Problem The annual exclusion is intended to eliminate gifts of relatively small value from the gift tax system -- in large part to eliminate administrative and record-keeping concerns of reporting numerous small gifts and to cover such items as wedding and Christmas gifts of relatively small amounts.

The $3,000 amount was adequate to eliminate most small gifts in 1943; however, inflation has greatly eroded the purchasing power of $3,000 since 1943. Consequently, many gifts of relatively small amounts are now subject to the gift tax.

Solution The bill increases the gift tax annual exclusion to $10,000 per donee.

V. Improvements to Special Valuation Provision

Present law allows farms to be valued for estate tax purposes on the basis of the use of the land for farming purposes rather than its "highest and best" use as would otherwise be required under the estate tax law. Real property used in a closely held family business can also qualify for special use valuation. There are a variety of qualifications and restrictions on the special use valuation provision -- a number of which have been interpreted by the IRS in ways which make the provision unavailable to many farm estates. These problems are discussed below.

A. Material Participation Requirement

In order to qualify for special use valuation, the decedent or a member of his family must have "materially participated" in the operation of the farm or other small business during at least five out of the eight years prior to death.

1. Problem When a person reaches retirement age, it often can be nearly impossible to meet the material participation requirement and still be eligible for social security retirement benefits. Meeting the material participation requirement also becomes a problem for a person who becomes disabled.

Solution Real property can qualify for special use valuation if the decedent met the material participation test during five out of the eight years prior to the time he became eligible for social security benefits or became disabled.

2. Problem If a spouse inherits a farm or other property which qualified for special use valuation, she may have difficulty, either because of her experience or health, in meeting the material participation test in order to have the

property qualify for special valuation on her death. And, for any of a variety of reasons, there may be no member of the family available to operate the farm for her.

Solution If property which qualified for special use valuation passes to a surviving spouse, the spouse need only be involved in the "active management" of the farm or other property. Active management requires only the making of significant management decisions rather than the management and participation in the daily operations of the farm or other business.

3. Problem In the case of woodlands, it is extremely difficult under present law for the owner to meet the material participation test prior to death because most privately owned timber operations do not require day-to-day management decisions and material participation by the owner.

Solution Woodlands can qualify for special valuation if the decedent or a member of his family has actively managed the property -- rather than having to meet the material participation requirement with respect to the woodlands.

B. Other Restrictions on Eligibility

1. Problem The regulations provide that, even if the "material participation" requirement is satisfied, the decedent must have an equity interest in the farming business conducted on the farm. Thus, if a decedent rents a farm to his child for a cash rental (or allows him to use it rent free), the property would not qualify for special use valuation.

Solution The bill would eliminate this equity interest rule. (On April 27, 1981, Treasury announced that it would issue proposed regulations under which this equity interest rule would be eliminated. Thus the property could qualify as "used as a farm for farming purposes" if either the decedent or a member of the family used the property for farming purposes. These new regulations would be retroactive.)

2. Problem If real property which otherwise qualifies for special use valuation passes to a trust for the benefit of members of the decedent's family, the IRS takes the position that

the property is not eligible unless a member of the decedent's family has a "present interest" in the trust — defined as the <u>right</u> to revoke the trust or to receive all (or a specified portion of) the periodic income.

<u>Solution</u> The bill provides that if real property passes from the decedent to a trust all the beneficiaries of which are members of the decedent's family, the property shall be treated as passing to a qualified heir (i.e., a member of the decedent's family) even if no beneficiary of the trust has a "present interest" in the trust. (On April 27, 1981, Treasury announced that it would issue proposed regulations under which property passing to a trust in which all of the beneficiaries were members of the decedent's family would be treated as passing to a qualified heir. This elimination of the present interest rule in the regulations would be retroactive.)

3. <u>Problem</u> In some states (particularly Illinois), title to land is often held in a trust (such as an Illinois land trust) to facilitate transfer of title. The beneficial owner of the land is the beneficiary of the trust. In other situations land is held in revocable or irrevocable trusts for other reasons (such as facilitating transfer at death). Since the beneficiary's interest in a trust is normally regarded as personal property under State law, property which would otherwise be treated as qualifying real property might be ineligible for special use valuation.

<u>Solution</u> The bill provides that if real property is held by a trust in which the decedent has an interest, the special use valuation rules are to be applied as if the decedent owned his proportionate interest in the real property in the trust and as if the interest were real property.

4. <u>Problem</u> If a decedent who owned a remainder interest in otherwise qualified real property predeceases the life tenant, the IRS takes the position that his estate cannot qualify for special use valuation because the decedent did not have a present interest in the real property. The IRS takes this position even if the decedent himself (or a member of his family) was materially participating in farming activities on the real property.

Solution The bill explicitly provides that the fact that the decedent does not have a present interest in real property shall not prevent the property from being treated as qualified real property.

5. Problem To be eligible for special use valuation, real property must pass to a qualified heir (i.e., a member of the decedent's family). Under present law, members of the decedent's family do not include members of the family of the decedent's spouse. Consequently, relatives of the decedent's spouse, such as a child by a previous marriage or a brother, are not qualified heirs.

Solution The bill expands the definition of member of the decedent's family to include members of the family of the decedent's spouse to the same extent as members of the decedent's family.

6. Problem For the executor of an estate to be eligible to elect special use valuation, each person who has an interest in property (whether or not in possession) for which an election is made is required to sign an agreement consenting to the application of the recapture provisions.

The IRS takes the position that if a minor or other person under a legal disability has an interest in the property, his consent must be made by a legal guardian and cannot be made by that person's parent (unless the parent has been appointed a guardian). The reason for this position is that the IRS is concerned that liability for the recapture tax could be avoided if the agreement were disaffirmed by the minor or other person when his legal disability ceases.

Solution The bill permits the natural parent of a minor or other person under a legal disability to sign the agreement for the minor (without requiring a guardianship proceeding) and provides that the agreement binds the minor or other person even if the person would otherwise have a right to disaffirm the agreement under State law. The bill also would permit the trustee of a trust holding property for the benefit of a person under a legal disability to sign the agreement and bind such person.

7. Problem If the decedent acquired property by reason of a tax-free exchange within the five years before his death, the property cannot qualify for special use valuation under present law.

Solution The bill permits property acquired by reason of a tax-free exchange or through replacement of involuntarily converted property to qualify for special use valuation if the property exchanged (and the property received) were used for a qualifying use.

C. Valuation Formula

Once property qualifies for special use valuation, the easiest and most beneficial way to value the property under present law is to use a capitalization formula which is set forth in the statute for valuation of farms. Under this formula, the value of the farm land is determined by dividing the annual cash rental (less state and local real estate taxes) for comparable farmland in the locality by the average annual interest rate during the last five years for all new Federal Land Bank Loans.

1. Problem IRS regulations state that comparable "crop share" rentals cannot be used in the formula. Thus, if no comparable "cash" rentals can be found in the locality (which is the case in many localities where crop share rentals are used almost exclusively), then the property cannot be valued by using the capitalization formula -- a great detriment to the farm estate. Also, the IRS has taken a very strict interpretation of what "comparable" land is and has denied the use of the capitalization formula whenever it does not believe there is comparble land in the locality.

Solution The capitalization formula is revised so that the real property is valued by using the average annual rental value of that property (rather than the cash rental value of comparable property). The average annual rental value is to be determined on the basis of the rental that would be paid in an arm's-length transaction with an unrelated party and may be computed by use of cash rentals or crop share rentals (net of expenses). This approach eliminates the need for finding "comparable" land and using cash rentals.

2. Problem The formula described above does not work well for woodlands because woodlands do not produce a recurring annual crop. Frequently, woodlands are harvested in commercial quantities only once every 10, 20, or even 30 years.

Solution The bill provides a special valuation formula to be used for woodlands. Under this formula, the expected yield over a reasonable period of time (taking into account the expected frequency of harvesting the woodlands) is annualized and this annualized income (less state and local real estate taxes) is divided by the average annual interest rate for all new Federal Land Bank Loans to compute the special use valuation.

3. Problem If the formula described above for valuing farm real property cannot be used (or the executor elects not to use it), the real property is to be valued under a five factor, or facts-and-circumstances, approach. This approach is highly subjective, and this subjectivity tends to promote controversy with the IRS.

Solution The five-factor method is replaced by a provision that allows the executor to value the qualified real property at 50 percent of its fair market value.

4. Problem It is not clear whether an election to use a particular method of valuing property is irrevocable. Because of disputes which may arise in audit about certain aspects of formula valuation, it may be advantageous for an executor to change his method of valuing the property.

Solution The bill permits an executor who made an initial election to value real property under one of the formulas to make a later election to use the 50 percent discount method. This new election could be made at any time before the statute of limitations for assessing additional estate tax has run.

D. Limitations on Benefits

Under present law, the value of a farm or other qualified property can only be reduced by $500,000 as a result of using the special valuation provision, after which the property must be valued on the basis of its highest and best use.

<u>Problem</u> Inflation has driven the price of land up rapidly during the past several years. As a result, many estates will be denied the benefits of special valuation on a significant portion of the farm land in the estate, causing severe liquidity problems for payment of estate taxes. Since the purpose of the provision is to preserve family farms and small businesses, there is no reason why there should be a limitation on the use of special valuation, assuming the farm or business otherwise qualifies.

<u>Solution</u> The $500,000 limitation is repealed.

E. Recapture of Tax Benefits if Qualified Use Does Not Continue

If property qualifies for special valuation and the estate has received the resulting tax benefits, the heirs must continue to own the property and to meet the qualifications, including material participation by the surviving spouse or member of the family, for 15 years. If the heirs do not continue to own the property and to meet the requirements for 10 years following the death of the decedent, an additional estate tax equal to the total tax savings resulting from special valuation must be paid. If the heirs fail to meet the qualifications during the period from 10 years to 15 years following the death of the decedent, the additional tax is reduced by 20 percent per year. An exception to this general "recapture" rule is made in the case of property which is involuntarily converted if similar or like-kind property is acquired to replace it.

1. <u>Problem</u> If a surviving spouse needs the farm for her own support but must have a non-family member run the farm operation for her because of her inexperience, health, or desire to claim social security benefits, a cessation of qualified use ordinarily will result. This would trigger the additional estate tax liability equal to the tax savings due to special valuation. This same situation can also arise in cases where an heir becomes disabled.

<u>Solution</u> The surviving spouse, a member of her family, or a disabled heir would be allowed to use an agent to operate the farm or other business without triggering recapture of the tax savings due to special valuation.

2. Problem If property which has been specially valued is voluntarily exchanged for other property to be used for the same qualified purpose within 15 years following the death of the person who owned such property, a recapture of some or all of the tax savings will be required, even though there is a good business reason for the exchange and the family will continue to operate the business.

Solution When property which has been specially valued is exchanged for "like-kind" property, no recapture of the original tax savings due to special valuation would be required. If only part of the exchange was for "like-kind" property, then a proportionate part of the tax savings would have to be repaid. Also, the bill does away with the "election" requirement in order to avoid repayment when there is an involuntary conversion of property which has been specially valued.

3. Problem The 15-year "recapture" period under present law is unduly long.

Solution There would be a full recapture of the tax savings during the first 10 years if the farm property or other property is disposed of or the qualifications are not met. Thereafter there would be no recapture of any of the tax savings.

4. Problem Under present law, when there is a recapture of any of the tax savings due to special valuation, there is no adjustment to the tax basis of the property to reflect the payment of the additional tax or the resulting higher estate tax value of the property acquired by the heirs.

Solution If all or a portion of the tax savings due to special valuation is recaptured, the basis of the property would be increased to the value on which the total estate taxes, including the additional estate taxes, are imposed. In the case of a full recapture, the basis of the property would equal its fair market value as of the date of the decedent's death (or the alternate valuation date).

5. Problem Under the IRS' interpretation of present law, if there is a disposition or cessation of qualified use with respect to a portion of property which has been

specially valued, all or a disproportionate amount of the tax savings from special valuation may be recaptured.

Solution The bill provides that only pro rata recapture (based on relative fair market values) occurs upon partial dispositions or partial cessations of use.

F. Reduced Deduction for Mortgage Debt

Under present law, an estate is allowed a deduction for unpaid mortgages on, or any indebtedness in respect of, property included in the decedent's estate.

Problem The IRS takes the position that, in the case of property which is valued pursuant to the special use valuation provisions, the deduction for mortgage debt (or other debt on the property) is limited to the same portion of the debt as the special use value of the property is of the fair market value of the property. This rule does not appear to be supported by statutory authority and has the effect of substantially diminishing the benefits of special use valuation, particularly in situations where a farmer or businessman has borrowed money on the security of his land for use in his business.

Solution The bill makes it clear that the deduction for mortgage debt (or other indebtedness on the property) is not to be reduced if the property is valued under the special use valuation provisions.

VI. Estate Tax Treatment of Transfers Made Within Three Years of Death

Under present law, transfers made by a decedent within three years of death are included in the decedent's gross estate without regard to whether the gifts were actually made in contemplation of death. However, an exception to this rule applies for transfers of property (other than a transfer with respect to a life insurance policy) where no gift tax return was required to be filed with respect to the gift.

When a gift made within three years of the decedent's death is required to be included in the decedent's gross estate, the gift is valued at the time of the decedent's death. However, a credit is allowed against the estate tax for any gift tax paid by the decedent on the gift. Generally, the net effect of these two rules is to include in the gross estate the appreciation in value of the property from the date of the gift until the date of death.

1. Problem Valuing gifts as of the date of death (or alternate valuation date) presents a significant complexity for executors and administrators, especially if the donee has disposed of the property or is not a family member.

Solution The bill provides that the value of gifts which are includible in the gross estate by reason of being made within three years of death is to be their value on the date of gift instead of their value at the date of death. The estate will continue to receive a credit for any gift taxes imposed on the gift. Thus, the net effect of the bill is to subject the gift to the gift tax at its value at the time of gift and to exclude any post-gift appreciation in value from the estate tax.

2. Problem Under present law, certain gifts made by the decedent during the three years prior to his death must be included in his gross estate. However, the gross estate of a decedent does not include gifts made by the decedent during this period if no gift tax return was required to be filed by the decedent because the gifts were within the $3,000-per-donee annual exclusion. With the consent of both the donor and the donor's spouse, gifts may be treated as made one half by each, and the full annual exclusion is allowed with respect to each spouse's one-half share of gifts. Present law does not allow the exclusion of these "split-gifts" from the donor's gross estate if the gifts were made within three years of death. The pullback of these gifts is an unnecessary complexity for executors of decedents.

Solution The bill excludes these "split-gifts" made within three years of the decedent's death from the decedent's estate if the value of the gifts did not exceed the combined exclusions of the decedent and the decedent's spouse.

VII. Election to Pay Gift Tax

Under present law, any unused portion of the unified credit must be used to reduce the gift tax payable for taxable gifts made during a taxable period. Thus, a donor cannot elect not to use a portion of the unified credit that is otherwise allowable.

Problem Requiring the use of the unified credit against the gift tax, rather than using it on an elective basis, prevents finalizing the valuation of gifts made for preceding calendar years and quarters because the valuation used for a gift made in a taxable period closed by the period of limitations for assessing deficiencies is fixed only if a gift tax has been assessed or paid for the taxable period in which the gift was made. Although no gift tax deficiency may be assessed for the prior taxable period, an increase in the valuation of the prior gift may push the taxable gifts for the subsequent taxable periods into a higher tax bracket under the progressive rate structure.

Solution Under the bill, a donor could elect to have all or any portion of the unified credit apply.

VIII. Special Rules for Stock Redemption and Installment Payment of Estate Taxes for Owners of Closely Held Businesses

The Internal Revenue Code contains two separate elective provisions allowing the installment payment of estate taxes where a major portion of the estate consists of an interest in a closely held business (or interests in closely held businesses). These rules contain different payout periods, interest rates, and conditions under which payments are accelerated. The Code also contains a special rule under which a qualified redemption of stock to pay estate taxes, funeral expenses, and administration expenses would be taxed as capital gain, rather than ordinary income, even though a similar redemption during the decedent's lifetime would have been treated as a dividend.

1. Problem Each of these provisions has its own set of definitional qualifications. Also, the two extended payout provisions contain different rules for payment periods (up to 15 years in one situation and up to 10 years in another), interest rates, and acceleration of payments. In addition, by defining a closely held business by reference to 15 or fewer shareholders in many situations, the 15-year extended payout provision is inconsistent with provisions of the income tax law which encourage the transfer of corporate stock to Employee Stock Ownership Plans (ESOPs) and key employees.

Solution In general, the bill expands the 15-year extended payment provision so that it is more widely available than is either the 15-year provision or the 10-year payment provision under present law and eliminates the separate 10-year payment provision. Consequently, under the bill, an estate in which the value of a closely held business (or businesses) included in the estate exceeds 25 percent of the value of the gross estate or 35 percent of the taxable estate would be eligible for payment of the estate tax over 15 years, with interest only payable over the first five years.

The bill also expands the definition of closely held businesses to cover partnerships with 20 or fewer partners and corporations where 50 percent or more of the stock is owned by 20 or fewer shareholders so long as the corporation's stock is not publicly traded on a stock exchange or over-the-counter.

Under present law, a 4-percent interest rate is currently available with respect to the estate tax liability on the first $1 million of the taxpayer's gross estate which is deferred under the 15-year payment provision. The bill makes this 4-percent interest rate available to all estate tax deferred under this 15-year payment provision.

Also, the rules relating to acceleration of deferred payments are liberalized by increasing from 33-1/3 percent to 50 percent the amount of a business interest that could be withdrawn before payments would be accelerated. The bill also makes technical changes in the rules as to what constitutes an event which can cause acceleration of deferred payments for a sole proprietorship. Under these amendments, neither a like kind exchange of business property nor the cutting of timber will be considered an accelerating event. A more general amendment to the rules relating to accelerating events provides that an installment sale of an interest in a closely held business will accelerate the payments only to the extent that the portion of the purchase price received exceeds the portion of the estate tax deferred. Furthermore, a late payment made within six months of the due date would not accelerate all payments; instead, a penalty of 5 percent per month would be imposed.

The bill also expands the availability of the provision relating to qualified stock redemptions to pay estate taxes, funeral expenses, and administration expenses so that it would apply if the value of the closely held business exceeds 25 percent of the value of the gross estate or 35 percent of the taxable estate. The rules relating to aggregation of two or more businesses are also conformed to those in the deferred payment provisions. In order to increase the availability and utility of these redemptions, the bill also eliminates a requirement of present law which requires that the party from whom the shares are redeemed bear the burden of the estate taxes (or other expenses) to the extent of the amount of stock redeemed.

Under present law, the exemption from the tax on corporate accumulated earnings for amounts accumulated to redeem a stock from the estate of a deceased shareholder applies only to amounts accumulated after the death of the shareholder. Since this restriction severely limits the utility of the provision relating to qualified redemptions to pay estate taxes, the bill allows a closely held corporation to accumulate funds (free of the accumulated earnings tax) for the reasonably anticipated estate tax redemption needs with respect to living shareholders.

2. Problem Under present law, the closely held business interest must be either a trade or business carried on by the decedent as a proprietor or an interest in a partnership or corporation which is engaged in carrying on a trade or business at the time of the decedent's death. If business is carried on by a decedent as a sole proprietor, the interest in a closely held business includes only the assets of the decedent which are actually utilized by him in the trade or business.

In a series of rulings, the IRS has set forth guidelines for determining what constitutes a trade or business for purposes of the extended payout sections. These guidelines set up a somewhat narrower definition of trade or business than that applied in other areas of the tax law. In general, these rulings do not treat the management of income-producing property as a trade or business. Consequently, the splitting of an owner's business between an operating corporation and his personal retention of the premises may prevent his estate from using installment payments for estate tax purposes. Thus, in one situation, a decedent incorporated his sole proprietorship but retained personal ownership of the land and building used in the business. Decedent leased the real property to the corporation which actually used it in the corporation's business. The IRS ruled that decedent's ownership of the real property did not qualify as a business interest and thus could not be taken into account in determining whether the estate met the percentage requirements for deferral of estate taxes.

Similarly, giving up active participation in farming because of age and health may result in the loss of the use of the installment payment provisions. In one situation a 96-year-old farmer gave his children the livestock used on his farm and leased the farm property to them on a rent-free basis. The farmer, who took no further interest in the management of the farm, died a year later. The IRS ruled that neither the livestock, which was included in his estate because the gift was made within three years of death, nor his real property qualified as an interest in a closely held business because he had not actively participated in carrying on the farm business.

As interpreted by the IRS, the present provisions are not adequate to allow estate tax deferral in many situations where the family is carrying on a trade or business on property even though the decedent is not personally doing so. Also, the present present provisions do not allow deferral where property is not owned by the same entity that is engaged in the trade or business.

Solution The bill provides that a decedent's direct or indirect ownership of an asset or assets leased to or used by a family-owned business shall be deemed to be an interest in a closely held business carried on by the decedent. Generally, a family-owned business will qualify under this rule if a member of the decedent's family is engaged in the active management of a trade or business conducted by a proprietorship, a partnership, or a corporation, and the business is treated as a closely held business under the extended payout rules generally. The bill also provides that, in the case of property which is included in the decedent's estate because it was given away within three years of death, the time for determining whether the decedent was actually using such property in a closely held business is to be made as of the time immediately before the transfer (rather than immediately before death as is done for other property).

3. Problem Under present law, lifetime redemptions of stock present very difficult problems for closely held businesses since most redemptions will be treated as dividends. This makes it difficult for an older generation to turn control of a business over to a younger generation through redemptions of the older generation's stock. Under present law, a redemption cannot qualify for capital gain treatment as "substantially disproportionate" if the shareholder retains more than 50 percent of the stock or if his percentage interest after the redemption is at best

80 percent of his percentage interest prior to the redemption. Furthermore, a redemption cannot qualify as a "complete termination of interest" if the redeemed shareholder retains an "interest" in the corporation as an officer, director or employee (even if all his stock has been redeemed).

Solution The bill provides that, in the case of a closely held business, the 50-percent rule (referred to above) will not apply and the 80-percent test will be a 95-percent test. Also, the bill provides that the redemption of stock from a shareholder will not be disqualified from "complete termination of interest" treatment merely because such former shareholder continues to be an officer, director or employee of the corporation.

IX. Special Valuation Rule for Closely Held Businesses

Under present law, an estate which consists largely of ownership interests in a closely held business or businesses may be able to pay the estate taxes attributable to the inclusion of these interests in the estate over a period of 10 to 15 years and a favorable interest rule may apply to some portion of the deferred tax payments. Also, under certain circumstances, an estate may elect to value real property used in a farm or another closely held business on the basis of its current use rather than at its highest and best use. (Both of these provisions are discussed above.)

Problem Although present law seeks to ameliorate the burdens of the estate tax on certain closely held businesses, the provisions of present law referred to above are grossly inadequate to allow the owners of most closely held businesses to pass on their interests in the businesses to their families. Rather, in many cases the businesses must be sold to pay estate taxes. (In fact, in many instances, businesses are sold prior to the owner's death in anticipation of the estate tax burdens.) Frequently the only market for these businesses is a large, widely held company with a significant share of the market, and the acquisition of the closely held company increases the degree of concentration in the industry.

An extension of time to pay estate taxes is often not sufficient because the substantial dollar amounts needed to pay the installments ordinarily can be obtained, if at all, only from funds which are needed in the business. Even with relatively generous extended payout periods, the absolute dollar burden of the estate tax is simply too great to prevent sale of the business. Furthermore, although special use valuation has been valuable for many estates which consist largely of real property used in farming, the provision does not benefit estates with other types of closely held businesses (except in very unusual circumstances).

Solution Under a new provision added to the tax code by the bill, if an estate includes an interest in a closely held business, the executor may elect to value the interest at 50 percent of its fair market value. For purposes of the provision, an interest in a closely held business is defined in the same manner as under the present provisions relating to extensions of time for paying estate taxes (as modified by the provisions of this bill described above). Thus, the term "interest in a closely held business" includes (1) an interest in a proprietorship, (2) an interest as a partner in a partnership if either (a) the decedent owns 20 percent or more of the capital interest in the partnership or (b) the partnership has 20 or fewer partners, and (3) stock in a corporation if either (a) the estate includes 20 percent or more in value of the corporation's voting stock or (b) 20 or fewer shareholders own at least 50 percent of the corporation's stock. (However, interests in publicly traded corporations or in corporations with net equity of more than $50 million would not qualify.) Unlike the extension of payment provisions, there is no requirement that the interest in a closely held business constitute any specific portion of the decedent's gross estate, adjusted gross estate, or taxable estate.

If the estate or the decedent's heirs dispose of their interest in the business within 10 years after the decedent's death, the tax benefits will be recaptured in a manner similar to the manner in which the benefits of special use valuation are recaptured under present law. Recapture would not occur on distributions from the estate to the decedent's heirs or on transfers between members of the decedent's family.

An executor could not elect to use the provision with respect to an interest in a closely held business if he elects to value real property used in the closely held business under the special use valuation rules (Code sec. 2032A).

X. Disclaimers

Under present law, a disclaimer is effective for Federal transfer tax purposes if certain specified statutory requirements are satisfied. One of these requirements is that the disclaimer be made within nine months after the transfer creating the interest is made (or, in the case of a minor, within 9 months after he attains age 21). If a qualified disclaimer is made, the Federal estate, gift, and generation-skipping transfer tax provisions apply with respect to the property interest disclaimed as if the interest had never been transferred to the person making the disclaimer.

Problem Proposed Regulations issued on July 21, 1980, state that a disclaimer satisfies the requirements of Code section 2518 only if it also qualifies as a disclaimer under applicable local law. Thus, if a disclaimer is made within the nine-month period prescribed by Federal law but not within a shorter period prescribed by State law, it would not be effective for Federal tax purposes. Similarly, if State law does not recognize a disclaimer of an interest in real property as such, but treats it as a transfer of the interest by the disclaiming party, the disclaimer would not be effective for Federal tax purposes.

Solution Under the bill, a disclaimer that does not result in the passing of an interest under local law would still be a qualified disclaimer for Federal tax purposes if, within the present time limits for making a qualified disclaimer, the disclaimant transfers the property interest to the person who would have received the property interest if the disclaimant had predeceased the holder of legal title to the property.

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