ADDITIONAL ESTATE AND GIFT TAX ISSUES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 649, S. 851, S. 852, S. 1430, S. 1487, S. 1695, S. 1733 and S. 1734

NOVEMBER 4, 10, AND 18, 1981

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ADDITIONAL ESTATE AND GIFT TAX ISSUES

TUESDAY, NOVEMBER 4, 1981

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

The subcommittee met, pursuant to call, in room 2221, Dirksen Senate Office Building, Hon. Steven Symms (chairman of the subcommittee) presiding.

[The committee press release, the bills, S. 1695, S. 1733, and S. 1734 and the Joint Committee on Taxation description of these follow:]

[Press Release No. 81-171]

FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION SETS HEARINGS ON 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 hearings to discuss estate tax issues on November 4, 1981 and November 10, 1981. These hearings will replace a hearing proposed for October 26, 1981. The October 26 hearing has been cancelled.

The hearings on November 4 and November 10, will each begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

In announcing the hearings, Senator Symms indicated that the following bills would be discussed:

NOVEMBER 4

S. 1695—Introduced by Senator Symms. The bill would repeal the tax on generation-skipping transfers, Chapter 13 of the Internal Revenue Code.

S. 1733—Introduced by Senator Symms, would provide for judicial review of determinations made under section 6166 of the Internal Revenue Code.

S. 1734—Introduced by Senator Symms, would expand the acceleration exception under section 6166 of the Internal Revenue Code.

In addition, Senator Symms stated that on November 4 the Subcommittee would examine other issues under section 6166 and section 303 of the Internal Revenue Code. These issues include: An acceleration exception for section 303 redemptions; including indebtedness as part of a closely held business interest; eliminating the distinction in partnerships between capital and profits interests; eliminating the distinction between voting and non-voting stock; qualifying interest as an administration expense; coordinating with subchapter S; simplifying attribution rules, and including a numerical test under the aggregation rule.

NOVEMBER 10

Bills dealing with estate and gift tax and income tax problems of artists:

S. 649, intorduced by Senator Baucus, would allow an executor of an artist's estate to elect to value the decedent's works in the estate at the cost of materials rather than fair market value. The bill would also allow artists to deduct charitable donations of their own works based on fair market value.

S. 851, introduced by Senator Moynihan, would allow the deduction for charitable contributions of an artist's works to be computed at a percentage of fair market value.

S. 852, introduced by Senator Moynihan, would allow a credit against income tax for charitable contributions of an artist's own works.

DESCRIPTION OF TAX BILLS

(S. 1695, S. 1733, and S. 1734)

RELATING TO

GENERATION-SKIPPING TRANSFER TAX AND CERTAIN OTHER TAX MATTERS INVOLVING CODE SECTIONS 303, 2032A, AND 6166

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on November 4, 1981, regarding the generation-skipping transfer tax, and certain provisions of the Code relating to installment payment of estate tax, redemptions of stock in closely held corporations to pay estate tax and administration and funeral expenses, and current use valuation for estate tax purposes.

There are three bills and four additional matters scheduled for the hearing. The first bill, S. 1695 (Senator Symms), provides for the repeal of the generation-skipping transfer tax. S. 1733 (Senator Symms) and S. 1734 (Senator Baker for Senator Symms) and the four other tax matters relate to provisions allowing installment payment of estate tax, redemption of stock of closely held corporations to pay estate tax and administration and funeral expenses, and current use valuation.

The first part of the pamphlet is a summary of the bills and matters covered by the hearing. This is followed by a more detailed description of the bills and other matters, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 1695—Senator Symms

Repeal of Generation-Skipping Transfer Tax

Under present law, a 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 grantor of the trust) or upon termination of an intervening interest in the trust (for example, upon termination of a life income interest in the trust held by the grantor's grandchild). The tax generally is effective for generation-skipping transfers made after June 11, 1976.

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

The bill would repeal the tax on generation-skipping transfers retroactively to generation-skipping transfers occurring after June 11, 1976.

2. S. 1733—Senator Symms

Declaratory Judgment Procedure for Installment Payment of Estate Tax and Current Use Valuation

Present law provides that certain real property used in a farm or other closely held business may be valued at its current use value instead of its fair market value at its highest and best use (sec. 2032A). If the specially valued property is disposed of or otherwise ceases being used by the heir for the farming or other closely held business purpose based upon which it was valued in the decedent's estate, there is a recapture of the tax benefit from the current use valuation. The amount of the recapture tax depends upon the fair market value of the real property at the decedent's death. However, under present law, there is no provision for judicial review of an Internal Revenue Service determination of the fair market value of the property which qualifies for current use valuation unless the entire election is disallowed.

Present law also allows the installment payment of estate taxes attributable to interests in certain closely held businesses (sec. 6166). If 50 percent of the value of the business is withdrawn from the business or disposed of, there is an acceleration of any remaining installments. However, under present law, the determination by the Internal Revenue Service that the estate is not eligible for the installment payment, the amount of estate tax eligible for installment payment, and whether there was an accelerating event, is not subject to judicial review because no deficiency is involved.

With respect to the current use valuation provision (sec. 2032A), the bill would provide a statutory procedure to enable an executor to obtain a final determination of the fair market value through an administrative audit and a Tax Court declaratory judgment.

With respect to installment payment of estate taxes (sec. 6166), the bill would provide a Tax Court declaratory judgment procedure to determine (1) whether an estate is eligible for installment payment, (2) the amount of the adjusted gross estate determined on the basis of facts and circumstances in existence on the date for filing the decedent's tax return (from which it will be possible to determine the amount of estate tax that may be paid in installments), or (3) whether there is an acceleration of the time for payment of the deferred estate taxes.

3. S. 1734—Senator Baker (for Senator Symms)

Acceleration of Installment Payments of Estate Tax

Section 6166 permits an estate to pay the estate taxes attributable to qualifying interests in closely held businesses in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). However, upon the occurrence of certain events, including the sale or other disposition of the qualifying interest in the closely held business, payment of the remaining unpaid tax is accelerated.

An exception to this acceleration rule is provided for transfers of property from the decedent's estate to the heirs. There is no requirement that the property pass to members of the decedent's family. Section 422 of the Economic Recovery Act of 1981 provided a further exception to this acceleration rule where the interest in a closely held business is transferred by an heir (or subsequent transferee) at his death to a family member of the heir (or subsequent transferee).

The bill would remove the limitation requiring that each subsequent transferee be a family member of the transferor from whom the property was received.

4. Other Tax Matters Relating to Installment Payment of Estate Tax (Code sec. 6166) and Redemptions of Stock in Closely Held Corporations (Code sec. 303)

a. Issues relating to acceleration of the installment payment of estate taxes

Section 6166 permits an estate to pay the estate taxes attributable to qualifying interests in closely held businesses in installments for up to 14 years (interest only for four years, followed by up to 10 annual installments of principal and interest). However, upon the occurrence of certain events, including the withdrawal of funds from the business, payment of the remaining unpaid tax is accelerated.

However, section 6166 provides several exceptions to these acceleration rules. One such exception provides that redemptions of stock under section 303 (relating to certain redemptions for the payment of estate taxes and certain other expenses) do not count as withdrawals for purposes of the acceleration rules, provided that an amount equal to the redemption proceeds is used to pay Federal estate taxes within a specified period.

Section 303 provides that the redemption of certain stock in closely held businesses to pay estate taxes, funeral expenses, and administration expenses will be treated as a sale or exchange (eligible for capital gains treatment) instead of a dividend (which would be taxed as ordinary income). Thus, section 303 redemption may be made for purposes other than payment of Federal estate taxes. However, if an amount equal to the redemption proceeds is not applied toward payment of Federal estate tax (which could occur where the proceeds are used to pay State death taxes, administration expenses, or funeral expenses and no other amounts are used to pay Federal estate taxes), the redemption will be considered a withdrawal for purposes of the acceleration rules under section 6166.

The issue is whether the exception to the acceleration rules for section 303 redemptions should be modified to treat redemption proceeds as not being withdrawn if an amount equal to those proceeds is used for any purpose permitted under section 303.

b. Issues relating to the definition of an interest in a closely held business

Section 6166 permits installment payment of the estate taxes attributable to qualifying interests in closely held businesses. Qualifying interests include: (A) an interest of a proprietor in a trade or business carried on as a proprietorship; (B) an interest of a partner in a trade or business carried on as a partnership if (i) 20 percent or more of the partnership's total capital interest is included in determining the decedent's gross estate or (ii) the partnership had 15 or fewer partners; or (C) stock in a corporation carrying on a trade or business if (i) 20 percent or more of the value of such corporation's voting stock is included in determining the decedent's gross estate or (ii) such corporation has 15 or fewer shareholders.

The value of a decedent's interest in partnership profits which is included in his gross estate is not treated as an interest in a closely held business in determining either (1) whether the estate taxes attributable to interests in closely held businesses may be paid in installments or (2) the amount of tax which may be paid in installments. Similarly, the value of partnership or corporate indebtedness included in the decedent's gross estate is not considered an interest in a closely held business for purposes of section 6166.

In determining the number of shareholders or partners, each individual generally is counted once. However, section 6166 also provides several rules for aggregating certain interests. First, under a spousal attribution rule, interests held in joint tenancy or as community property by an individual and his spouse are treated as held by one shareholder or partner. This rule does not attribute individually titled property held by a spouse to the other spouse.

However, under the second so-called "family attribution" rule, partnership interests or stock held by family members of the decedent (e.g., father, mother, spouse, brothers, sisters and descendants) are treated as held by the decedent in counting the number of shareholders or partners for purposes of determining whether the business is closely held. Thus, with respect to jointly held property or community property held by the decedent and his spouse, these two attribution rules overlap. However, the family attribution rule is broader in that all interests owned by the spouse are considered as owned by a single shareholder or partner—the decedent, regardless of the form of ownership. On the other hand, the spousal attribution rule is broader in that it applies to all spouses, not just the decedent and his spouse as under the family attribution rule.

The family attribution rule, which treats interests held by certain family members as owned by the decedent for purposes of determining the number of shareholders, does not apply to interests owned by spouses of a decedent's brothers or sisters. Thus, if a decedent's brothers or sisters predecease him, the interests owned by their surviving spouses will be treated as owned by a partner or shareholder other than the decedent. If the number of partners or shareholders then exceeds 15, the business will not be considered closely held unless 20 percent or more of the value of the partnership's capital interest or the corporation's voting stock is included in the decedent's gross estate.

In order for a corporation to be eligible for special tax treatment under subchapter S of the Internal Revenue Code (which generally provides that the corporation's income or loss is taxed proportionately to the shareholders rather than the corporation), the corporation must have a limited number of qualifying shareholders. For taxable years beginning after December 31, 1981, section 232 of the Economic Recovery Tax Act of 1981 (ERTA) increased this maximum number from 15 to 25.

The issues are:

(1) Whether the value of an interest in partnership profits which is included in a decedent's gross estate should be considered as an interest in a closely held business;

(2) Whether the value of partnership or corporate indebtedness included in a decedent's gross estate should be considered an interest in a closely held business;

(3) Whether the value of nonvoting stock includible in the decedent's estate should be considered for purposes of determining whether a corporation is closely held under the 20-percent test;

(4) Whether the attribution rules should be modified (a) by combining the spousal and family attribution rules and (b) by expanding the family attribution rules to include interests held by spouses of a decedent's brothers and sisters (solely for purposes of section 6166); and

(5) Whether it is appropriate to expand the section 6166 definition of a closely held business to include corporations with 25 or fewer shareholders because such corporations may be eligible to make a subchapter S election.

c. *Issues relating to the treatment of interest as an administration expense*

Where an estate is permitted to pay the estate taxes attributable to interests in closely held businesses in installments, the interest attributable to such installments accrues on the deferred taxes and is payable annually.

Present law permits the interest attributable to such installments to be deducted for estate tax purposes as an administration expense under section 2053 as the interest is paid. Because the amount of interest is based upon the unpaid estate tax while the estate tax liability is reduced by the interest deduction, a complicated interrelated computation is required. Further, because no deduction is permitted until the interest is actually paid or accrued, this computation must be adjusted with each payment.

The issue is whether interest attributable to installment payments of estate taxes should continue to be allowed as an administration expense under section 2053 and, if so, whether the computation needed to establish the amount of the deduction can be simplified.

II. DESCRIPTION OF THE BILLS AND OTHER TAX MATTERS

A. BILL RELATING TO GENERATION-SKIPPING TRANSFER TAX

S. 1695—Senator Symms

Repeal of Generation-Skipping Transfer Tax

Present Law

Under present law, a 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 grantor of the trust) or upon termination of an intervening interest in the trust (for example, termination of a life income interest in the trust held by the grantor's grandchild).

Basically, a generation-skipping trust is one which provides for a splitting of the benefits between two or more generations that are younger than the generation of the grantor of the trust. The generation-skipping transfer tax is not imposed in the case of outright transfers to younger generation heirs or to a trust if the benefits are not split between two or more younger generations. Thus, no generation-skipping transfer tax is imposed upon a "generation-jumping" or "layering" transfer directly to the grantor's grandchildren or other lower generation heirs. In addition, the tax is not imposed if the younger generation heir has (1) nothing more than a right of management over the trust assets or (2) a limited power to appoint the trust assets among the lineal descendants of the grantor. Present law also provides a grandchild exclusion for the first $250,000 of generation-skipping transfers per deemed transferor that vest in the grandchildren of the grantor.

The tax is substantially equivalent to the tax which would have been imposed if the property had been actually transferred outright to each successive generation (in which case, the gift or estate tax would have applied). For example, assume that a trust is created for the benefit of the grantor's grandchild during the grandchild's life, with remainder to the great-grandchild. 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 computing the tax at the grandchild's marginal estate tax rate. In other words, for purposes of determining the amount of the tax, the grandchild would be treated under present law as the "deemed transferor" of the trust property.

The grandchild's marginal estate tax rate is used for purposes of determining the tax imposed on the generation-skipping transfer, but the grandchild's estate is not liable for the payment of the tax. Instead, the tax is generally paid out of the proceeds of the trust property. In determining the amount of the generation-skipping transfer tax arising after the death of the deemed transferor, the trust is entitled to any unused portion of the grandchild's unified transfer tax credit, the credit for tax on prior transfers, the credit for State death taxes, and a deduction for certain administrative expenses.

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

Issue

The issue is whether the tax on generation-skipping transfers should be repealed.

Explanation of the Bill

The bill would repeal the generation-skipping transfer tax.

Effective Date

The bill would apply to generation-skipping transfers occurring after June 11, 1976.

Revenue Effect

It is estimated that the bill would have a negligible effect on budget receipts in the near-term. The long-term effect of the bill would be to reduce receipts by approximately $280 million.

B. BILLS AND OTHER TAX MATTERS RELATING TO INSTALLMENT PAYMENT OF ESTATE TAX AND CURRENT USE VALUATION

1. S. 1733—Senator Symms

Declaratory Judgment Procedure for Installment Payment of Estate Tax and Current Use Valuation

Present Law

***Current use valuation* (*sec. 2032A*)**

For estate tax purposes, real property ordinarily must 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 a specified amount (sec. 2032A).[1]

If, within 10 years of the decedent's death [2] (and before the death of the heir inheriting the farm or other business), the property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purposes based upon which it was valued in the decedent's estate, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" imposed on the heir who inherited the real property. A lien generally is imposed on the real estate for the amount of the additional estate tax.

To compute the amount of the reduction in estate tax value from current use valuation and the maximum amount of the potential "additional estate tax," and to determine the extent of the special estate tax lien required where an estate elects current use valuation, both the current use value and the fair market value of the qualified property must be established as of the date of death (or alternate valuation date, if elected).

Under present law, judicial review of tax issues generally is available only where there is a dispute over the correctness of a tax assessment (except in a few limited instances in which the Code contains provisions for declaratory judgments). Since the issue of the fair market value of specially valued property may not affect any presently assessable amount of tax where it is the only unresolved issue in an estate, there is no opportunity for judicial review of the issue under present law unless the entire use valuation election is disallowed.

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[1] The maximum reduction is $500,000 in the case of decedents dying before January 1, 1981, $600,000 in the case of decedents dying in 1981, $700,000 in 1982, and $750,000 in the case of decedents dying in 1983 and subsequent years.

[2] The recapture period with respect to decedents dying before January 1, 1982, is 15 years.

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Installment payment of estate tax (sec. 6166)

With respect to the estates of certain decedents dying before January 1, 1982, two overlapping provisions permit the estate taxes attributable to interests in closely held businesses to be paid in installments. If the value of an interest in a closely held business exceeds 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest may be paid in installments for up to 14 years (annual interest may be paid in installments for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applies to tax on the first $1 million of interests in closely held businesses (sec. 6601(j)). If the value of the interest in a closely held business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest may be paid in up to ten annual installments (sec. 6166A).

With respect to the estates of decedents dying after December 31, 1981, section 422 of the Economic Recovery Tax Act of 1981 repealed section 6166A and expands the provisions of present law section 6166 to all estates in which the value of interests in closely held businesses exceeds 35 percent of the value of the adjusted gross estate. If the value of the interests in closely held businesses (reduced by allowable expenses, losses, and indebtedness) exceeds 35 percent of the value of the adjusted gross estate, the estate taxes may be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first $1 million of interests in closely held businesses (sec. 6601(j)).

Under these installment payment provisions, the remaining unpaid tax is accelerated if there is a disposition or withdrawal of a specified fraction of the value of a decedent's interest in the business.[3] In addition, the remaining unpaid tax may be accelerated (1) if any installment of principal or interest is not paid on or before the date which is six months after the date fixed for the payment of such installment [4] or (2) the estate has undistributed net income in any taxable year ending on or after the due date of the first installment of principal.

Under present law, judicial review of tax issues generally is available only where there is a dispute over the correctness of a tax assessment (except in a few limited instances in which the Code contains provisions for declaratory judgments). Because the decision of the Treasury Department to deny an election to pay all or a portion of the estate tax attributable to interests in closely held businesses or a decision to accelerate the remaining tax involves a dispute as to the timing of estate tax payments rather than the amount of tax, no deficiency is involved and, therefore, the decision is not subject to judicial review.

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[3] Under section 6166, the fraction is one-third with respect to the estates of decedents dying before January 1, 1982, and one-half with respect to the estates of decedents dying after December 31, 1981. In addition, for estates of decedents dying before January 1, 1982, who elected deferral under section 6166A (repealed by sec. 422 of the Economic Recovery Tax Act of 1981), the fraction is one-half.

[4] For the estates of decedents dying before January 1, 1982, payments may be accelerated if any installment of principal is not paid on or before the date fixed for the payment of such installment.

Issues

The issues are whether a judicial forum should be provided to review (1) Treasury Department determinations of the fair market value of property qualifying for section 2032A current use valuation (without the disallowance of the entire 2032A election), and (2) Treasury Department decisions regarding a section 6166 election to pay all or a portion of the estate tax attributable to interests in closely held businesses in installments.

Explanation of the Bill

Current use valuation (sec. 2032A)

The bill would permit an executor to request the Treasury Department to examine the fair market value of the qualified property and thereby determine that value for all purposes. The bill further provides that the Treasury would be able to initiate such audits without the executor's request and thereby determine the fair market value of the qualified property for all purposes.

If the Treasury Department determines that the fair market value of the specially valued property is different from that value as reported by the executor (either pursuant to an audit requested by the executor or an audit initiated by the Treasury), a notice of the Treasury's determination is to be sent to the executor by registered or certified mail. If the executor and the Treasury agree on the fair market value after the notice is sent, that value is binding on all parties in future actions. If the executor does not agree with the Treasury Department's determination, the executor has ninety days from the date on which notice of the Treasury's determinaton is sent in which to petition the Tax Court to review the fair market value of the property. A decision of the Tax Court is binding on all parties in future actions in which the fair market value of the specially valued property on the date of the decedent's death is at issue. The Tax Court declaration of the fair market value would have the force and effect of a decision of the Tax Court and would be reviewable as such.

Failure by the executor to petition the Tax Court within the ninety day period following the date on which the notice of the Treasury Department's determination is sent results in the value as determined by the Treasury being binding on all parties, except where a qualified heir establishes another value to the satisfaction of the Treasury Department. Any disagreement between the qualified heir and the Treasury Department arising from the heir's attempt to establish a different value is not subject to judicial review, except as provided below, and such a disagreement does not affect the binding nature of a previous determination for which judicial review was available.

Because the fair market value of the specially valued property determines the maximum amount of the recapture tax for which a qualified heir is personally liable, the heir is granted a right to intervene in any action brought by an executor. The heir is also given the right to initiate an action in the Tax Court himself within the ninety day period available to the executor. If the heir initiates such an action, the executor is joined as a party in interest.

If the Treasury Department does not determine that the fair market value of the property is different from that value as reported by the executor on the decedent's estate tax return within the period of limitations for assessment of estate tax, the value as reported by the executor is not binding on the executor, the qualified heirs, or the Treasury Department in any future actions involving any matters arising under the current use valuation provision, the special lien under section 6324B, or with respect to the qualified heir's income tax basis in the specially valued property.

Installment payment of estate tax (sec. 6166)

The bill would provide a procedure for obtaining a declaratory judgment with respect to (1) an estate's eligibility for deferred payment of estate taxes attributable to an interest in a closely held business under section 6166, (2) the computation of the adjusted gross estate, based on the facts and circumstances in existence on the date (including extensions) for filing the estate tax return or, if earlier, the date such return was filed, and (3) whether there is an acceleration of the deferred payments. However, because this declaratory judgment procedure would only apply where there is an actual controversy, no declaratory judgment would be available prior to the decedent's death (with respect to eligibility for deferral or the amount of the adjusted gross estate) or prior to a transaction involving dispositions or withdrawals of an interest in a closely held business (with respect to whether there is an acceleration). Jurisdiction to issue a declaratory judgment would be limited to the Tax Court and the determination would have the force and effect of a Tax Court decision and be reviewable as such. This remedy would be available only if the petitioner (i.e., the executor of the decedent's estate) has exhausted all available administrative remedies within the Internal Revenue Service.

In addition, no petition to the Tax Court could be filed after 90 days from the date on which the Secretary or his delegate sends notice to the executor of his determination as to (1) the estate's eligibility for deferred payment, (2) the amount of the adjusted gross estate (determined on the facts and circumstances in existence on the date (including extensions) for filing the estate tax return, or, if earlier, the actual filing date), or (3) the application of the acceleration rules.

Effective Date

The bill would apply with respect to the estates of decedents dying after December 31, 1981.

Revenue Effect

It is estimated that this bill would have a negligible effect on budget receipts.

Prior Congressional Action

Current use valuation

A similar provision was included in section 421 of H.R. 4242 (the Economic Recovery Tax Act of 1981), as passed by the House. That provision was not agreed to in the conference on H.R. 4242.

Installment payment of estate tax

A similar provision was included in section 422 of H.R. 4242 (the Economic Recovery Tax Act of 1981) as passed by the House. That provision was not agreed to in the conference on H.R. 4242.

2. S. 1734—Senator Baker (for Senator Symms)

Acceleration of Installment Payments of Estate Tax

Present Law

With respect to the estates of certain decedents dying before January 1, 1982, two overlapping provisions permit the estate taxes attributable to interests in closely held businesses to be laid in installments. If the value of an interest in a closely held business exceeds 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest may be paid in installments extending for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applies to tax on the first $1 million of interests in closely held businesses (sec. 6601(j)). If the value of the interest in a closely held business exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest may be paid in up to ten annual installments (sec. 6166A).

With respect to the estates of decedents dying after December 31, 1981, section 422 of the Economic Recovery Tax Act of 1981 (ERTA) repeals section 6166A and expands the provisions of present law section 6166 to all estates in which the value of interests in closely held businesses exceeds 35 percent of the value of the adjusted gross estate. If the value of the interests in the closely held businesses exceeds 35 percent of the value of the adjusted gross estate, the estate taxes may be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first $1 million of interests in closely held businesses (sec. 6601(j)).

Under section 6166, the remaining unpaid tax balance is accelerated if there is a disposition of a specified fraction of the value of a decedent's interest in the business.[1]

For purposes of the acceleration rules, the transfer of the decedent's interest in a closely held business from his estate to his heirs is not considered a disposition. This exception applies whether or not the interest passes to family members.

With respect to transfers made after December 31, 1981, ERTA provided that the transfer of an interest in a closely held business from an heir (or subsequent transferee) at his death to a family member (within the meaning of sec. 267(c)(4)) of the her (or subsequent transferee) will not be considered a disposition.

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[1] Under section 6166, the fraction is one-third respect to the estates of decedents dying before January 1, 1982, and one-half with respect to the estates of decedents dying after December 31, 1981. In addition, for estates of decedents dying before January 1, 1982, which elected deferral under section 6166A (repealed by sec. 422 of the Economic Recovery Tax Act of 1981), the fraction is one-half.

Issue

The issue is whether the present exception from the acceleration rules should be broadened to allow for transfers from an heir (or subsequent transferee) caused by the death of the heir (or subsequent transferee) where the property is transferred to a person who is not a family member of the heir or subsequent transferee.

Explanation of the Bill

The bill would further expand the exception from the acceleration rules for subsequent transfers caused by the death of an heir or subsequent transferee by eliminating the requirement that the interest in a closely held business pass to a family member of the heir or subsequent transferee. Thus, under the bill, any transfer of an interest in a closely held business caused by the death of the heir (or subsequent transferee) would not result in acceleration of the unpaid tax.

Effective Date

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

Revenue Effect

It is estimated that this bill would reduce budget receipts by $5 million annually.

Prior Congressional Action

A similar provision was included in H.R. 4242, The Economic Recovery Tax Act of 1981, as passed by the Senate (floor amendment by Senator Symms, adopted by voice vote). That provision was not agreed to in the conference on H.R. 4242.

3. Other Tax Matters Relating to Installment Payment of Estate Tax (Code Sec. 6166) and Redemptions of Stock in Closely Held Corporations (Code Sec. 303)

a. Overview of present law

With respect to the estates of certain decedents dying before January 1, 1982, two overlapping provisions permit the estate taxes attributable to interests in closely held businesses to be paid in installments. If the value of interests in closely held businesses exceeds 65 percent of the value of the adjusted gross estate, the estate taxes attributable to the interest may be deferred for up to 14 years (annual interest payments for four years, followed by up to ten annual installments of principal and interest) (sec. 6166). A special four-percent interest rate applies to tax on the first $1 million of interests in closely held businesses (sec. 6601(j)). If the value of the interests in closely held businesses exceeds either 35 percent of the gross estate or 50 percent of the taxable estate, the estate taxes attributable to the interest may be paid in up to ten annual installments (sec. 6166A).

With respect to the estates of decedents dying after December 31, 1981, section 422 of the Economic Recovery Tax Act of 1981 repeals section 6166A and expands the provisions of present law section 6166 to all estates in which the value of an interest in a closely held business exceeds 35 percent of the value of the adjusted gross estate. If the value of the interests in the closely held businesses exceeds 35 percent of the value of the adjusted gross estate, the applicable estate taxes may be paid in installments extending for up to 14 years (annual interest payment for four years, followed by up to ten annual installments of principal and interest). The special four-percent interest rate of present law continues to apply to estate taxes on the first $1 million of interests in closely held businesses (sec. 6601(j)).

b. Issues relating to acceleration of installment payments of estate tax by reason of section 303 redemptions

Present Law

Under section 6166, payment of the remaining tax is accelerated upon the occurrence of certain events. One event which triggers acceleration is the withdrawal of funds from the business where such withdrawal equals or exceeds a specified fraction of the value of the decedent' interest in the trade or business.[1]

[1] Under section 6166, the fraction is one-third with respect to the estates of decedents dying before January 1, 1982, and one-half with respect to the estates of decedents dying after December 31, 1981. In addition, for estates of decedents dying before January 1, 1982, which elected deferral under section 6166A (repealed by sec. 422 of the Economic Recovery Tax Act of 1981), the fraction is one-half.

However, section 6166 also provides several exceptions to these acceleration rules. One such exception provides that redemptions of stock under section 303 (relating to certain redemptions for the payment of estate taxes and certain other expenses) will not be considered a withdrawal for purposes of the acceleration rules, provided that Federal estate taxes in an amount equal to the redemption proceeds is paid on or before the due date of the first installment which becomes due after the date of redemption.

With respect to the estates of decedents dying before January 1, 1982, if more than 50 percent of the gross estate (reduced by allowable expenses, losses, and indebtedness) consists of stock in a single corporation, redemption of all or a portion of that stock to pay estate taxes, funeral expenses, and administration expenses will be treated as a sale or exchange subject to capital gains treatment instead of dividend income (sec. 303). With respect to the estates of decedents dying after December 31, 1981, the special treatment for redemptions will be permitted if the decedent's interest in the corporation comprises at least 35 percent of the decedent's adjusted gross estate.

However, if a qualifying section 303 redemption is made to secure funds to pay State death taxes, funeral expenses, or administration expenses and Federal estate taxes are not paid in an amount equal to the proceeds from the redemption, such redemption will be considered a withdrawal which may trigger acceleration of the remaining unpaid tax.

Issue

The issue is whether the acceleration rules of section 6166 should be modified to provide that any redemption to which section 303 applies will not be consdered a withdrawal of a decedent's interest in a closely held business if the proceeds of the redemption are used for any of the purposes enumerated in section 303.

c. Issues relating to the definition of an interest in a closely held business

Present Law

Under section 6166, an interest in a closely held business is defined as (A) an interest as a proprietor in a trade or business carried on as a proprietorship; (B) an interest as a partner in a trade or business carried on as a partnership if (i) 20 percent or more of the partnership's total capital interest is included in determining the decedent's gross estate or (ii) such partnership had 15 or fewer partners: or (C) stock in a corporation carrying on a trade or business if (i) 20 percent or more of the value of such corporation's *voting* stock is included in determining the decedent's gross estate or (ii) such corporation has 15 or fewer shareholders.

The value of a decedent's interest in partnership profits which is included in his gross estate is not treated as an interest in a closely held business in determining either (1) whether the estate taxes attributable to interests in closely held businesses may be paid in installments or (2) the amount of estate tax which may be paid in installments. Similarly, the value of partnership or corporate indebtedness included in the decedent's gross estate is not considered an interest in a closely held business for purposes of section 6166.

Attribution rules

In determining the number of shareholders or partners, each individual generally is counted once. However, section 6166 also provides several rules for aggregating certain interests.

First, under a spousal attribution rule, stock or a partnership interest which is community property or which is jointly held by an individual and his spouse is attributed to the individual and is treated as held by one shareholder or partner. This rule does not attribute individually titled property held by a spouse to the other spouse.

Under the second attribution rule (the so-called "family attribution rule"), partnership interests or stock held by family members within the meaning of section 267(c)(4) (e.g., father, mother, spouse, brothers, sisters and descendants) will be treated as held by the decedent in counting the number of shareholders or partners.

In applying these two attribution rules, all stock or partnership interests held indirectly by a family member (e.g., through a corporation, partnership, estate, or trust) are also attrbiuted first to the family member and then to the decedent.[2]

The spousal attribution rule and the family attribution rule overlap in the case of the jointly held property or community held property of the decedent and his spouse. However, the spousal attribution rule is broader than the family attribution rule in that the spousal attribution rule applies to all individuals (e.g., stock owned by individuals other than the decedent or his family) while the family attribution rule applies only to the decedent (e.g., stock owned by the decedent or his family).

The family attribution rule, which treats interests held by certain family members as owned by the decedent for purposes of determining the number of shareholders, does not apply to interests owned by spouses of a decedent's brothers or sisters. Thus, if a decedent's brothers or sisters predecease him, the interests owned by their surviving spouses will be treated as owned by a partner or shareholder other than the decedent. If the number of partners or shareholders then exceeds 15, the business will not be considered closely held unless 20 percent or more of the value of the partnership's capital interest or the corporation's voting stock is included in the decedent's gross estate.

Subchapter S

To qualify for special tax treatment under subchapter S of the Internal Revenue Code (which generally provides that the corporation's income or loss is taxed proportionately to the shareholders rather than the corporation), the corporation must have a limited number of

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[2] In addition, an executor may elect to apply the family attribution rules to determine whether at least 20 percent of the capital interest or the value of voting stock in a business is included in the decedent's gross estate. However, in the case of stock, this election may be made only if there was no market on a stock exchange or in an over-the-counter market for such stock at the time of decedents' death. If an executor makes this election, then the special 4-percent interest rate will not apply and the period for the installment payment of estate taxes attributable to the closely held business interest may not exceed 10 years.

qualifying shareholders. For taxable years beginning after December 31, 1981, section 232 of the Economic Recovery Tax Act of 1981 (ERTA) increased this maximum number from 15 to 25.[3]

Issues

The issues are:

(1) Whether the value of an interest in partnership profits which is included in a decedent's gross estate should be considered as an interest in a closely held business;

(2) Whether the value of partnership or corporate indebtedness included in a decedent's gross estate should be considered an interest in a closely held business;

(3) Whether the value of nonvoting stock includible in the decedent's estate should be considered in determining whether that corporation is closely held for purposes of the 20-percent test;

(4) Whether the attribution rules should be modified (a) by combining the spousal and family attribution rules and (b) by expanding the family attribution rules to include interests held by spouses of a decedent's brothers and sisters (solely for purposes of section 6166); and

(5) Whether it is appropriate to expand the definition of a closely held business to include corporations with 25 or fewer shareholders because such corporations may be eligible to make a subchapter S election.

[3] Historically, both the estate tax deferral provisions and the subchapter S provisions have provided benefits for closely held businesses. The following chart indicates the historical relationship between the section. (Sec. 6166A was originally sec. 6166, but was renumbered in 1976 with the enactment of new sec. 6166 and was repealed by ERTA with respect to the estates of decedents dying after December 31, 1981.)

Period	*Sub-S*	*6166*	*6166A*
1958–1976	10	N.A.	10
1976–1978	* 10	15	10
1978–1981	15	15	10
1981 and thereafter	25	15	N.A.

*15 for certain existing corporations.

It should also be noted that subchapter S contains other restrictions not found in the estate tax deferral sections. For example, a corporation with 25 or fewer shareholders may not be eligible for subchapter S treatment if it is a member of an affiliated group or if some or all of those shareholders are certain types of trusts. Under the estate tax deferral provisions, no similar restrictions apply and a corporation will be considered closely held if it satisfies the numerical test. On the other hand, corporations eligible for the existing estate tax deferral sections include corporations which could not qualify as subchapter S corporations. For example, the estate tax deferral sections may apply to corporations that have more than 25 shareholders where the family attribution rules treat the corporation as having less than 15 shareholders or where the decedent's stock comprises more than 20 percent of his estate.

d. Issues relating to treatment of interest as an administration expense

Present Law

If an estate elects to defer taxes under section 6166, interest is payable on the unpaid tax balance from the due date of the original return until the date of payment.[4]

Under present law, the interest attributable to the estate tax paid in installments may be deducted, for estate tax purposes, as an administration expense or as an income tax deduction (sec. 642(g)).[5]

If the interest is claimed as an administration expense, several problems arise. First, because the amount of interest is based on the unpaid estate tax, and the estate tax liability in turn is reduced by the allowable interest deduction, a complicated, interrelated computation is required. Further, because no deduction is permitted until the interest is actually paid or accrued,[6] a revised computation (and supplemental estate tax return) must be made after each payment.

Issue

The issue is whether an estate tax deduction for interest paid on installment payments of estate taxes should be allowed and, if so, whether the computation needed to establish the amount of the deduction can be simplified.

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[4] Under section 6166, interest is payable at 4 percent with respect to the first $345,800 of tax attributable to interests in closely held businesses, reduced by the unified credit (sec. 6601(j)). Interest on the remaining tax balance is computed at the statutory rate under section 6621 (12 percent currently to be increased to 20 percent in February 1982).

[5] See Rev. Rul. 78-125, 1978-1 C.B. 292; *Estate of Bahr* v. Commissioner, 68 T.C. 74 (1977), acq. 1978-1 C.B. 1.

[6] See Rev. Rul. 80-250, IRB 1980-37, 15.

II

97TH CONGRESS
1ST SESSION

S. 1695

To repeal the generation skipping transfer tax.

IN THE SENATE OF THE UNITED STATES

OCTOBER 1 (legislative day, SEPTEMBER 9), 1981

Mr. SYMMS introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To repeal the generation skipping transfer tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) chapter 13 of the Internal Revenue Code of 1954 is repealed effective June 11, 1976.

(b) The amendment made by subsection (a) shall apply to the estates of decedents dying after June 11, 1976.

II

97TH CONGRESS
1ST SESSION

S. 1733

To amend the Internal Revenue Code of 1954 to provide a procedure for determining the fair market value of certain assets for estate tax purposes, and to provide for declaratory judgments relating to installment payment of estate tax.

IN THE SENATE OF THE UNITED STATES

OCTOBER 14, 1981

Mr. BAKER (for Mr. SYMMS) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide a procedure for determining the fair market value of certain assets for estate tax purposes, and to provide for declaratory judgments relating to installment payment of estate tax.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PROCEDURE FOR BINDING DETERMINATION OF FAIR MARKET VALUE OF SPECIAL VALUATION PROPERTY.

(a) IN GENERAL.—Part IV of subchapter C of chapter 76 (relating to declaratory judgments) is amended by adding at the end thereof the following new section:

"SEC. 7479. PROCEDURE FOR BINDING DETERMINATION OF FAIR MARKET VALUE OF SPECIAL VALUATION PROPERTY.

"(a) ADMINISTRATIVE AUDIT.—

"(1) DESIGNATION BY EXECUTOR.—An executor may request the Secretary to audit the fair market value of any special valuation property which is shown on the return of the tax imposed by chapter 11. Any such request shall be made on such return. Any request so made may be withdrawn only with the consent of the Secretary.

"(2) AUTHORITY OF THE SECRETARY.—For purposes of examining the correctness of the fair market value of any special valuation property, the Secretary shall have the same authority as if he were determining the liability of any person for a tax imposed by this title.

"(b) JUDICIAL REVIEW.—

"(1) BRINGING OF ACTION.—If the executor and the Secretary have not entered into an agreement described in subsection (c)(2) with respect to any special valuation property, the executor may bring an action in the Tax Court with respect to such property.

"(2) DECLARATION BY TAX COURT.—Upon the filing of an appropriate pleading in an action brought under paragraph (1), the Tax Court may make a declaration of the fair market value of property with respect to which such an action is brought. Such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(3) TIME FOR BRINGING ACTION.—

"(A) DURING FIRST 18 MONTHS.—No action may be brought under this subsection with respect to any property during the 18-month period which begins on the date on which the executor made a request under subsection (a)(1) with respect to such property unless the pleading is filed on or after the notification date.

"(B) PLEADING MUST BE FILED WITHIN THE 90-DAY PERIOD BEGINNING ON NOTIFICATION DATE.—No action may be brought under this subsection relating to any property with respect to which a notification date has occurred unless the pleading is filed within the 90-day period beginning on the notification date.

"(C) NOTIFICATION DATE DEFINED.—For purposes of this paragraph, the term 'notification date' means the day on which the Secretary sends by certified or registered mail a notification of his disagreement with the fair market value of the property shown on the return of the tax imposed by chapter 11.

"(c) BINDING EFFECT OF DETERMINATIONS.—

"(1) NOTICE FROM SECRETARY.—If—

"(A) an executor makes a request under subsection (a)(1) with respect to the fair market value of any property, and

"(B) before the date 3 years after the day on which such request is made, the Secretary sends to the executor by certified or registered mail notice of his disagreement with the fair market value of such property shown on the return of the tax imposed by chapter 11 together with his determination of such fair market value,

then the fair market value as so determined by the Secretary shall be binding and conclusive on the Secretary and on any qualified heir unless the executor brings an action in the Tax Court as provided within the period prescribed by subsection (b), or unless any such qualified heir establishes a different fair market value to the satisfaction of the Secretary.

"(2) NO NOTICE FROM SECRETARY.—If—

"(A) an executor makes a request under subsection (a)(1) with respect to the fair market value of any property, and

"(B) before the date 3 years after the day on which such request is made, the Secretary does not send to the executor by certified or registered mail notice of his disagreement with the fair market value of such property shown on the return of the tax imposed by chapter 11,

then the fair market value so shown shall be binding and conclusive on the Secretary and on any qualified heir unless any such qualified heir establishes a different fair market value to the satisfaction of the Secretary.

"(3) AGREEMENT BETWEEN SECRETARY AND EXECUTOR.—If the executor and the Secretary sign a written agreement as to the fair market value of any property with respect to which the executor made a request under subsection (a)(1), such agreement shall be binding and conclusive on the Secretary and on any qualified heir in the same manner as if such agreement were a closing agreement under section 7121 between the Secretary and such qualified heir.

"(4) TAX COURT DECISION BINDING ON HEIRS.—Any declaration of the fair market value of any property made under the provisions of this section by any court which has become final shall also be binding on any qualified heir.

"(d) INTERVENTION.—Any qualified heir shall be allowed to intervene in any administrative or judicial proceeding under this section.

"(e) DEFINITIONS.—For purposes of this section—

"(1) FAIR MARKET VALUE.—The term 'fair market value' means fair market value on the date of the decedent's death (or, the alternate valuation date under section 2032, if the executor of the decedent's estate elected the application of such section).

"(2) SPECIAL VALUATION PROPERTY.—The term 'special valuation property' means any real property to which an election under section 2032A applies.

"(3) QUALIFIED HEIR.—The term 'qualified heir' means any person who is a qualified heir (within the meaning of section 2032A(e)(1)) with respect to the estate of the decedent.".

(b) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 7456 (relating to Tax Court commissioners) is amended by striking out "and 7478" and inserting in lieu thereof "7478, and 7479".

(2) The table of sections for part IV of subchapter C of chapter 76 is amended by adding at the end thereof the following new item:

"Sec. 7479. Procedure for binding determination of fair market value of special valuation property.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the estates of decedents dying after December 31, 1981.

SEC. 2. DECLARATORY JUDGMENTS RELATING TO SECTION 6166.

(a) IN GENERAL.—Part IV of subchapter C of chapter 76 (relating to declaratory judgments) is amended by adding at the end thereof the following new section:

"SEC. 7480. DECLARATORY JUDGMENTS RELATING TO SECTION 6166.

"(a) IN GENERAL.—In the case of an actual controversy involving—

"(1) whether an estate is eligible for the extension of time for payment of the estate tax provided by section 6166,

"(2) the amount of the adjusted gross estate determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the return of tax imposed by section 2001 (or, if earlier, the date on which such return is filed), or

"(3) whether there is an acceleration of the time for payment under paragraph (1), (2), or (3) of section 6166(g),

upon the filing of an appropriate pleading, the Tax Court may make a declaration with respect to such issue. Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

"(b) LIMITATIONS.—

"(1) PETITIONER.—Any pleading may be filed under this section only by the executor of the decedent's estate.

"(2) EXHAUSTION OF ADMINISTRATIVE REMEDIES.—The court shall not issue a declaratory judgment under this section unless it determines that the petitioner has exhausted all available administrative remedies within the Internal Revenue Service.

"(3) TIME FOR BRINGING ACTION.—If the Secretary sends by certified or registered mail notice of his determination of an issue described in subsection (a), no proceeding may be initiated under this section with respect to such issue unless the pleading is filed before the 91st day after the date of such mailing.".

(b) CONFORMING AMENDMENTS.—

(1) Subsection (c) of section 7456 (relating to Tax Court commissioners) is amended by striking out "and 7479" and inserting in lieu thereof "7479, and 7480".

(2) The table of sections for part IV of subchapter C of chapter 76 is amended by adding at the end thereof the following new item:

"Sec. 7480. Declaratory judgments relating to section 6166.".

(c) Effective Date.—The amendments made by this section shall apply to the estates of decedents dying after December 31, 1981.

II

97TH CONGRESS
1ST SESSION

S. 1734

To amend the Internal Revenue Code of 1954 to provide qualified use valuations for certain real property acquired by any individual from a decedent and to prevent acceleration of estate tax payments in certain situations.

IN THE SENATE OF THE UNITED STATES

OCTOBER 14, 1981

Mr. BAKER (for Mr. SYMMS) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide qualified use valuations for certain real property acquired by any individual from a decedent and to prevent acceleration of estate tax payments in certain situations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INSTALLMENT PAYMENT OF ESTATE TAX.

(a) NO DISQUALIFICATION IN CASE OF SUBSEQUENT DEATHS.—Subparagraph (D) of section 6166(g)(1) is amended by striking out the second sentence thereof and inserting in lieu thereof the following new sentence: "A similar rule shall apply in the case of subsequent transfers of the property by reason of the death of such person or of a subsequent transferee.".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to transfers ~~made~~ after December 31, 1981.

Senator SYMMS. Welcome to our third hearing of the Estate and Gift Tax Subcommittee.

Today's hearing will focus on needed technical changes in section 6166 and the necessity of repealing chapter 13 or the generation-skipping transfer tax. While both of these issues have been addressed in previous Estate and Gift Tax Subcommittee hearings, this subcommittee believes that it was necessary to again review these subjects since it is absolutely imperative that these issues be immediately addressed.

First, before the committee begins its proceedings, I would like to make just a few comments.

I have introduced two bills which would effect changes in section 6166 and I am currently working on a third bill which will be a comprehensive bill encompassing of all the needed technical changes in section 6166 and the corresponding sections of the code.

The comments made at today's hearing will be reviewed and possibly incorporated into the intent of the comprehensive bill which I intend to introduce in the near future. Often, as we know from experience, when Congress passes a tax legislation, it unfortunately cannot foresee all the technical problems that might arise from the passage of a particular provision. As a result, technical revisions are normally necessary so that the full intent of Congress can be implemented with the greatest possible ease.

The problems in section 6166 can be corrected, unlike chapter 13. Personally I do not believe that any of the corrections are controversial. I don't believe that my colleagues believe them to be controversial. Therefore, I am hopeful that the changes can be made in the near future without opposition.

With regard to the generation-skipping transfer tax, I see no alternative but to repeal chapter 13 entirely. The tax is unworkable, not able to be implemented, and will be of significant cost to both the private and public sectors, and will never collect any revenue. No amount of patch up will ever be able to make this tax work and be anywhere near cost effective.

I believe that at this time it is important to mention exactly how this provision became law. Oftentime, in the Congress, when a provision is passed, whether ridiculous or not, it is as if the provision were made into the 11th commandment.

This provision was put into the tax bill in a 2 a.m. conference session on the 1976 Tax Act. No member who was in the conference has been able to explain or understand this provision since that time. Clearly, this provision was not a well-reasoned item that was implemented in an attempt to correct some gross inequity.

Supporters of chapter 13 argue that it is necessary as a matter of equity. I personally would like to know exactly what is equitable about a tax that will never collect any money, but will cost taxpayers and tax collectors significant sums of money to try to implement.

It is apparent that with all the tax practitioners who are represented here today advising the committee, that this simply is not workable. The Congress needs to take urgent action to repeal this provision.

I would at this time ask for unanimous consent to submit a copy of my Congressional Record statement on S.1695.

[Congressional Record statement of Senator Symms follows:]

[From the Congressional Record, Oct. 1, 1981]

By Mr. Symms: S. 1695. A bill to repeal the generation skipping transfer tax; to the Committee on Finance.

GENERATION-SKIPPING TRANSFER TAX

Mr. SYMMS. Mr. President, could you imagine a tax being imposed that nobody could understand: that costs the private sector hundreds of thousands of dollars to try to understand and implement; for which the IRS has not yet published key regulations which are essential to understanding and implementing the law; for which the IRS has not yet published forms to enable individuals to file even if they knew about the tax or could understand the procedure; which costs the Government more to administer than it is supposed to collect; and which has not yet collected 1 red cent? Does this sound like a tax that would be imposed by the Duchy of Fenwick? No, it is a tax that is supposed to be imposed by the U.S. Department of the Treasury and which has been on the books since it was thrown into the 1976 Tax Reform Act during a 2 a.m. conference session.

The generation-skipping transfer tax is extremely complex and costly to administer. It is, in fact, so complex that even the most knowledgeable individual or corporate fiduciaries, insurance people, accountants, and attorneys, all of whom are affected by this tax, are finding it extremely difficult to interpret or apply.

The generation-skipping transfer tax can never be defended on revenue grounds. According to the Joint Tax Committee, this tax is projected to have no revenue effect in its early years and they hope to generate $400 million of revenue to the Treasury in its 20th year. However, the private sector has spent hundreds of thousands of dollars in attempting to understand and implement the law and to no avail. Two volumes, each the size of the yellow pages, have been published in an attempt to comprehend the law. Clearly, the tax is regressive since it does not collect any revenue but is costing the private sector significant sums of money to try and comply with the law.

While the generation-skipping transfer tax cannot be defended on revenue grounds, neither can it be defended on the ground that the statute can be made to work. There are numerous, complicated, analytical steps that must be followed in order to determine whether any amounts are held in trust that will be subject to the generation-skipping transfer tax. This analytical process often results in an unexpected and inequitable application of the tax.

There are at least 14 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 transfer 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 tax 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 rulemaking 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 rulemaking. 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.

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 transfer tax. Even to the few attorneys who enjoy the status of experts in estate planning affairs, chapter 13 presents difficulties which are insurmountable.

As an example, according to a survey done at an Amercian Bar Association nationwide meeting, only one attorney thought he comprehended most of the statute. Furthermore, the American Bar Association recently endorsed repeal of the generation-skipping transfer tax at their 1981 annual meeting.

It is important to note that the 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 S2611 (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 equilvalent 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 transfer tax rules to these devices is sure to result in the uninformed failure to comply with chapter 13 on a grand scale.

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 simply out of ignorance. On the other hand, some will be encouraged to ignore chapter 13 in the belief that it is impossible for the Government to effectively 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.

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 and how much property is added to all preexisting trusts in order to determine the extent to which existing trusts have become subject under chapter 13. It must know when and in what fashion powers of appointment are exercised under generation-skipping trusts, and when interests or power 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 transfer 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 that is required would seem to be beyond the storage capacity of any known computer. 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 transfer 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.

If it were the policy of this administration to not repeal estate and gift taxes, then idealistically it would be equitable to have a generation skipping transfer tax as ~~well, if a system of taxation could be implemented that was cost-effective. However,~~ since it is the policy of this administration and the policy of the chairman of the Estate and Gift Tax Subcommittee in the Senate Finance Committee to repeal estate and gift taxes, it would not be consistent to try and impose another version of this tax at this time. Furthermore, it is highly unlikely that a cost-effective generation skipping transfer tax could be implemented. The cost of record-keeping alone would be prohibitive.

Clearly, the generation skipping transfer tax reenforces the notion that the Government not only wants to collect revenue but only wants to collect revenue but that the Government is trying to punish the taxpayers in the process. And, in this case, no revenues have yet been collected.

The only time that the tax might work is if every individual in the estate plan dies in order. If an individual dies out of order, then the wrong generation might be taxed. I know in the years that I have served as a Member of Congress, that the Congress has been able to do many things but there is one thing I am sure of and that is that Congress will never be able to make individuals understand or comply with this law, and more important, I do not believe that we will ever be able to make people die in order.

Senator SYMMS. I would like to now welcome all those that will be testifying this morning, and say that we will make every attempt to move along so that all of you will be able to have presented your position to the committee before noon, so that you can catch afternoon flights, those of you who came in from out of town.

As our first witness, we welcome to the committee this morning the Deputy Assistant Secretary for Tax Policy, Mr. David Glickman of the Department of the Treasury. Welcome to the committee this morning, David.

STATEMENT OF DAVID GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. Thank you, Mr. Chairman.

I am pleased to have the opportunity to present the views of the Treasury Department on S. 1695, which would repeal the generation-skipping transfer tax imposed by chapter 13 of the Internal Revenue Code.

With the subcommitte's permission, we will submit at a later date our comments for the record on the other two bills scheduled for the hearing: S. 1733, which would provide for judicial review of certain determinations relating to special use valuation property and deferred payment of estate taxes; and S. 1734, which would expand a recently enacted exception to the acceleration rules for deferred estate tax payments.

The impact of transfer taxes on our Nation's economic productivity has been a source of considerable concern to the administraton. This concern was reflected most recently in the Economic Recovery Tax Act of 1981, which included major reductions in the estate and gift taxes.

These changes were designed to reduce or eliminate the burden of transfer taxes in situations where they operate as significant disincentives to work and to save.

The Treasury Department is now studying a number of basic issues concerning the tax consequences that should be associated with an individual's death. These issues include the question of whether the transfer tax system should be retained and, if not, whether it is appropriate at death to continue to provide a step up in the basis of appreciated property in the absence of either an estate tax or an income tax on the appreciation.

Without regard to the conclusions we ultimately reach with respect to these issues, it is clear that the transfer tax will remain an important source of Federal revenue even after the 1981 act, and thus will be retained for the immediate future.

Since Treasury is of the view that a generation-skipping tax is necessary to preserve the integrity and fundamental fairness of the overall transfer tax system, we must oppose S.1695.

We do agree, however, that chapter 13 in its present form is overly complex from an administrative standpoint, and may have an undue influence on estate planning in many common situations where skipping a generation for estate tax avoidance purposes is generally not a primary motivation.

Accordingly, we would like to take this opportunity to discuss a number of changes that we believe might be made in chapter 13 to make the generation-skipping transfer tax simpler and more workable and to focus the tax more directly on the kind of tax avoidance arrangements that were the primary targets of chapter 13 when it was originally enacted.

I would first like to review briefly some of the background leading up to the enactment of the present generation-skipping transfer tax statute.

Prior to the Tax Reform Act of 1976, our estate and gift tax system was severely criticized for the substantially different treatment accorded transfers of property from one generation to lower generations, depending on the means used to accomplish the transfer.

When property was transferred from parent to child to grandchild to great-grandchild by means of successive outright transfers, a gift or estate tax was imposed at each generation's level.

In contrast, if a trust mechanism was used, the property could be kept outside the transfer tax base for the maximum period permitted by the rule against perpetuities, which might be as long as 100 years, as it passed from generation to generation, even though the economic benefit enjoyed by each succeeding generation could be tantamount to outright ownership.

The preferential treatment of transfers from generation to generation by means of generation-skipping trusts came to be known as the generation-skipping problem, and was the subject of intense study in the late 1960's and early 1970's.

Virtually all parties that studied the matter at that time agreed that some sort of tax on generation skipping was needed to remove or reduce this discrepancy in the transfer tax system, and the debate focused primarily on the parameters of the mechanism to be devised to deal with the problem.

Treasury Department, the American Law Institute, the American Bankers Association, and the American Institute of Certified Public Accountants all made specific proposals for a generation-skipping transfer tax during this period.

In response to these and other proposals, a generation-skipping transfer tax, chapter 13, was added to the Internal Revenue Code as part of the sweeping structural changes in the transfer tax made by the Tax Reform Act of 1976.

Under chapter 13, a tax is imposed upon generation-skipping distributions of trust principal and upon the termination of intervening interests or powers of skipped beneficiaries in generation-skipping trusts or trust equivalents.

Chapter 13 does not impose a tax on direct transfers that do not split the benefits between two or more younger generations. The tax is computed as if the trust property had been added to the taxable gifts or estate of a particular deemed transferor, except that the tax is payable out of the trust property.

A grandchild exclusion is also provided for the first $250,000 of generation-skipping transfers per deemed transferor that vest in grandchildren of the grantor.

I would now like to comment on several of the primary arguments that have been made in support of the repeal of chapter 13. First, revenue impact.

The generation skipping transfer tax, like the gift tax, is merely one facet of a unified transfer tax system that seeks, to the extent that it is feasible, to tax all transfers of property in an equivalent manner regardless of the time or manner in which the transfers are made.

The revenue impact of the generation-skipping transfer tax, therefore, cannot be viewed in isolation, but must be evaluated in connection with the revenue impact of the overall transfer tax system.

Although the revenue yield from all transfer taxes is relatively small when compared with the yield from other sources, the revenues produced by transfer taxes are insignificant in absolute terms, especially in today's environment.

Even after the significant transfer tax reductions made by the Economic Recovery Tax Act are taken into account, we estimate that the transfer taxes will produce revenues of approximately $7.3 billion in fiscal 1982, $5.9 billion in 1983, $5.5 billion in 1984, $5.2 billion in 1985, $4.5 billion in 1986, and $4.6 billion in 1987.

Because the transfer tax system is an essential source of Federal revenues, and because a tax on generation skipping is an integral part of that system, we believe that revenue considerations support the retention of chapter 13 rather than its repeal.

The second argument that has been raised concerning the repeal of chapter 13 involves complexity.

We certainly agree that chapter 13 in its present form does create a complicated system for taxing generation-skipping transfers. Perhaps the major cause of complexity in chapter 13 is the statute's attempt to integrate the generation-skipping transfer tax with the estate and gift taxes in order to maintain a completely unified transfer tax system.

The objective of full integration makes it necessary to select a particular deemed transferor and to pull together all the information concerning that person's prior gifts, estate taxes, and other generation-skipping transfers.

This requires the Internal Revenue Service to be able to produce upon request a complete gift, estate and generation-skipping tax history for virtually every individual for whom transfer tax returns are filed.

A second cause of complexity in chapter 13 is the rule that treats a power to affect the enjoyment of trust property in the same manner as a beneficial interest in the trust property. However, as an exception to this general rule, chapter 13 provides that a power to dispose of the trust property solely among lineal descendants of the grantor is not treated as a power over the trust.

This exception permits a child of the grantor to act as the sole trustee of a discretionary or sprinkling trust for his own children and grandchildren without the imposition of a generation-skipping tax at the child's level, even though a less significant power may cause the tax to apply.

Yet another cause of complexity is the statute's failure to create any de minimis exception for generation-skipping transfers below a given dollar amount in value. This means that trustees and trust beneficiaries have to file returns to report generation-skipping transfers regardless of the amount. Obviously, this imposes a substantial burden upon the parties who must prepare and file returns to report insignificant transfers and upon the Internal Revenue Service, which must receive and process these returns.

A primary source of overall concern about chapter 13's complexity among estate planning practitioners is the fact that the tax may apply to virtually any family trust or trust equivalent arrangement even though the probability of application as an actuarial matter in a given case may be small.

There is also widespread concern about the potential impact of chapter 13 on arrangements such as custodianships under the Uniform Gifts to Minors Act, State law guardianships, and trusts for minor children created under Internal Revenue Code section 2503(c).

A third reason given for repeal concerns the failure to tax direct transfers.

Chapter 13 has been criticized by some for its failure to tax direct transfers to the second, third, or fourth generation below the grantor while taxing transfers under trust arrangements that create intervening interests in intermediate generations.

If the present statute is deficient in its failure to reach direct generation-skipping transfers, an appropriate remedy might be to broaden its scope to tax direct generation-skipping transfers in the same manner as it taxes transfers through trust arrangements.

Certainly, the failure of chapter 13 to tax direct transfers does not support the argument for complete repeal of the statute.

Moreover, the failure to tax direct transfers can be defended on the grounds that it is inappropriate as a policy matter to impose a transfer tax on property in a generation which receives no interest in or control over the property.

As I have stated, the Treasury Department shares many of the concerns that have been expressed about the complexity of chapter 13, particularly with respect to its impact on common family arrangements that are generally not motivated by the desire to skip generations for transfer tax purposes.

We do not believe, however, that these concerns warrant the repeal of the generation-skipping tax. Rather, we believe that these concerns should be met by amending chapter 13 to make it inapplicable to certain common family arrangements and to simplify the operation of the tax in those cases where it does apply.

Accordingly, I would like to outline some specific changes in chapter 13 that we now have under consideration.

First, we are considering an amendment to chapter 13 to create a "safe harbor" for the common family trust that holds property for the benefit of the grantor's spouse and children and then distributes the property among the children and the descendants of any deceased child at the spouse's death.

One way to resolve this problem would be to amend chapter 13 to provide, in general, that any termination of a beneficiary's interest by reason of death will not be taken into account if it occurs prior to or upon the death of the grantor or his spouse.

A change of this sort would greatly simplify estate planning in the ordinary case by eliminating the potential problem of an unanticipated imposition of a generation-skipping tax upon the death of a child prior to the death of both parents.

In order to simplify the operation of chapter 13, we are considering a proposal to have the tax imposed at a flat rate in the cases where it would still apply, disregarding the transfer tax history of any deemed transferor. Further, we are considering an amendment to the grandchild's exclusion to have it apply on a per grandchild rather than a per deemed transferor basis.

These changes would eliminate the necessity of determining the transfer tax history of a particular deemed transferor in order to compute the tax and would thus remove the enormous recordkeeping burden that the current statute now imposes on taxpayers and the Internal Revenue Service.

In view of the problems attributable to the power rule and the current exception for the power to appoint among lineal descendants of the grantor, we are considering a proposal to eliminate the rule altogether. Deletion of the power rule would greatly simplify the operation of the statute and would eliminate many of the cases where the statute now has unwarranted application.

Because of the administrative burden imposed on taxpayers and the Internal Revenue Service in reporting inconsequential generation-skipping transfers, we are considering a proposal to amend chapter 13 to provide an exclusion for generation-skipping transfers from any generation-skipping trust to the extent that they do not exceed a stated dollar amount per year. We have some concern about the possible use of multiple trusts to obtain multiple exclusions, but we believe that the additional administrative expenses associated with multiple trust arrangements would probably eliminate most problems of this sort as a practical matter.

We are also studying additional ways that chapter 13 might be amended to simplify its operation without compromising its underlying purpose.

For example, we are seriously considering an amendment that provides an individual does not have a beneficial interest in a trust for chapter 13 purposes merely because the trust income or principal might be used to satisfy the individual's obligation under local law to support his children. This amendment, particularly if coupled with an elimination of the power rule, should make chapter 13 inapplicable to Uniform Gifts to Minors Act custodianships, section 2503(c) trusts, and similar arrangements.

Finally, with respect to the effective date and transition rules, the effective date rule under present law provides that the generation-skipping transfer tax is generally inapplicable to transfers under trusts that were irrevocable on June 11, 1976.

The transition rule under present law provides that the tax will not apply to transfers under revocable trusts or wills in existence on June 11, 1976, if the instrument is not amended after that date to increase generation-skipping transfers and the grantor or trustee dies before 1983. It will be recalled that this latter date in the transition rule was extended one year by the recent Tax Act.

We believe that chapter 13 should continue to apply to transfers under irrevocable trusts created after June 11, 1976, since it is fair to assume that trusts established after that date were established with the knowledge that chapter 13 would be a part of the transfer tax system. We would certainly consider applying the amendments that I previously discussed that we would consider making to chapter 13 with respect to these trusts. This would eliminate the problems in substantially all the cases where trusts created since that date have inadvertently run afoul of the generation-skipping transfer tax.

The transition rule under present law creates problems of a different sort. We are aware that many estate planners are now faced with a difficult choice of deciding whether to amend grandfathered wills and revocable trusts to take advantages of the recent changes in the marital deduction, since such changes may increase a generation-skipping transfer, thus causing a loss of the transition rule protection if the individual dies before 1983. We are also concerned that the present transition rule creates serious administrative difficulties.

In view of these problems, we are considering a proposal to revise the transition rule to provide that the chapter 13 tax will not apply to transfers under the will or revocable trust of any individual who dies before a certain date, regardless of the date on which the will or trust instrument was signed.

Mr. Chairman, in conclusion, in our judgment the generation-skipping transfer tax is necessary to prevent avoidance of estate and gift taxes through the use of tax-motivated generation-skipping trust arrangements, and to insure that families which are not in a position to use generation-skipping trusts do not bear more than their fair share of the overall transfer tax burden.

Accordingly, Treasury opposes the repeal of chapter 13. We believe, however, that significant changes are needed in chapter 13 to narrow its scope and to make it simpler and more workable in the cases where it does apply.

Thank you, Mr. Chairman.

[Statement of Mr. Glickman follows:]

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STATEMENT OF DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 1695, which would repeal the generation-skipping transfer tax imposed by Chapter 13 of the Internal Revenue Code.

Summary of Treasury Position

The impact of transfer taxes on our nation's economic productivity has been a source of considerable concern to the Administration. This concern was reflected most recently in the Economic Recovery Tax Act of 1981, which included major reductions in the estate and gift taxes. These changes were designed to reduce or eliminate the burden of transfer taxes in situations where they operated as significant disincentives to work and to save.

The Treasury Department is now studying a number of basic issues concerning the tax consequences that should be associated with an individual's death. These issues include the questions of whether the transfer tax system should be retained and, if not, whether it is appropriate at death to continue to provide a "step up" in the basis of appreciated property in the absence of either an estate tax or an income tax on the appreciation.

Without regard to the conclusions we ultimately reach on these issues, it is clear that transfer taxes will remain an important source of Federal revenues, even after the 1981 Act, and thus will be retained for the immediate future. Since Treasury is of the view that a generation-skipping transfer tax is necessary to preserve the integrity and fundamental fairness of the overall transfer tax system, we must oppose S. 1695.

We do agree, however, that Chapter 13 in its present form is overly complex from an administrative standpoint and may have an undue influence on estate planning in many common situations where skipping a generation for estate tax avoidance purposes is generally not a primary motivation. Accordingly, we would like to take this opportunity to discuss a number of changes that we believe might be made in Chapter 13 to make the generation-skipping transfer tax simpler and more workable and to focus the tax more directly on the kind of tax avoidance arrangements that were the primary targets of Chapter 13 when it was originally enacted.

Background

I would first like to review briefly some of the background leading up to the enactment of the present generation-skipping transfer tax statute.

Prior to the Tax Reform Act of 1976, our estate and gift tax system was severely criticized for the substantially different treatment accorded transfers of property from one generation to lower generations, depending upon the means used to accomplish the transfer. When property was transferred from parent to child to grandchild to great-grandchild by means of successive outright transfers (either by gifts or inheritance), a gift or estate tax was imposed at each generation's level. In contrast, if a trust mechanism was used, the property could be kept outside the transfer tax base for the maximum period permitted by the rule against perpetuities (which might easily exceed 100 years) as it passed from generation to generation, even though the economic benefit enjoyed by each succeeding generation (through the receipt of income and the control over the property's ultimate disposition) could be tantamount to outright ownership.

The preferential treatment of transfers from generation to generation by means of generation-skipping trusts came to be known as the "generation-skipping problem," and was the subject of intense study in the late 1960's and early 1970's. Virtually all parties that studied the matter agreed at that time that some sort of tax on generation-skipping transfers was needed to remove or reduce this discrepancy in the transfer tax system, and the debate focused primarily on the parameters of the mechanism to be devised to deal with the problem. The primary issues involved in this debate were: (1) the kinds of transfers and trust arrangements that should be subject to a generation-skipping tax; (2) the time at which the tax should be imposed; and (3) the tax rate to be used in assessing the tax.

The Treasury Department, the American Law Institute, the American Bankers Association and the American Institute of Certified Public Accountants all made specific proposals for a generation-skipping transfer tax during this period. The Treasury proposal, which was described in the 1969 Tax Reform Studies and Proposals, would have imposed an additional transfer tax upon outright gifts or bequests, as well as upon transfers by means of trust arrangements, to beneficiaries more than one generation below the donor or testator. The tax rate would have been 60 percent of the transfer tax marginal rate applicable to the original transferor, unless there was an election to use a particular skipped individual's rate. The American Law Institute proposal would not have imposed the additional tax on outright transfers and would have taxed trust transfers only if distributions were made to the second generation below the grantor at a date later than the death of persons in the first generation below the grantor. The tax would have been computed at the average transfer tax rate applicable to the grantor and would have been imposed at the time of the original transfer to the trust or the time of the distribution, at the election of the grantor or his personal representative.

The American Institute of Certified Public Accountants agreed that there should be a tax upon transfers in trust that skip a generation, but also took the position that there should be no additional tax on outright gifts or bequests. The AICPA proposed to have a portion of the trust property included in the gross estate of the skipped beneficiary based upon the proportionate value of the trust attributed to the skipped beneficiary at the time of the trust's creation.

The American Bankers Association proposal would have limited the additional tax to long-term trusts where the property either would vest ultimately in a person in a generation below that of the grantor's grandchildren or would vest at a later time than the death of the last living child of the grantor. The tax would have been determined by inclusion of the trust property in the transfer tax base of a particular skipped beneficiary (usually a child of the grantor) at the time of any distribution to a person more than two generations below the grantor (e.g., the grantor's great-grandchild) or upon the termination of a skipped beneficiary's interest in the trust.

In response to these and other proposals for a generation-skipping tax, Chapter 13 was added to the Internal Revenue Code as a part of the sweeping structural changes in the transfer tax system made by the Tax Reform Act of 1976. Departing from the 1969 Treasury proposal, Chapter 13 does not impose an additional tax on outright transfers to beneficiaries more than one generation below the original transferor. Rather, Chapter 13 adopts the basic conceptual structure of the American Bankers Association proposal, except that the tax is broader in scope and can be imposed at the generation level of the original grantor's children as well as at lower generation levels. The tax imposed under Chapter 13 is determined as if the trust property had been transferred directly by the skipped beneficiary, who is referred to as the "deemed transferor." An exclusion is also provided for the first $250,000 of generation-skipping transfers per deemed transferor that vest in grandchildren of the grantor.

Comments on Arguments for Repeal of Chapter 13

I would like now to comment upon some of the primary arguments that have been made in support of the repeal of Chapter 13.

Revenue Impact

The purposes of the generation-skipping tax are to end (or at least diminish) the preferential estate and gift tax treatment of generation-skipping trust arrangements, and to insure that families that choose not to create generation-skipping trusts (in many cases because their wealth is not large enough to justify the additional trouble and expense) do not shoulder more than their fair share of the overall transfer tax burden. The generation-skipping transfer tax, like the gift tax, is merely one facet of a unified transfer tax system that seeks (to the extent that it is feasible) to tax all transfers of property in an equivalent manner, regardless of the time or manner in which such transfers are made. The existence of the generation-skipping transfer tax will discourage many individuals from using generation-skipping trust arrangements that they would otherwise employ primarily for estate tax avoidance purposes. The revenue impact of the generation-skipping transfer tax, therefore, cannot be viewed in isolation, but must be evaluated in connection with the revenue impact of the overall transfer tax system.

Although the revenue yield from all transfer taxes is relatively small when compared with the yield from other sources, the revenues produced by transfer taxes are not insignificant in an absolute sense. Even after the significant transfer tax reductions made by the Economic Recovery Tax Act are taken into account, we estimate that transfer taxes will produce revenues of approximately $7.3 billion in fiscal 1982, $5.9 billion in 1983, $5.5 billion in 1984, $5.2 billion in 1985, $4.5 billion in 1986, and $4.6 billion in 1987. The Federal estate tax is also an indirect source of revenues to state governments, since the allowance of credits against the Federal tax for specific amounts of state death tax leads many state governments to impose "pick up" death taxes (i.e., taxes equal to the maximum amount allowable as a credit against the Federal tax) that they otherwise might not impose.

Because the transfer tax system is an essential source of Federal revenues, we believe that revenue considerations support the retention of Chapter 13 rather than its repeal.

Complexity

We acknowledge that Chapter 13 in its present form does create a complicated system for taxing generation-skipping transfers. The complexity is attributable in part to the fact that generation-skipping trusts and equivalent arrangements may be very complicated themselves and some complexity in the law is necessary to deal with such arrangements. There are, however, a number of sources of complexity in the present statute upon which I would like to comment.

Perhaps the major cause of complexity in Chapter 13 is the statute's attempt to integrate the generation-skipping transfer tax with the estate and gift taxes in order to maintain a completely unified transfer tax system. The objective of full integration makes it necessary to select a particular "deemed transferor" and to pull together all the information concerning that person's prior gifts, estate taxes, and other generation-skipping transfers in order to determine the tax consequences of a particular generation-skipping transfer. In its present form, the statute also requires the Internal Revenue Service to be able to produce on request a complete gift, estate and generation-skipping tax history for virtually every individual for whom transfer tax returns are filed, so that trustees and beneficiaries of generation-skipping trusts can obtain the information necessary to complete and file the tax returns required by Chapter 13.

A second cause of complexity in Chapter 13 is the rule that treats a "power" to affect the enjoyment of trust property (other than a mere right of management) in the same manner as a beneficial interest in the trust property. This rule recognizes that the power to determine who will receive the enjoyment of property is one of the most significant elements of property ownership. The power rule under Chapter 13 parallels the longstanding estate tax rules that require property transferred by a decedent to be included in the gross estate if the decedent retained at death the power to establish or alter beneficial enjoyment of the property. However, as an exception to this general rule, Chapter 13 provides that a power to dispose of the trust property among lineal descendants of the grantor is not treated as a power over the trust. This exception permits a child of the grantor to act as the sole trustee of a discretionary or "sprinkling" trust for his own children and grandchildren without the imposition of a generation-skipping tax at the child's level, even though a less significant power (e.g., the power to distribute property to the grantor's parent or spouse, to a spouse of a descendant of the grantor, or to any unrelated person) may cause the tax to apply.

Another cause of complexity in Chapter 13 is the statute's failure to create any de minimis exception for generation-skipping transfers below a given dollar amount in value. This means that trustees and trust beneficiaries have to file returns to report generation-skipping transfers regardless of their amount. Obviously, this imposes a substantial burden upon the parties who must prepare and file returns to report insignificant transfers and upon the Internal Revenue Service, which must receive and process these returns.

A primary source of concern about Chapter 13's complexity among estate planning practitioners is the fact that the tax may apply to virtually any family trust or trust equivalent arrangement, even though the probability of application as an actuarial matter in a given case may be small. Because of the broad potential application of the tax, it is argued that an estate planner is forced to consider the impact of the generation-skipping tax and all of its complexity in drafting even the most simple documents. For example, a common dilemma faced by the estate planner in drafting a testamentary trust for a testator's spouse and children is whether the testator should give the children present interests in the trust during the spouse's lifetime, which may result in the imposition of a Chapter 13 tax if a child predeceases the spouse, or whether the children should be denied any present interest in the trust during the spouse's lifetime to avoid generation-skipping tax consequences in the event of an unusual order of deaths. There is also widespread concern about the potential impact of Chapter 13 on arrangements such as custodianships under the Uniform Gifts to Minors Act, state law guardianships, and trusts for minor children created under Internal Revenue Code § 2503(c).

Failure to Tax Direct Transfers

Chapter 13 has been criticized by some for its failure to tax direct transfers to the second, third or fourth generation below the grantor while taxing transfers under trust arrangements that create intervening interests in intermediate generations. As previously noted, the generation-skipping transfer tax system originally proposed by the Treasury Department in 1969 would have imposed the tax on direct generation-skipping transfers as well as on transfers under trust arrangements that create intervening interests. Despite the theoretical merit to taxing such direct transfers, this approach met with strong objections from tax practitioners and banking industry groups and was not included in Chapter 13. Thus, if the present statute is deficient in its failure to reach direct generation-skipping transfers, an appropriate remedy might be to broaden its scope to tax direct generation-skipping transfers in the same manner as it taxes transfers through trust arrangements that create interests in intermediate generations. Certainly, the failure of Chapter 13 to tax direct transfers does not support the argument for complete repeal of the statute. Moreover, the failure to tax direct transfers can be defended on the grounds that it is inappropriate as a policy matter to impose a transfer tax on property in a generation which receives no interest in or control over the property.

Treasury Proposals for Amendment of Chapter 13

The Treasury Department shares many of the concerns that have been expressed about the complexity of Chapter 13, particularly with respect to its impact on common family arrangements that are generally not motivated by the desire to skip generations for transfer tax purposes. We do not believe, however, that these concerns warrant the repeal of the generation-skipping tax. Rather, the Treasury Department believes that these concerns should be met by amending Chapter 13 to make it inapplicable to certain common family arrangements and to simplify the operation of the tax in those cases where it does apply. Accordingly, I would like to outline some specific changes in Chapter 13 that we now have under consideration.

1. Exclusion for Certain Generation-Skipping Transfers Prior to or Upon the Death of the Grantor or the Grantor's Spouse. We believe that Chapter 13 should be amended to create a "safe harbor" for the common family trust in which skipping a generation for estate tax purposes is not a primary motive -- *i.e.*, the trust that holds property for the benefit of the grantor's spouse and children and then distributes the property among the children and the descendants of any deceased child at the spouse's death. We have not made any final decision concerning the precise means by which we would propose to resolve this problem. One possibility, however, would be to amend Chapter 13 to provide, in general, that any taxable termination by reason of a younger generation beneficiary's death (and perhaps any generation-skipping transfer) that occurs prior to or upon the death of the grantor or the grantor's spouse will not be taken into account for generation-skipping transfer tax purposes. A change of this sort would greatly simplify estate planning in the ordinary case by eliminating the potential problem of an unanticipated imposition of a generation-skipping tax upon the death of a child prior to the death of both parents.

An amendment of this sort would significantly narrow the scope of Chapter 13 and might be thought too generous by some. Nonetheless, it can be justified in the sense that it simply prevents the application of a Chapter 13 tax to transfers that an individual might otherwise have made directly without Chapter 13 tax consequences during his or her own lifetime or at death. The change is also justified by the fact that an individual who establishes a trust to take advantage of this exception would necessarily incur a gift or estate tax in establishing the trust (to the extent the value of the trust exceeds the applicable gift and estate tax exemptions) and would forego the marital deduction that would have been available for a transfer to his or her spouse which would have enabled the spouse to retransfer the property directly to grandchildren or great-grandchildren without a Chapter 13 tax.

2. Imposition of Tax at a Flat Rate and Modification of Grandchild's Exclusion. In order to simplify the operation of the generation-skipping transfer tax, we are considering a proposal to amend Chapter 13 to provide that the tax shall be imposed at the same rate to all generation-skipping transfers that are subject to the tax, disregarding the transfer tax history of any deemed transferor. Further, we are considering an amendment to the grandchild's exclusion (which now excludes $250,000 per deemed transferor) to have it apply on a "per grandchild" rather than a "per deemed transferor" basis. For example, Chapter 13 might be amended to exclude generation-skipping transfers to each individual from each set of grandparents to the extent that they do not exceed the total amount of $250,000 divided by the number of children of the individual's parents or $100,000, whichever is greater. These changes would eliminate the necessity of determining the transfer tax history of a particular deemed transferor in order to compute the tax, and thus would remove the enormous record-keeping burden that the current statute now imposes on taxpayers and the Internal Revenue Service.

Selecting the appropriate tax rate to be used under the flat rate system is obviously a difficult task. If the highest transfer tax rate is used, the tax would be too severe if actual transfers from the skipped individual would not be subject to the top rate. On the other hand, taxing generation-skipping transfers at a rate that is below the top transfer tax rate would permit tax avoidance if the skipped individual would be subject to the top rate. In view of these competing considerations, it could be argued that an appropriate rate for a flat rate tax might roughly correspond to the lowest marginal rate at which estate taxes are imposed after the full unified credit is used. To those who may argue that this rate is too harsh, the response could be that any harshness is substantially eliminated by the grandchild's exclusion and by an exclusion for generation-skipping transfers occurring prior to or upon the death of the grantor or the grantor's spouse. To those who may argue that this rate permits tax avoidance, it could be responded that the need for simplification outweighs that concern.

3. Revision of the Power Rule. In most cases, the power of a skipped individual to dispose of trust property among his own children (who ordinarily are lineal descendents of the grantor) is the most significant power that the individual could hold over a trust. To provide an exception for this type of power (as the present statute does), while imposing a tax when a skipped individual holds a much less significant power, leads to arbitrary results. Thus, it could be argued that Chapter 13 should be amended either (i) to delete the exception for powers

to appoint among the grantor's lineal descendants, (ii) to narrow the exception drastically, or (iii) to delete the power rule altogether. In view of the significance of the power to control the distribution of trust property and the analogy to the estate tax treatment of such powers when they are retained by a donor, a strong argument can be made for narrowing or eliminating the exception for powers to appoint among the grantor's lineal descendants. On the other hand, the problems attributable to the power rule could be deemed to outweigh these considerations and, therefore, may support a proposal to eliminate the rule altogether. One thing is clear -- deletion of the power rule would greatly simplify the operation of the statute and would eliminate many of the cases where the statute now has unwarranted application.

4. Exclusion for Transfers Below a Certain Dollar Amount. Because of the administrative burden imposed on taxpayers and the Internal Revenue Service in reporting inconsequential generation-skipping transfers, we are considering a proposal to amend Chapter 13 to provide an exclusion for generation-skipping transfers from any generation-skipping trust to the extent that they do not exceed a stated dollar amount per year. We have some concern about the possible use of multiple trusts to obtain multiple exclusions, and recognize that some form of multiple trust rule may be needed to deal with the most obvious forms of abuse. Nevertheless, we believe that the additional administrative expenses associated with multiple trust arrangements would probably eliminate most problems of this sort as a practical matter.

5. Additional Simplification Measures. We are studying additional ways that Chapter 13 might be amended to simplify its operation without compromising its underlying purpose. For example, we are seriously considering an amendment that provides that an individual does not have a beneficial interest in a trust for Chapter 13 purposes merely because the trust income or principal might be used to satisfy the individual's obligation under local law to support his children. This amendment, particularly if coupled with an elimination of the power rule, should make Chapter 13 inapplicable at a parent's generation level with respect to U.G.M.A. custodianships, state law guardianships, and section 2503(c) trusts for a child of the parent.

6. Effective Date and Transition Rules. The effective date rule under present law provides that the generation-skipping transfer tax is inapplicable to transfers under trusts that were irrevocable on June 11, 1976, except to the extent that transfers are attributable to additions made to such trusts after that date. The transition rule under present law provides that the tax will not apply to transfers under revocable trusts or wills in existence on June 11, 1976, if the instrument is not amended after that date to create or increase the amount of any generation-skipping transfer, and if the grantor or testator

dies before January 1, 1983. It will be recalled that this latter date in the transition rule was extended from January 1, 1982 to January 1, 1983, by the Economic Recovery Tax Act.

A legitimate argument can be made that the blanket exemption for transfers under pre-June 11, 1976 irrevocable trusts is overbroad -- after all, when the federal estate tax was first enacted, there was no blanket exemption for decedents living or assets held on the date of enactment. Nevertheless, we would not propose to modify the effective date rule to impose the Chapter 13 tax on such trusts. On the other hand, we believe that Chapter 13 should continue to apply to transfers under irrevocable trusts created after June 11, 1976. It is fair to assume that trusts established after that date were established with the knowledge that Chapter 13 would be a part of the transfer tax system. We would certainly consider applying to these trusts any amendments to Chapter 13 that we would propose. This would eliminate the problems in substantially all cases where trusts created since that date have inadvertently run afoul of the generation-skipping transfer tax.

The transition rule under present law creates problems of a different sort. We are aware that many estate planners are now faced with difficult choices in deciding whether to amend "grandfathered" wills and revocable trusts to take advantage of the recent changes in the marital deduction, since such changes may increase a generation-skipping transfer and thereby cause a loss of transition rule protection if the individual dies before 1983. We are also concerned that the present transition rule creates serious administrative difficulties, since the determination of whether or not the rule applies in a given case may have to be made many years after the death of the grantor or testator (i.e, at the time the first generation-skipping transfer occurs) when it may be difficult or impossible to determine when a will or revocable trust was actually executed and whether any particular amendment created or increased the amount of a generation-skipping transfer.

In view of these problems, it has been argued that the transition rule should provide that the Chapter 13 tax will not apply to transfers under the will or revocable trust of any individual who dies before a specific date, regardless of the date on which the will or trust instrument was signed. This is another issue that we are studying closely at this time.

Conclusion

The generation-skipping transfer tax is necessary to prevent avoidance of the estate and gift taxes through the use of tax-motivated generation-skipping trust arrangements, and to insure that families which are not in a position to use generation-skipping trusts do not bear more than their fair share of the overall transfer tax burden. Accordingly, Treasury opposes the repeal of Chapter 13. We believe, however, that significant changes are needed in Chapter 13 to narrow its scope and to make it simpler and more workable in the cases where it does apply.

ADDITIONAL

STATEMENT OF DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to present the views of the Treasury Department on S. 1733, which would provide for judicial review of certain determinations relating to special use valuation property and deferred payment of estate taxes, and S. 1734, which would expand the "second death" exception to the acceleration rules for deferred estate tax payments. We understand that this statement will be included in the record for the November 4, 1981 hearing on S. 1695, S. 1733 and S. 1734.

Summary of Treasury Positions

The Treasury Department agrees that there should be some means for an estate to obtain judicial review of IRS determinations concerning the fair market value of special use valuation property and the estate's right to defer payment of Federal estate taxes. We question, however, the desirability of a number of specific aspects of the procedures proposed in S. 1733. Treasury is also concerned that the bill would increase the number of cases brought in the Tax Court and would exacerbate the caseload problem now facing the Court.

The complexity caused by the "second death" exception to the acceleration rules under section 6166 may make it appropriate to continue to limit the exception to cases in which the closely held business interest is retained within the second decedent's family. Nevertheless, in view of the relatively small number of cases that would be affected by removal of the family limitation, we doubt that the additional administrative problems caused by S. 1734 would be substantial. Treasury therefore does not oppose S. 1734.

S. 1733 -- Judicial Review of Certain Determinations Relating to Special Use Valuation Property and Deferred Estate Tax Payments

Present Law

Under present law, the fair market value of farm and other closely held business real property that is specially valued under section 2032A of the Code must be established as of the estate tax valuation date. The fair market value determination is required to ascertain the maximum amount of the section 2032A valuation discount (which cannot exceed $600,000 for decedents dying in 1981, $700,000 for decedents dying in 1982, and $750,000 for decedents dying in 1983 and thereafter), and to compute the amount of the special lien under section 6324B that secures payment of the additional estate tax ("recapture tax") imposed under section 2032A(c) if the qualified heir makes a disqualifying disposition of the special valuation property. Nevertheless, there is often no opportunity in the regular estate tax proceeding for resolution of the fair market value issue, since the issue does not affect the amount of any currently assessable tax unless the maximum discount limitation comes into play. Thus, the fair market value determination may be postponed until the section 2032A(c) recapture tax is actually imposed.

There is also no effective means under current law for an estate to obtain judicial review of a determination by the Internal Revenue Service that the estate is not entitled to elect to pay estate taxes in installments under section 6166. Similarly, there is no means to obtain judicial review of an IRS determination that the estate must accelerate the payment of estate taxes previously deferred under section 6166.

Description of S. 1733

Section 1 of the bill would add a new section 7479 to the Code to enable an executor to request that the Service examine the fair market value of any property that is specially valued for estate tax purposes under section 2032A. If the executor and the Service agree on the fair market value of the special valuation property after the executor makes a request for an IRS determination, the agreed value would be binding on the Service and any qualified heir in the future. If the Service and the executor are unable to reach agreement on the fair market value question, section 7479 would authorize the executor to bring an action in the Tax Court within 90 days from the day on which Service sent the executor a formal notification of its disagreement with the executor's valuation. The executor would also be authorized to initiate a Tax Court proceeding to obtain a fair market value determination if the Service does not respond to the executor's request for a fair market determination within 18 months following the executor's request. (It is our understanding that a qualified heir would not be entitled to initiate such a Tax Court action on his own.)

If the Service responds to the executor's request by sending a formal notice of disagreement to the executor within three years of the request, the fair market value indicated on the Service's notice would be binding and conclusive on the Service and on any qualified heir unless the executor brings a Tax Court action within the prescribed period. If the Service does not respond to the executor's request within three years, the value set by the executor would be binding on all parties.

Section 7479 would provide that any declaratory judgment entered by the Tax Court on the fair market value issue would have the force and effect of a decision of the Tax Court and would be reviewable as such. A court decision that has become final would be binding on any qualified heir as well as on the Service. Any qualified heir would be allowed to intervene in any administrative or judicial proceeding under section 7479.

Section 2 of S. 1733 would add a new section 7480 to the Code to provide a procedure for obtaining a declaratory judgment with respect to (1) whether an estate is eligible for the extension of time for payment of estate tax under section 6166, (2) the amount of the adjusted gross estate determined on the basis of facts and circumstances in existence on the due date of the estate tax return, and (3) whether there is an acceleration of the time for payment of previously deferred estate taxes.

Under section 7480, the executor of an estate would be entitled to initiate a declaratory judgment proceeding in the Tax Court concerning any of the three section 6166 issues enumerated above, provided the executor has exhausted all available administrative remedies within the Internal Revenue Service and files the pleadings to initiate the proceeding within 90 days of the Service's sending of a notice of determination of the issue. The decision of the Tax Court in the case would have the force and effect of a decision of the Tax Court and would be reviewable as such.

Discussion

Section 1 of S. 1733

The Treasury Department agrees that if the special valuation approach of section 2032A is retained in the Code,* there should be some means for an executor to obtain judicial review of an IRS determination of the fair market value of special use valuation property. We believe that the procedure established under new section 7479 of the Code, as proposed in Section 1 of S. 1733, would be appropriate for this purpose.

We would suggest one technical change in the proposed new statute. Section 7479(c)(3) as presently drafted would permit an executor and the Service to enter a binding written agreement as to the fair market value of the special valuation property only if the executor has made a formal request of the Service to audit the issue. The statute should provide that the executor and the Service may bind all interested parties by entering a written agreement regardless of whether the executor has made a formal written request to the Service.

Section 2 of S. 1733

Treasury also agrees that there should be some means for an estate to obtain judicial review of an adverse IRS determination concerning the estate's right to pay estate taxes in installments under section 6166. We are concerned, however, by several aspects of new section 7480 of the Code, as proposed in Section 2 of the bill.

First, we note that section 7480(a)(2) would authorize the Tax Court to make a declaration with respect to the amount of the adjusted gross estate determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the federal estate tax return. The determination of the amount of the adjusted gross estate for purposes of section 6166 depends upon the value of the property included in the gross estate and the amount of the deductions allowable (based on facts and circumstances in existence on the date the estate tax return is filed) under section 2053 and 2054. Addressing such issues in the declaratory judgment

*/We note that the General Accounting Office, in its report entitled Special Estate Tax Provisions For Farmers Should Be Simplified To Achieve Fair Distribution of Benefits (September 30, 1981), has recommended that Congress replace the special use valuation provision with an expanded and simplified version of the extended payment provision (section 6166) or with a flat exclusion of a specified part of farm assets.

proceeding might prolong that proceeding (which itself could provide a means for nonqualifying estates to obtain unwarranted deferral of estate tax payment) and may preempt the determination of values and deductions in the normal estate tax proceeding. Since an estate does have an opportunity under current law to obtain judicial review of IRS determinations concerning the value of assets included in the gross estate and the deductions allowable under sections 2053 and 2054, we believe that controversies involving the amount of the adjusted gross estate should not be a part of the special declaratory judgment procedure.

Second, we oppose the provision of new section 7480 that would permit appellate review of Tax Court declaratory judgments concerning an estate's right to estate tax deferral. The appellate review procedure could easily be abused, in that it would afford nonqualifying estates the right to obtain *de facto* deferral for an additional period during the pendency of the appellate proceedings.

Finally, we are concerned that the declaratory judgment procedure would cause a significant number of additional cases to be filed in the Tax Court and would increase the caseload burden now facing the Court.

S. 1734 -- Expansion of "Second Death" Exception to Section 6166 Acceleration Rules

Present Law

Prior to the Economic Recovery Tax Act of 1981 (ERTA), there were two overlapping provisions in the Code (sections 6166 and 6166A) permitting deferral of estate taxes attributable to closely held business interests. ERTA combined these two provisions in a new section 6166 of the Code, which is applicable to estates of decedents dying after 1981. In general, new section 6166 incorporates the features of the two preexisting provisions that are most favorable to taxpayers.

Prior to ERTA, both sections 6166 and 6166A provided that any remaining unpaid estate tax liability would be accelerated if there was a disposition of a specific fraction (one-third under section 6166, one-half under section 6166A) of the value of the decedent's interest in the closely held business after the decedent's death. (Certain stock redemptions under section 303, exchanges of stock in certain nonacquisitive corporate reorganizations, and certain transfers under the decedent's will or trust or the laws of intestate succession are not treated as dispositions for purposes of the acceleration rules.) Section 6166, as amended by ERTA, provides that deferred estate taxes will be accelerated only if one-half of the value of the closely held business interest is transferred in a disqualifying manner.

ERTA further liberalized the estate tax deferral rules by adding a "second death" exception to the acceleration provisions. This exception provides that the transfer of a closely held business interest from an heir (or subsequent transferee) at his death to a family member (including his brothers and sisters, spouse, ancestors and lineal descendants) will not be considered a disposition for purposes of the acceleration rules with respect to the first decedent's estate.

Description of S. 1734

S. 1734 would further expand this recently enacted "second death" exception to the acceleration rules by eliminating the requirement that the closely held business interest pass to a family member of the heir or subsequent transferee. This change would prevent the acceleration rules from applying with respect to the first decedent's estate even though the closely held business interest passes to a non-family member at the second decedent's death.

Discussion

The original purpose of section 6166 was to alleviate the pressure to break up or sell closely held businesses by permitting an estate whose assets are concentrated in a closely held business to pay the estate taxes attributable to the closely held business interest in installments. The acceleration rules under section 6166, which terminate the deferral privilege if more than one-half of the closely held business interest is transferred in a disqualifying manner, are designed to limit the deferral privilege to cases in which the closely held business interest is, in fact, retained by the decedent's heirs.

The "second death" exception to the acceleraton rules, as enacted by ERTA, prevents an acceleration of an estate's unpaid liability at the death of the first decedent's heir if the closely held business interest is retained within the family of the second decedent. This exception creates an additional degree of administrative complexity, since it will require tracing the property through two separate estates for purposes of the special estate tax lien procedures of section 6324A and for purposes of applying the acceleration rules with respect to future events. In view of this additional complexity, it may be appropriate to continue to limit the special exception to cases where the business interest is retained within the second decedent's family (which will also be within the first decedent's family in most cases).

On the other hand, we doubt that removing the family limitation would increase substantially the number of cases in which the "second death" exception would apply. For this reason, the additional administrative problems caused by the change are not significant enough to cause us to oppose S. 1734.

Senator SYMMS. Thank you, Mr. Secretary.

This is very complicated testimony as far as what you are advocating, but the bottom line is, if I can be sure that I understand what you are saying, the reason the Treasury is opposed to repeal is because you want equity between the other death taxes, and in case somebody uses generation-skipping as a way to avoid the other death taxes; is that correct?

Mr. GLICKMAN. That is the bottom line, yes, sir.

Senator SYMMS. You are aware of the fact that the President of the United States, Ronald Reagan, favors outright repeal of the death tax when the day can come that we can fit it into the budget, aren't you?

Mr. GLICKMAN. As I said at the beginning of the testimony, Mr. Chairman, this is something which the President has stated, something that if you will recall during our conversations on the last bill we discussed as a possibility. There are substantial revenue problems with that right now. So I would trust that at some future time, if it is appropriate, we would be looking at whether it is appropriate to completely eliminate the transfer tax system.

Let me just add in that regard, there are problems with that. As I stated in my remarks, to make that statement is one thing, but then to start looking at the actual nuances of it is something else. For example, consideration would have to be given in that type of situation to what you do about the free step up in basis with no tax at all, and whether that is appropriate and whether that causes inequities in the system.

Senator SYMMS. You are, of course, aware of the fact that we have many witnesses here today, who have been given credit in the past, if I understood your testimony right, and supported some sort of generation-skipping tax, who will be testifying in favor of repeal.

Mr. GLICKMAN. Mr. Chairman, one of the staff of our office will be staying here through that testimony, because one of the things we are going to be interested in is to see whether the reasons they are going to be recommending repeal is that they disagree with the fundamental concept that if you are going to have a transfer tax system, that a generation-skipping rule is appropriate, or whether they are going to be testifying to the effect that because of the complexity that it should go.

If it is the latter, it is the type of thing that the Treasury Department would very much like to work with this committee to try to simplify the tax if we are going to leave it in place.

Senator SYMMS. I am glad that you will be doing that.

I guess what is frustrating to me as a Member of the Congress over the years that I have been here, I am not a tax lawyer or a CPA, but it seems that our taxing code gets more complicated each year.

When I hear your testimony, and some of the ideas that the Treasury is recommending, all of the complications and all of the obstacles that you will require the private sector to go through to try to comply with this, not to mention the fact that we will have to pay all the attorneys at Treasury to try to come up with these regulations, how much revenue will the Treasury lose?

What is your cost estimate of generation-skipping? I know you said $4 billion by 1987, if I saw it correctly.

Mr. GLICKMAN. That is with elimination of the entire transfer tax.

Senator SYMMS. But how much for the generation-skipping?

Mr. GLICKMAN. Mr. Chairman, our revenue estimators, I would think, would agree with the estimates of the Joint Committee that during x number of out-years, the revenue loss is going to be insubstantial with respect to this tax.

Senator SYMMS. Is not substantial.

Mr. GLICKMAN. Is not substantial, right. However, the same argument could be made, I think, with the gift tax, the revenues loss there would not be substantial by its repeal, but it is such an integral part of the overall transfer tax system that I think that most people would agree that it is something that should stay in the law.

In our judgment, when you look at the overall transfer tax system, and the generation-skipping tax, we would very strongly feel that this is an integral part of it. I guess what you would have to look at to some degree, since it requires the death of two people for it to come into play, that is one of the reasons why you will see that kind of estimate——

Senator SYMMS. What is your cost estimate on section 6166 changes?

Mr. GLICKMAN. Mr. Chairman, I don't have that. I will submit that with our prepared statement.

Senator SYMMS. All right.

I guess the part that is somewhat confusing to me is that when there are 1 million lawyers and 250,000 accountants in the United States that keep contacting our committee and telling us that they can't give me or the Treasury the assurances that any taxable event is even going to be noted.

The gift tax, you can understand that, but most people have not been able to figure out the generation-skipping tax and how it is going to be applied. Your testimony is very confusing, or complicated I should say, and not necessarily confusing, but I think that it would bring about more complex regulations than we need to put up with.

Then you also have stated that the taxable event itself will not be noticeable to Treasury on generation-skipping. I guess that is correct, isn't that right?

Mr. GLICKMAN. For a number of years, that is correct.

Senator SYMMS. For a number of years.

Mr. GLICKMAN. I guess the real question to have looked at, and I am sorry I don't have these figures, but if we had had generation-skipping in the law 20 years ago, or 25 years ago, what would the revenue impact be right now with respect to that.

Senator SYMMS. If this tax is understandable, why hasn't the IRS and the Department of the Treasury been able to develop a system which can identify when the tax is supposed to be paid and collected, or for that matter even devise a form which would enable a taxpayer to pay the tax?

Mr. GLICKMAN. Mr. Chairman, I would think that it would be fair to say that anybody who practices in the field of taxation cannot be terribly enamored with the complexity of our system. I think that the complexity of this provision is totally unwarranted.

I think there are many complex provisions in the Internal Revenue Code, unfortunately, many of which you are personally familiar with. For example, 2032A is a very complex provision. Unfortunately, our law, the way it has developed from the beginning, is a complex set of rules.

With regard to the regulations, and why we have not developed them——

Senator SYMMS. What I would appeal to Treasury, why don't we just get rid of one of these complex ones, and this would be one that we could get rid of, and then we could work on some of the others.

I can still remember this one time a few years ago when then Governor Reagan came to Idaho and gave a speech at a Republican rally, and one of the things he said was that a government agency always seems to have eternal life. I guess that you could apply that to the Tax Code. Once we get one of these things on it, whether it was passed at 2 o'clock in the morning by accident or not, somehow there seems to be some mysticism that we have to stay with it and try to fix it so it is going to work.

I will not belabor that point, but I did want to bring up another question for our record. Last week, Mr. Chapoton testified on another matter before another subcommittee here in the Finance Committee, and at that time he stated that the IRS estimated that if one additional line were to be placed on the IRS 1040 form, which would designate $1 for a specific cause, it would cost $10 for IRS 1040 form processed.

With those kinds of estimates, it is plainly obvious from any rational point of view that it will cost the IRS tremendous sums of money to try to collect this tax. With the passage of the Economic Recovery Act, it is doubtful that even 1 cent would ever be collected.

Given those facts, how can Treasury testify before the subcommittee and suggest implementing a tax which will most likely never collect any money, but will cause severe hardships on the taxpaying community not only because they cannot possibly comply with the tax, but also because the taxpayer is going to finance the hiring of legions of IRS auditors to try to collect the tax.

I don't know whether that is a question or statement, but I just can't see how we can come to this conclusion, notwithstanding your testimony. How can we justify this? How do you answer this to the taxpayers?

Mr. GLICKMAN. Mr. Chairman, I really believe in certain respects that your views, at least in this regard, and the Treasury views are very much in synch. The complexity is unwarranted, and I think we realize that. The Internal Revenue Service realizes that. Certainly the tax bar realizes that.

I think the only thing we are saying is, if we are going to maintain the integrity of the system, and we believe that it should be maintained as long as we have it, you do need a generation-skipping transfer tax.

Now if you pinned me down and said, "Would we be better off with what we have now or nothing?" I might in that situation say, "We might be better off with nothing." At the same time, in my judgment, we can come up with a generation-skipping transfer tax system between this committee and the Treasury Department that will be a workable system, that will be much easier to administer, that the Internal Revenue Service will not have nearly as many problems with, and that the tax bar will not have as many problems with.

I believe the people who are going to testify today, at least the ones who are the ones that did this work with the Treasury on some of the studies in 1969 and 1970, would agree that if we could reach that point of simplicity that we are looking for, that the system should have a transfer tax with a generation-skipping provision in.

I think their concern is going to be, you can't reach that point. What we may have to do is be heavy handed in certain respects. We may have to leave some potential holes in there that we don't particularly like for the benefit of simplicity. This administration is willing to go that far to try to get a system that is workable and that is easy to administer on both sides.

Senator SYMMS. The administration doesn't favor violating the Privacy Act as far as allowing the IRS to pass out confidential information on taxpayers, does it?

Mr. GLICKMAN. Obviously, the rules that are presently in place with respect to the confidentiality of returns, the Commissioner and the Treasury Department exercise a very close——

Senator SYMMS. What are you going to do in the case where a deemed transferor dies and is not willing to provide the necessary information to the transferee? The IRS is going to have to provide the information, if they have maintained and stored it over the years, but I don't see how they can do it without violating the Privacy Act.

Mr. GLICKMAN. That is certainly a potential problem. But let's go back to one of our recommendations. Let's assume we come up with a flat rate of tax, and we are going to apply that on a beneficiary basis rather than a deemed transferor basis. It seems to me that many of the types of problems you are talking about then disappear because then the prior transfers, prior estates, prior gifts, prior generation-skipping provisions become meaningless.

This is the type of approach that we would be moving toward.

Senator SYMMS. In other words, if the taxpayer out here who is going to comply with the code can then be prepared to, instead of keeping records back or 3 or 4 years, would have to have them for 25 years?

Mr. GLICKMAN. I am not sure I follow that, Mr. Chairman.

If we come up with a flat rate of tax——

Senator SYMMS. Where are they going to find the information if the taxpayer doesn't have it.

Mr. GLICKMAN. They know what the value of the property is that the generation will be skipped on because that tax will be paid at that point in time. Then we don't have to worry about what the marginal rate is of the deemed transferor any more. In other words, we would just then come with whatever rate we agreed to. We have kicked around a number of rates. Perhaps it should be the lowest rate that an estate would be taxable at at this point, or something in between there.

Senator SYMMS. You are missing one point, though. How does the taxpayer know that he has to pay the tax?

Mr. GLICKMAN. Obviously, to the extent that the information has to be retained for purposes of determining whether there has been a generation skip involved, whatever retention would be required there, it seems to me that it would be required.

Again, we are talking about the type of situation where you have——

Senator SYMMS. But you see the complications I am talking about. You are making a very, very difficult and complicated situation out of something that it would be easy just to repeal it.

Mr. GLICKMAN. Right now the trustee has to give information to the various beneficiaries of the trust. If we are still talking about a trust, it seems to me that one of the trustee's responsibilities would be, on the termination of the trust or the distribution, to advise the beneficiary that this distribution or termination is subject to the generation-skipping rule.

I just don't believe, Mr. Chairman, that the mechanics of that are going to be as complicated as you are inferring. But, again, we are willing to work to try to come up with something that is as simple as we possibly can make it, short of repeal.

Senator SYMMS. That is it, short of repeal.

I appreciate you testifying before us this morning, and we will ask you to submit your comments on section 6166 as you said at the beginning of your testimony. We will keep the record open to accommodate you on that, and we appreciate it very much.

I thank you very much, although we have not quite come to an agreement on this, as you can tell.

I might just note for the record that today is my son's 20th birthday. He is a junior in college and majoring in business. I think, after hearing the testimony this morning, maybe I had better advise him to plan on going on to law school and become a tax lawyer because if we continue this, we are going to need more and more tax lawyers. I can see the room is full of them this morning.

It appears to me that we really should make some efforts to get rid of some complicated parts of the code, and simplify these things. It is not getting simpler even trying to simplify something that is so complicated. I think that it becomes self-defeating to try to do it.

Thank you very much. I appreciate your testimony, and if you have any more comments, we will be glad to hear from you.

Mr. GLICKMAN. Thank you, Mr. Chairman.

Senator SYMMS. Thank you. You say that your staff will be here today?

Mr. GLICKMAN. Yes; they will be.

Senator SYMMS. We will make sure that they get copies of all the testimony.

Now we have a panel that will be up next. It is the task force on technical revision of section 6166, the Honorable Carl Curtis, former member of this committee, now partner of Nelson & Harding; Ronald D. Abramson, partner of Silverstein & Mullens; Bernard Long, partner of Dow, Lohnes & Albertson; and Alexander Zakupowsky, partner of Deloitte, Haskins & Sells.

Welcome to the committee, gentlemen and Senator Curtis. It is nice to have you here this morning.

STATEMENT OF SENATOR CARL CURTIS, PARTNER, NELSON & HARDING

Senator CURTIS. Thank you, Mr. Chairman. It is an understatement when I say I am very happy to be at this hearing.

It is a necessary and accepted part of the legislative process to follow the enactment of certain tax provisions with later legislation in the nature of a technical revision. The reasons for this procedure are many. The U.S. economy is complex. Part of the American genius, which results in our high standard of living and our high per capita income, is that American business is innovative and creative.

It is impossible to anticipate in advance all of the transactions or business arrangement which will be affected by the enactment of any particular tax proposal. I marvel at how well the committee does its job, and I have a profound respect for the professional competence of those who serve as members of the staff. In addition, all must work under a deadline. This means long hours, rushing, and quick thinking.

The end product, however, is a very credible one indeed, but by reason of the very nature of the situation there are problems to come to light which must be dealt with in a technical revision. It is important that these technical revisions be made by the Congress.

We are all very pleased that this distinguished committee is considering legislation dealing with some of these technical problems in reference to section 6166. The task force on technical revision of section 6166 represents the unified view of more than a dozen law firms and accounting throughout the country.

With me today are three other members of the task force: Ronald Abramson from the law firm of Silverstein & Mullens; Bernard Long from the law firm of Dow, Lohnes & Albertson; and Alexander Zakupowsky of the accounting firm of Deloitte, Haskins & Sells.

I want to mention one problem in particular. I am confident that it was clearly the intent of Congress to extend the benefits of section 6166 to the heirs of all taxpayers where the taxpayers were in truth and in fact the owners of a trade or business.

I also believe it was the intent of Congress to grant the benefits of this section to the heirs of all taxpayers, who otherwise qualify, regardless of the particular form of the taxpayer had chosen to operate his business.

In other words, if the taxpayer was the real owner of the business, his heirs should have the benefits of the section even though he had chosen to operate through a holding company owned by him which, in turn, owns the corporation which is carrying on the trade or business.

Thus, the benefits of section 6166 should be available to the heirs of the real owner of the trade or business whether his ownership is direct or indirect. This point should be made clear by legislation.

Mr. Abramson will address the very important problem that in the event of a dispute with the Internal Revenue Service as to matters under section 6166, taxpayers now are unable to seek resolution of such disputes through court proceedings.

Mr. Long will speak to the issue that section 6166 does not coordinate with redemptions under section 303, thereby preventing any taxpayers from utilizing both of these important code provisions at the same time.

Finally, Mr. Zakupowsky will elaborate on additional problems under section 6166 that need to be resolved by legislation in order to make the provision more workable.

Senator SYMMS. Thank you very much, Senator Curtis.

Please go ahead, Mr. Abramson.

May I say for the record, so we don't overlook it, at the conclusion of the task force's testimony, I would like to submit an article that was recently written by Mr. Ron Abramson, who is now about to speak. So we will see that that follows your entire testimony.

STATEMENT OF RONALD ABRAMSON, PARTNER, SILVERSTEIN & MULLENS

Mr. ABRAMSON. Thank you very much.

One of the hallmarks of our Federal tax system is the ability to resolve disputes between the taxpayers and the Internal Revenue Service through the courts. The courts are the final arbiter. In fact, the Tax Court was created to provide taxpayers with a judicial forum without requiring the prior payment of amounts in dispute. Thus, there can be no dispute with the principle that taxpayers should be provided with a judicial forum in all events.

As a result of definitional complexities, it appears that taxpayers cannot go to court in the event the Internal Revenue Service denies the executor's election to use section 6166. However, there is no indication that when the predecessors of section 6166 were enacted in 1958 and 1976, Congress intended that taxpayers should be prevented from going to court to settle disputes with the Revenue Service. What is, in effect, a denial to taxpayers of due process in the case of section 6166 appears to have been caused purely by accident and not by design.

We note that the House of Representatives provided for a nonreviewable judicial forum for section 6166 controversies when it passed its version of the Economic Recovery Tax Act in 1981 this summer. Unfortunately, the House-passed provision was not included in the bill that was finally enacted into law.

We respectfully request the committee to provide through legislation a judicial forum to resolve disputes with the Internal Revenue Service arising under section 6166. Accordingly, we fully endorse S. 1733 introduced by the distinguished chairman, which provides a reviewable Tax Court judicial forum for section 6166 disputes.

One final note. Although uniform judicial results in the event of tax disputes may be a desirable goal, all decisions of the Tax Court now are reviewable by one or more circuit courts. Thus, we believe that decisions of the Tax Court involving section 6166 should be reviewable in the same manner as all other decisions of that court.

In closing, we urge that Congress provide a judicial forum for controversies arising under section 6166.

Thank you.

STATEMENT BY BERNARD J. LONG, PARTNER, DOW, LOHNES & ALBERTSON

Mr. LONG. Thank you, Mr. Chairman.

Section 303 provides a means whereby the estate of the owner of a closely-held incorporated business can cause stock to be redeemed to pay death taxes and expenses and, thereby, preserve the ownership of the business for future generations.

Section 6166, as it relates to section 303, enables a corporation to make these section 303 redemptions over a 15-year period. However, in order for the estate and corporation to fully utilize this deferral, the total distribution cannot exceed the amount of the estate tax.

The net effect of this limitation is that where section 303 must be utilized, much of the 15-year period under section 6166 will often not be available. This is the case because in many instances the section 303 distributions will necessarily include amounts sufficient to pay interest on the unpaid estate tax, plus other section 2053 amounts, which amounts will accelerate additional tax payments on a dollar-for-dollar basis.

Moreover, under existing law, even where section 303 distributions do not exceed the estate tax liability, they nevertheless must be taken into account in determining whether other distributions, not covered by section 303, will trigger acceleration under the 50 percent test of section 6166(g)(1)(A).

It is believed, Mr. Chairman, that the lack of coordination between sections 303 and 6166 was an intentional legislative oversight and our task force recommends that it be corrected.

While fairness would support, we submit, a fully retroactive application of this equitable relief, the administrative burden in connection with redemptions which have already taken place would appear to render this impracticable.

Nevertheless, as was the case with the recent amendment of section 6166(g)(1)(D), which corrected a technical oversight in connection with the transfer of property by reason of the death of the recipient thereof, the prospective application of the proposed change to redemptions taking place in 1982 and thereafter, without regard to date of death, would not suffer from any such administrative disability.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you.

STATEMENT OF ALEXANDER ZAKUPOWSKY, PARTNER, DELOITTE, HASKINS & SELLS

Mr. ZAKUPOWSKY. First, the uncertainty of whether an interest in a holding company that in turn owns the stock of a subsidiary engaged in a trade or business can qualify for section 6166 election has created needless practical problems in estate planning.

There are many valid business reasons for placing a holding company between the owners of the business and the operating units. The current status of holding companies under section 6166 is an impediment to their use. This problem also potentially exists when a partnership is used to hold interests in one or more other partnerships or corporations.

The form in which the business is conducted should be irrelevant in the determination of whether section 6166 relief should be allowed. There is a general principle of our tax law that substance should govern over form and I think that section 6166 should not be an exception.

Second, if a beneficiary disposes of a business interest that is the subject of a section 6166 election, the balance of the tax becomes due. The theory of this is that now the individual has the funds with which to pay the tax. An exception to the general rule has been added by the Economic Recovery Tax Act of 1981 for cases where the beneficiary dies, but only where the interest is transferred to a member of the decedent beneficiary's family.

There is no apparent reason why this family limitation is imposed since no such limitation is imposed on the initial transfer and the transfer has provided no additional liquidity with which to pay the tax.

Finally, many estate plans include an agreement that cause the estate of the first deceased coowner to sell the decedent's interest back to the business. Such buyout arrangements are typically consummated by use of a note issued by the corporation to the decedent's estate. This note is then paid off over a period of time, facilitating the continued status of the business as closely held.

Since these notes are not marketable and generally cannot be sold without suffering significant economic loss, they should be considered investment in the business and be treated similar to stock for purposes of section 6166. Again, this note provides no additional liquidity with which to pay the tax. Section 6166 now, in effect, undercuts the usefulness of such arrangements.

There are additional section 6166 issues which require prompt corrective legislative action. However, in the interest of time, the issues and suggested solutions are discussed in detail in a statement attached to our testimony, and I ask that they be included in the record.

Senator SYMMS. They shall be part of the record.

Mr. ZAKUPOWSKY. Thank you, Mr. Chairman.

Although the task force endorses many changes to section 6166, all of the suggested changes are essentially technical in nature. Section 6166 is a very sound provision and it has operated for the benefit of small businesses in particular and the economy as a whole. It should be retained, but improved.

Thank you, Mr. Chairman.

[Statement of the task force, and article by Mr. Abramson follow:]

TASK FORCE ON TECHNICAL
REVISION OF SECTION 6166

Committee on Finance
Subcommittee on Estate
and Gift Taxation

Hearing on
Wednesday, November 4, 1981
SUMMARY OF WRITTEN STATEMENT

I. PRESENTATION BY SENATOR CARL CURTIS

Mr. Chairman, it is an understatement when I say that I am delighted to appear at this hearing. I have profound respect for the Committee on Finance and its able staff. This Committee has done an outstanding job in tax legislation. The various provisions of the Economic Recovery Tax Act of 1981 constitute a landmark in sound tax legislation.

It is a necessary and accepted part of the legislative process to follow the enactment of certain tax provisions with later legislation in the nature of a technical revision. The reasons for this procedure are many. The United States economy is complex. Part of the American genius which results in our high standard of living and our high per capita income, is that American business is innovative and creative. It is impossible to anticipate in advance all of the transactions or business arrangements which will be affected by the enactment of any particular tax proposal. I marvel at how well this Committee does its job and I have profound respect for the professional competence of those who serve as members of the staff. In addition, all must work under a deadline. That means long hours, rushing, and quick thinking. The end product ~~is,~~ however, is a very credible one indeed, but by reason of the very nature of the situation there are problems that come to light which must be dealt with in a technical revision.

It is important that these technical revisions be made by the Congress.

We are all very pleased that this distinguished Committee is considering legislation dealing with some of these technical problems in reference to Section 6166. The Task ~~Force on Technical Revision of Section 6166 represents the unified view of more than a dozen law firms and accounting~~

firms from throughout the country. With me today are three other members of the Task Force: Ronald Abramson from the law firm of Silverstein and Mullens; Bernard Long from the law firm of Dow, Lohnes & Albertson; and Alexander Zakupowsky of the accounting firm of Deloitte, Haskins & Sells.

I want to mention one problem in particular. I am confident that it was clearly the intent of Congress to extend the benefits of Section 6166 to the heirs of all taxpayers where the taxpayers were in truth and in fact the owners of a trade or business. I also believe it was the intent of Congress to grant the benefits of this section to the heirs of all taxpayers, who otherwise qualify, regardless of the particular form the taxpayer had chosen to operate his business. In other words, if the taxpayer was the real owner of the business, his heirs should have the benefits of the section even though he had chosen to operate through a holding company owned by him which in turn owns the corporation which is carrying on the trade or business. Thus, the benefits of Section 6166 should be available to the heirs of the real owner of the trade or business whether his ownership is direct or indirect. This point should be made clear by the ~~Congress.~~ legislation

Mr. Abramson will address the very important problem that in the event of a dispute with the Revenue Service as to matters under Section 6166, taxpayers now are unable to seek resolution of such disputes through court proceedings. Mr. Long will speak to the issue that Section 6166 does not coordinate with redemptions under Section 303, thereby preventing many taxpayers from utilizing both of these important Code provisions at the same time. Finally, Mr. Zakupowsky will elaborate on additional problems under Section 6166 that need to be resolved by legislation in order to make the provision more workable.

II. PRESENTATION BY RONALD ABRAMSON

One of the hallmarks of the Federal tax system is the ability to resolve disputes between taxpayers and the Internal Revenue Service in the courts. The courts are the final arbiter. In fact, the Tax Court was created to provide taxpayers with a judicial forum without requiring the prior payment of amounts in dispute. Thus, there can be no dispute with the principle that taxpayers should be provided with a judicial forum in all events.

As a result of definitional complexities, it appears that taxpayers cannot go to court in the event the Internal Revenue Service denies the executor's election to use Section 6166. However, there is no indication that when the predecessors of Section 6166 were enacted in 1958 and 1976, Congress intended that taxpayers should be prevented from going to court to settle disputes with the Revenue Service. What is, in effect, a denial to taxpayers of due process in the case of Section 6166 appears to have been caused purely by accident and not by design.

We note that the House of Representatives provided for a nonreviewable judicial forum for Section 6166 controversies when it passed its version of the Economic Recovery Tax Act of 1981. Unfortunately, the House-passed provision was not included in the bill that was finally enacted into law.

We respectfully request the Committee to provide Sec'n a judicial forum to resolve disputes with the Revenue Service arising under Section 6166. We fully endorse Senate Bill No. S.1733, introduced by the distinguished Chairman, which provides a reviewable Tax Court judicial forum for Section 6166 disputes. & Many ~~Although uniform judicial results in the event of~~

tax disputes may be a desireable goal, all decisions of the Tax Court now are reviewable by one or more circuit courts. Thus, we believe that decisions of the Tax Court involving Section 6166 should be reviewable in the same manner as all other decisions of that court.

In closing, we urge that Congress provide a judicial forum for controversies arising under Section 6166.

III. PRESENTATION BY BERNARD LONG

Section 303 provides a means whereby the estate of the owner of a closely-held incorporated business can cause stock to be redeemed to pay death taxes and expenses and, thereby, preserve the ownership of the business for future generations. Section 6166, as it relates to Section 303, enables a corporation to make the Section 303 redemptions over a 15-year period. However, in order for the estate and the corporation to fully utilize this deferral, the total distributions cannot ~~exceed the amount of the estate tax.~~

The net effect of this limitation is that where Section 303 must be utilized, much of the 15-year period under Section 6166 will often not be available. This is the case because in many instances the Section 303 distributions will necessarily include amounts sufficient to pay interest on the unpaid estate tax, plus other Section 2053 amounts, which amounts will accelerate additional tax payments on a dollar-for-dollar basis. Moreover, under existing law, even where Section 303 distributions do not exceed the estate tax liability, they nevertheless must be taken into account in determining whether other distributions, not covered by Section 303, will trigger acceleration under the 50 percent test of Section 6166(g)(1)(A). It is believed Mr. Chairman that the lack of coordination between Sections 303 and 6166 was an unintentional legislative oversight and ours which should be corrected.

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Moreover, while fairness would support a fully retroactive application of this equitable relief, the administrative burden in connection with redemptions which have already taken place would appear to render this impracticable. Nevertheless, as was the case with the recent amendment of Section 6166(g)(1)(D) (which corrected a technical oversight in connection with the transfer of property by reason of the death of the recipient thereof), the prospective application of the proposed change to redemptions taking place in 1982 and thereafter, without regard to date of death, would not suffer from any such administrative disability.

IV. PRESENTATION BY ALEXANDER ZAKUPOWSKY

Additional problems should be addressed.

First, the uncertainty of whether an interest in a holding company that in turn owns the stock of a subsidiary engaged in a trade or business can qualify for a Section 6166 election, has created needless practical problems in estate planning. There are many valid business reasons for placing a holding company between the owners of the business and the operating units. The current status of holding companies under Section 6166 is an impediment to their use. Their problem also potentially exists when a partnership is used to hold interests in one or more other partnerships or corporations.

The form in which the business is conducted should be irrelevant in the determination of whether Section 6166 relief should be ~~is~~ allowed.

A general principal of our tax laws requires that substance govern over form and Section 6166 should not be an exception.

Second, if a beneficiary disposes of a business interest that is the subject of a Section 6166 election, the balance of the tax becomes due. Insert An exception to this general rule has been added by the Economic Recovery Tax Act of 1981 for cases where the beneficiary dies, but only where the interest is transferred to a member of the decedent beneficiary's family. There is no apparent reason why this family limitation is imposed since no such limitation is imposed on the initial transfer.

Finally, many estate plans include an agreement that cause the estate of the first deceased co-owner to sell the decedent's interest in the business back to the business. Such "buyout" arrangements are typically consummated by use of a note issued by the corporation to the decedent's estate. This note is then paid off over a period of time, facilitating the continued status of the business as closely held. Since these notes are not marketable and generally cannot be sold without suffering a serious economic loss, they should be considered an investment in the business and be treated similar to stock for purposes of Section 6166. Section 6166 now, in effect, undercuts the usefulness of such arrangements.

There are additional Section 6166 issues which require prompt corrective legislative action. insert

Although the Task Force endorses many changes to Section 6166, all of the suggested changes are essentially technical in nature. Moreover, Section 6166 is a very sound provision and it has operated for the benefit of small businesses in particular and the economy as a whole.

The Task Force on Technical Revision of Section 6166 appreciates this opportunity to appear before the Subcommittee on Estate and Gift Taxation.

TASK FORCE ON TECHNICAL
REVISION OF SECTION 6166

Committee on Finance
Subcommittee on Estate
and Gift Taxation

Hearing on
Wednesday, November 4, 1981
WRITTEN STATEMENT

I. MEMBERS OF THE TASK FORCE ON TECHNICAL REVISION OF SECTION 6166

The following law firms and accounting firms from throughout the country are members of the Task Force on Technical Revision of Section 6166. It is anticipated that several additional firms will become members of the Task Force in the near future. Listed beside each firm is the name of the person who is principally involved with Section 6166 and related matters:

Arthur Andersen & Co.	Sam Murray
Cox, Castle & Nicholson	Jeffrey Lapota
Deloitte, Haskins & Sells	Alexander Zakupowsky
Dow, Lohnes & Albertson	Bernard J. Long, Jr.
Ernst & Whinney	Herbert J. Lerner
Gordon, Feinblatt, Rothman, Hoffberger & Hollander	Marc P. Blum
Greenberg, Doll & McDonald	Martin S. Weinberg

Hogan & Hartson	Sara-Ann Determan
Katten, Muchin, Zavis, Pearl & Galler	Sheldon I. Banoff
Lidell, Sapp, Zivley, Brown & LaBoon	Walter Zivley
Peat, Marwick, Mitchell & Co.	Gilbert Bloom
Nelson & Harding	Senator Carl Curtis
Silverstein and Mullens	Ronald D. Abramson
Sutherland, Asbill & Brennan	Mac Asbill, Jr.
Vinson & Elkins	Marvin K. Collie

II. SPECIFIC PROPOSALS FOR TECHNICAL REVISION OF SECTION 6166

The Economic Recovery Tax Act of 1981 made a number of significant changes in the availability and operation of Section 6166. Notwithstanding, Section 6166 continues to be plagued by numerous technical deficiencies. In order to remedy these technical deficiencies, the Task Force on Technical Revision of Section 6166 suggests the following specific legislative proposals.

A. Necessity for Judicial Review

An overriding problem in this entire area is the fact that any dispute which arises under Section 6166 cannot be resolved in court, thereby making the Revenue Service the sole arbiter of all controversies. This unintended imbalance between the taxpayer and the Revenue Service needs to be remedied at the earliest possible time through the creation of a judicial forum for the resolution of all disputes arising under Section 6166.[1/] The declaratory judgment provision contained in the House-passed version of the Economic Recovery Tax Act of 1981 can serve as a model for legislation. However, decisions of the Tax Court should be reviewable by the Circuit Courts, as is the case with all other decisions of the Tax Court. S.1733 provides for a reviewable Tax Court judicial forum.

B. Clarification of Status of Corporate and Partnership Holding Companies

In order to reflect present business practices which oftentimes utilize corporate and partnership holding company structures, Section 6166 should be clarifed to permit a

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[1/]Congress acted expeditiously in an analogous situation involving the jurisdiction of the Tax Court. See P.L. 96-596, "Chapter 42 Second Tier Tax Correction Act of 1980."

decedent to own either a direct or indirect interest in a corporation or partnership carrying on a trade or business. There is no justifiable reason for the Internal Revenue Code to exclude partnership and corporate holding companies from the benefits of Section 6166. The Congressional purpose underlying Section 6166 -- to provide a long-term payout to estates with liquidity problems in order to prevent a forced sale to larger publicly- owned companies -- should apply equally to holding companies and to entities without corporate or partnership subsdidiaries.

C. Closely Held Business Interest Should Include Indebtedness

Section 6166 should be amended to permit indebtedness to qualify for deferral benefits if the decedent's equity interest in the partnership or corporation, standing alone, would constitute a closely held business interest for purposes of Section 6166. Section 6166 should not contain a bias in favor of equity over indebtedness.

D. Individuals Engaged in Oil and Gas Business As Sole Proprietors

After 1981 Section 6166 permits the installment payment of estate taxes when the value of an interest in a closely held business, which is included in determining the gross estate of a decedent, exceeds 35 percent of the adjusted gross estate. An interest in a closely held business is defined as an interest in a proprietorship, partnership or corporation carrying on a trade or business. In the case of a partnership or a corporation, additional percentage or numberical requirements must also be satisfied.

As a result, a decedent's interest in a partnership carrying on a trade or business is an interest in a closely held business only if 20 percent or more of the partnership's capital interest is included in the decedent's gross estate or the partnership had 15 or fewer partners. Interests in two or more closely held partnerships may be aggregated to satisfy the 35 percent requirement if 20 percent or more of the total value of each partnership, is included in determining the value of the decedent's gross estate.

It is the present policy of the Internal Revenue Service that co-ownership of an oil and gas lease constitutes a partnership. Each lease, therefore, in which a decedent owns a leasehold interest is a separate partnership. While these partnerships may elect out of partnership treatment for the purposes of subcahpter K under Section 761(a), they are outside of subchapter K. As interests in separate partnerships, according to Service policy, each working interest must meet the percentage and numerical requirements contained in both the definition of an interest in a closely held business and the provision allowing aggregation of such closely held interests.

Congress enacted Section 6166 because prior provisions had proved inadequate in dealing with the liquidity problems experienced by estates consisting in substantial part of an interest in a closely held business or other illiquid assets. Under present law, the proprietorship status of a decedent who owned interests in oil and gas leases and who was admittedly engaged in carrying on a trade or business in the oil and gas industry, is ignored for purposes of Section 6166.

The present nature of the oil and gas industry (the need for leasehold diversification, the risks, the vast capital) is such that an individual engaged in the owning, operating, exploring and eveloping of oil and gas properties will possess numerous fractional leasehold interests. It is unlikely that an individual will own 20 percent or more of the tota leasehold interest in a substantial number of leases. Since present policy ignores this individual's proprietorship status and applies the percentage tests applicable to partnerships to each leasehold interest owned by him, it is unlikely that this individual's estate can qualify for installment payment of estate taxes under Section 6166. Even if the estate does qualify, the benefit of deferral is greatly diminished.

It is unreasonable to deny the benefits of Section 6166 to the estate of an individual who was carrying on a trade or business as a sole proprietor simply because that business necessarily entails the ownership of interests which are considered partnerships under present Service policy.

Corrective legislation should provide that an individual who owns interests in one or more organizations described in Section 761(a)(2) (i.e., organizations availed of for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted) will be treated as possessing an interest in a single proprietorship when applying the Section 6166 definition of an interest in a closely held business. This proprietorship must still satisfy the other statutory requirements before it can be classified as an interest in a closely held business.

E. Elimination of Distinction Between Capital and Profits Interest in a Partnership

Under present law, if a partnership has more than 15 partners (determined by taking into account all of the attribution rules), the decedent must own 20 percent or more of the total capital interest in such partnership in order to qualify for Section 6166. There are several reasons to amend Section 6166(b)(1)(B)(i) to eliminate the distinction between an interest in partnership capital and an interest in partnership profits. First, if the partnership has 15 or fewer partners, the decedent's partnership interest can qualify even if such interest is limited to partnership profits. Second, for purposes of the aggregation rule in Section 6166(c), the decedent must own 20 percent or more of the total value of each business without regard to whether the decedent's partnership interest relates to capital or profits. Finally, numerous sections of the Revenue Code provide for attribution between a partner and a partnership where the partner owns a prescribed interest in either partnership profits or partnership capital.[2]

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[2] See Sections 318(a)(2)(A) and (3)(A); 554(a)(1) and (2); 707(b)(1) and (2); 1239(c)(1)(B); and 1563(e)(2).

F. Elimination of Distinction Between Voting and Nonvoting Stock

Under present law, if a corporation has more than 15 shareholders (determined by applying all of the attribution rules), the decedent must own 20 percent or more in value of the voting stock of such corporation in order to qualify for Section 6166. There are several reasons Section 6166(b)(1)(C)(i) should be amended to eliminate the distinction between voting and nonvoting stock. First, if the corporation has 15 or fewer shareholders, the decedent's stock interest can qualify even if such interest is comprised solely of nonvoting stock. Second, for purposes of the aggregation rule in Section 6166(c), the decedent must own 20 percent or more of the total value of each business without regard to whether the decedent's stock is voting or nonvoting. Finally, several provisions of the Revenue Code provide for attribution between a shareholder and a corporation where the shareholder owns a certain minimum percentage of the value of the outstanding stock (including both voting and nonvoting stock).3/

3/See Sections 267(b)(2); 318(a)(2)(C) and (3)(C); 554(a)(1); 1239(c)(1)(A); and 1563(e)(4).

G. Solution to Interest As an Administration Expense

An extremely complicated situation is presented because interest throughout the 15-year period is deductible as an administration expense under Section 2053, but a deduction only can be claimed when the interest is actually paid or accrued. The simplest method of eliminating the complex procedures prescribed by the Revenue Service, while retaining the economic benefit of the deduction, would be to amend Section 2053 to exclude interest as a deduction but to reduce the interest rate to compensate for such elimination.4/

Alternatively, interest attributable to the Section 6166 deferral period could be permitted as an administration expense under Section 2053 on an estimated basis. The interest rate would be fixed for the entire deferral period, geared to the then prevailing yield on Treasury obligations of comparable

4/The executor should have the option to treat the interest expense as an income tax deduction. However, if such option was exercised, the interest rate would not be reduced because the interest still would be deductible.

maturity. In the event an estate terminated the deferral privilege prematurely, one recalculation procedure would be required at that time; otherwise no recalculation would be necessary. This approach preserves the legal principles presently operating, but drastically simplifies the current situation by eliminating the now complex and prolonged administrative procedures.

H. Coordination with Subchapter S Provisions

In order to preserve the historic relationship between the Subchapter S provisions and the estate tax deferral provisions, dating back to 1958, a decedent's interest in a corporation should qualify under Section 6166 if such entity has 25 or fewer stockholders.5/ In order to achieve additional coordination between the two provisions, the spousal attribution rules (in Section 6166(b)(2)(B) and Section 6166(c)) should be revised to eliminate the common ownership requirement and to include estates of deceased spouses.

5/If this change is made, a corresponding change in the numerical test for partnerships would be necessary.

I. Simplification of Attribution Rules

Under present law, in determining whether the 15-person numerical test is satisfied, three entity attribution rules are applicable: spousal, family and entity. In determining whether the percentage ownership test is satisfied, the executor can elect to apply these three attribution rules by giving up the 4 percent interest rate and the 5-year interest only provisions. Moreover, the attribution rules do not operate in the same fashion, since spousal and entity attribution are not limited to the decedent, whereas family attribution only applies between the decedent and members of his family. In addition, in the case of a husband and wife where one of the spouses is the decedent, both spousal and family attribution would be applicable, although spousal attribution is limited to situations in which the closely held business interest is jointly or commonly owned.

Present law should be amended to combine the spousal and family attribution rules into a single provision applicable to all owners and not just the decedent. In addition, in order to preserve the current interaction between family and spousal attribution, the definition of family should be amended to include spouses of an owner's brothers and sisters as well as spouses of such owner's lineal descendants.

J. Expansion of Aggregation Rule to Include Numerical Test

Aggregation under Section 6166(c) should be permitted for each of the decedent's interests which satisfy either the numerical or percentage qualification tests. Since modern business practices often favor the creation of multiple entities, Section 6166 should not impose a stiffer requirement in the case of two or more entities, but, at the same time, provide a more lenient qualification standard where the decedent dies owning a single closely held business interest.[6]

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[6]The numerical qualification test contains safeguards (specifically in the entity attribution rule) to assure that the total number of direct and indirect owners of a corporation or partnership are taken into account. Accordingly, no additional safeguards appear to be needed when the aggregation rule is expanded to include the numerical qualification test.

K. Expansion of Acceleration Exceptions

Since buyout agreements often are an essential element in the continuation of a closely held business after the death of one of the owners, Section 6166 should be amended to permit an estate to sell its stock or partnershship interest in exchange for a note without resulting in acceleration. The American Bar Association has recommended this specific change.[7]

Second, in order to enable buyouts to occur prior to the death of one of the owners, Section 6166 should be amended to permit a note receivable from a corporation or partnership to be eligible for the deferral privileges if the decedent had died owning such interest and such interest would have qualified under Section 6166.

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[7] If a closely held business is acquired by another company after the buyout agreement is implemented, conceivably acceleration would be proper if the note received as part of the buyout became readily tradable (within the meaning of Section 453(f)(5)) as a result of such acquisition.

Third, the acceleration exception for Section 303 redemptions should be expanded to permit the proceeds of such redemption to be used for any of the purposes enumerated in Section 303(a). Under current law, a Section 303 redemption can include amounts sufficient to cover federal and state death taxes, interest on such death taxes, and funeral and administration expenses under Section 2053, whereas Section 6166(g)(1)(B) is limited to federal estate taxes.

Fourth, the acceleration exception should be expanded to provide equivalent treatment for partnerships. There is no justification for permitting an estate to receive funds from a closely held corporation to pay enumerated expenses without causing acceleration, but to deny that privilege to partnerships. Acceleration is not justified in either case because the estate must pay such expenses with the funds it receives from the entity.

Fifth, the acceleration exception in Section 6166(g)(1)(C) should be expanded to include all reorganizations under Section 368 if the stock received by the decedent's estate (or heirs) would have qualified as a closely held business interest if owned by the decedent on the date of his death or constitutes non-readily-tradable stock within the meaning of Section 6166(b)(7)(B). In effect, closely held businesses should be allowed to be acquired by unrelated closely held businesses without causing acceleration.[8/]

Finally, the acceleration exception for <u>subsequent</u> death-related transfers should be amended to repeal the family limitation. When the original decedent dies, Section 6166 is available whether or not the decedent leaves any portion of the estate to non-family members. However, on the death of an heir of the original decedent, the acceleration exception only is available if the subsequent transferee is a member of the transferor's family. There are many situations in which business associates (including employees) and charitable organizations are beneficiaries of an estate. In effect, under present law, an heir of the original decedent is penalized if the closely held business interest is left, in whole or in part, to such business colleagues or charitable organizations. We support S.1734 because it repeals the family limitation.

[8/] Section 303(c) applies to all reorganizations. See Treas. Reg. §1.303-2(d). Moreover, Section 303 was amended by Section 422(b) of the Economic Recovery Tax Act of 1981 (P.L. 97-34) in order to coordinate those provisions with Section 6166. H.R. Rep. No. 201, 97th Cong., 1st Sess. 181 (1981).

Closely Held Business — Installment Payment of Estate Taxes After ERTA

by Ronald D. Abramson, Esq.

I. OVERVIEW OF CHANGES MADE BY THE ECONOMIC RECOVERY TAX ACT OF 1981

The Economic Recovery Tax Act of 1981 repealed §6166A and amended §6166[1] to liberalize the threshold qualification requirement, generally expand the exceptions to the acceleration provisions, and reduce in half, on a graduated basis, the effectiveness of the 4 percent interest rate. These changes generally apply with respect to decedents dying after December 31, 1981. Specifically, an estate now can qualify for the deferral and installment provisions of §6166 if the decedent's closely held business interest exceeds 35 percent of the adjusted gross estate rather than 65 percent under prior law. In addition, two or more closely held business interests can be aggregated to determine whether the combined value of such interests exceeds 35 percent of the adjusted gross estate if each interest represents "20 percent or more" of the total value of each business rather than "more than 20 percent."

With respect to the acceleration provisions, three additional exceptions have been added. The first permits installment payments of interest or principal to be late up to six months without causing acceleration. However, prior law is reversed in that the failure to make an interest payment during the first five years will now cause acceleration (subject to the new six-month exception). The second exception permits the closely held business interest to be transferred upon the death of the original and subsequent heirs without resulting in acceleration if such transfer is to a family member of the transferor.

Pursuant to the third exception, acceleration occurs only if there is a disposition of 50 percent or more of the closely held business rather than one-third or more under prior law. However, acceleration by virtue of the withdrawal of money or other property now results if such withdrawal equals or exceeds 50 percent of the value of the closely held business interest rather than one-third or more of the value of the *entire* trade or business.[2]

II. OPERATION OF SECTION 6166

A. Threshold Requirements

Section 6166 provides that, at the executor's election, estate taxes[3] can be paid in *equal* annual installments over a 10-year period, commencing five years from the ninth month after the decedent's death, if the value of a *single* interest in a "closely held business" *exceeds* 35 percent of the decedent's "adjusted gross estate."[4] Finally, §6166 is available only to citizens and residents of the United States (determined at the time of death).[5]

1. *Maximum Amount of Taxes Payable in Installments*

Only the estate taxes referable to the closely held business interest can be paid in installments. The amount eligible for deferral and installment treatment is determined by multiplying the total amount of estate taxes by a fraction: the numerator is the value of the interest in the closely held business and the denominator is the adjusted gross estate).[6]

2. *Interest Only for Five Years*

Interest only is payable on an annual basis during the 5-year period commencing nine months after the decedent's death.[7] During the succeeding 10-year period, interest is payable annually at the same time as, and as part of, each installment payment of tax.[8].

3. *Reduced Interest Rate*

Interest at the annual rate of 4 percent is applicable to the *first* $1 million in value of the closely held business interest (the "4 percent portion").[9] Since the unified credit will increase each year starting in 1982 until it reaches $192,800 in 1987,[10] the "4 percent portion" applies to a *decreasing* amount of estate taxes as follows:[11]

1981	$298,800
1982	283,000
1983	266,500
1984	249,500
1985	224,000
1986	190,000
1987	153,000

The regular rate of interest,[12] which fluctuates but does not compound,[13] applies to estate taxes in excess of the stated amounts.

4. *Definition of Adjusted Gross Estate*

The term "adjusted gross estate" is defined as the gross estate reduced by expenses, indebtedness and taxes described in §2053 and losses described in §2054.[14] The amount of expenses *allowable* under §§2053 and 2054 must be determined on the basis of the facts and circumstances in existence on the date (including extensions) on which the estate tax return is due

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(or, if earlier, the date on which such return is filed).[15]

5. Definition of Administration Expenses

Administration expenses under §2053 include the interest expense payable under §6166 if the expense is allowable under the laws of the jurisdiction in which the estate is being administered.[16] However, interest that has not yet accrued as of the time of the final audit of the estate tax return can be deducted only if the total amount of interest is ascertainable with reasonable certainty and not based on a vague or uncertain estimate.[17] However, the IRS has ruled that the "possibility that payment may be accelerated renders any estimate of future interest charges vague and uncertain, within the meaning of section 20.2053-1(b)(3) of the regulations."[18]

As the interest expense accrues, the §2053 deduction increases and the state tax decreases.[19] There are complex and rather cumbersome procedures to account for the overassessments due to additional interest being allowed as an administration expense when such interest is paid or payable.[20] A supplemental Form 706 should be filed with each annual installment payment or at a later date to reflect the adjustments.[21]

These procedures have the general effect of denying interest to the taxpayer for the overassessments since each supplemental form will not be considered a claim for refund or abatement.[22] Instead, overpayments are applied against the next installment payment.[23]

In addition, according to the Service, claims for refund are not allowed until the estate tax is due in full. Similarly, pursuant to *Flora v. United States*,[24] it is very possible that the decedent's estate would have to wait until the payment of the *final* installment before instituting a suit for refund in the event of an *erroneous* overpayment of estate taxes.[25]

Administration expenses also include debts secured by mortgages where the estate is personally liable.[26] If the estate is not personally liable, however, only the equity (total value minus mortgages) is included in the gross estate and no deduction under §2053 comes into play.

Finally, the presence of §6166(b)(6) would appear to prevent retroactive qualification under §6166(a)(1) or a recomputation of the limitation under §6166(a)(2), both of which refer to the adjusted gross estate. Section 6166(b)(6) provides that the deductions under §§2053 and 2054 are "determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the return . . . (or, if earlier, the date on which such return is filed.)"

B. Procedural Aspects

1. Necessity for an Election

Section 6166 deferral treatment is available only if an election is made by the executor. An election must be made by attaching a "notice of election" to a timely filed estate tax return (includes extensions).[27] No exception to the timely filed "notice of election" requirement appears to be available.[28]

2. Availability of "Protective Elections"

A "protective election" is available pending the determination of final values meeting the requirements of §6166. The protective election is made by filing a "notice of election" with a timely filed estate tax return. A "final notice of election" must be filed within 60 days after values are finally determined (or agreed to following examination of a return).[29]

If a deficiency is assessed with respect to the closely held business interest, an election covering such deficiency can be filed within 60 days after issuance of notice and demand for payment even *if* no election or protective election was filed with the estate tax return.[30]

3. Subsequent Reporting Requirements

The regulations require the executor to notify the IRS if there has been an event of acceleration. The executor is to notify the District Director, in writing, within 30 days of acquiring knowledge of the acceleration event.[31] In addition, each annual installment payment of estate taxes must be accompanied by a statement from the executor disclosing all dispositions and withdrawals (not previously reported) and a further statement that such dispositions and withdrawals have not resulted in an event of acceleration.[32]

4. Special Lien in Lieu of Executor's Personal Liability or a Bond

The executor can be discharged from personal liability for estate tax payments either by posting a bond or by electing a special lien procedure whereby the executor and *all* parties who have an interest in the property subject to the lien file an agreement consenting to the creation of the lien and designating a responsible person to deal with the Service.[33] The maximum value of the property which will be subjected to the lien is equal to the sum of the entire amount of deferred estate taxes and the aggregate amount of interest payable over the first four years of the deferral period.[34]

Property eligible for the lien procedure includes only real property and other property which "can be expected to survive the deferral period."[35] However, lien property can be property other than that included in the decedent's gross estate.[36]

Special rules are provided respecting the priority accorded such lien.[37] Specifically, such lien is inferior to a real property construction or improvement financing agreement, whether such financing agreement comes into existence before or after the filing of the tax lien.[38]

5. *Administrative Appeals Process*

Rev. Proc. 79-55[39] sets forth certain procedures for appealing a determination by the District Director that §6166 is not available. Such appeal is to the Appeals Office of the Office of the Regional Director of Appeals. In addition, a request for technical advice can be referred to the National Office while the case is under the jurisdiction of either the District Director or the Appeals Office.

6. *Unavailability of Judicial Review*

It appears that the taxpayer does not have a judicial forum in the event the IRS denies the executor's election to qualify for the benefits of §6166. For purposes of §6211, no deficiency is created when the Service denies the election under §6166 because the executor and the Service do not disagree as to the total amount of estate taxes due. The dispute relates solely to the timing of the estate tax liability.

The House-passed version of the Economic Recovery Tax Act of 1981 contained a declaratory judgment procedure which would have provided a judicial forum with respect to three potential areas of controversy:[40]

(1) The estate's eligibility to defer estate tax payments under §6166.

(2) The computation of the adjusted gross estate, as to which the closely held business interest must represent more than 35 percent.

(3) Whether there has been an event of acceleration which would require the immediate payment of the deferred estate tax liability.

The House-passed provision also required an actual controversy and an exhaustion of all administrative remedies within the Internal Revenue Service.[41] Finally, declaratory judgment jurisdiction was limited to the United States Tax Court and a determination by that court was final and conclusive and not reviewable by any other court.[42]

C. Definition of Interest in a Closely Held Business

Three types of property can be treated as a closely held business interest: sole proprietorship, partnership, and corporation. In addition, a revocable trust will be disregarded and the assets of the trust will be treated as owned directly by the decedent.

1. *Sole Proprietorship*

An interest as a proprietor in a trade or business carried on as a proprietorship qualifies as a closely held business interest.[43]

2. *Partnership*

An interest as a partner in a trade or business carried on as a partnership qualifies as a closely held business interest if (i) 20 percent or more of the total capital interest in such partnership is included in the decedent's gross estate, *or* (ii) the partnership has 15 or fewer partners (after applying the attribution rules described below).[44]

a. Limited Partners

A limited partnership interest can qualify as a closely held business interest even though a limited partner is not active in the affairs of the partnership if the partnership itself (through the general partners or the partnership's employees) carries on a trade or business.

b. Profits-versus Capital Interest

An interest solely in partnership profits will not qualify. However, the profits-capital distinction is not relevant where the partnership has 15 or fewer partners (determined by taking into account the attribution rules). In addition, for purposes of the aggregation rule, the profits-capital distinction is not important, since aggregation is tied to the *total value* of the partnership.

c. Partnership Indebtedness

Partnership indebtedness owed to a partner does not qualify as a closely held business interest even though the partnership interest does qualify.

3. *Corporation*

An interest as a shareholder in a corporation carrying on a trade or business qualifies as a close-

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ly held business interest if (i) 20 percent or more in value of the voting stock in such corporation is included in the decedent's gross estate, *or* (ii) the corporation has 15 or fewer shareholders (after applying the attribution rules described below).[45]

a. Nonvoting Stock

Nonvoting stock (e.g., nonvoting preferred stock) can qualify as a closely held business interest only if the decedent owns 20 percent or more of the corporation's *voting* stock *or* the corporation has 15 or fewer shareholders. In the case of two or more closely held business interests, the voting-nonvoting distinction is not relevant, since aggregation is determined by reference to the *total value* of the corporation.

b. Corporate Indebtedness

Corporate indebtedness owed to a shareholder does not qualify as a closely held business interest even though the stock interest does qualify. In addition, if the stock interest is redeemed after death in exchange for a note, acceleration will occur because such note is not treated as the equivalent of a stock interest.

4. Revocable Trust

The transfer by a taxpayer of an interest in a closely held business to a revocable "grantor trust" is disregarded for purposes of §6166. Thus, the taxpayer is treated as directly owning the closely held business interest even though legal title to such interest has been transferred to a trustee and the post-death disposition of such interest will be governed by the terms of the trust and not by the decedent's will.[46] This is a logical result since the value of the closely held business interest will be included in the decedent's gross estate under §2038.

D. Attribution Rules

There are several attribution rules which are designed to facilitate the qualification of a decedent's partnership or stock interest as a closely held business interest.[47]

1. Spousal Attribution

A stock or partnership interest which is community property of a husband or wife or held by a husband and wife as tenants by the entirety, joint tenants, or tenants in common is treated as owned by one shareholder or one partner, as the case may be.[48]

a. Individual versus Joint Ownership

If a husband and wife each own individually their stock or partnership interest, spousal attribution will not apply and they will be considered two shareholders (unless family attribution, described below, applies). By analogy to the Subchapter S spousal shareholder rule in §1371(c) (prior to amendment by the Revenue Act of 1978) and Regs. §1.1371-1(d)(2), attribution will not apply in the preceding sentence even if the husband and wife own other stock jointly, *but* would apply if only one of the spouses owned stock individually.[49]

b. Spousal Attribution Not Limited to Decedent

Spousal attribution applies to all shareholders and is not limited to the decedent and the decedent's spouse.

> *Example:* Fifteen couples owning partnership interests as joint tenants would be treated as 15 partners for purposes of §6166(b)(1)(B)(ii).

c. Spousal Attribution Does Not Apply to Estates

Attribution would not apply if one or both of the spouses dies and the estate of the deceased spouse became a shareholder.[50]

2. Family Attribution

A stock or partnership interest held by the decedent or any member of his "family" is treated as owned by the decedent.[51]

a. Definition of "Family"

The decedent's "family" includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.[52]

b. Family Attribution Limited to Decedent

Unlike spousal attribution, family attribution applies only to the decedent and members of his family.

> *Example:* The decedent (co-founder), his wife and six children, another husband (co-founder) and wife (holding their interests as joint tenants) and the latter's six children, and eight unrelated individuals constitute the shareholders of a corporation. For purposes of §6166(b)(1)(C)(ii), the decedent, his wife, and all of his children would be treated as one shareholder, the husband and wife as one shareholder, the latter's children as six separate shareholders, and each employee as a separate shareholder.

Thus, there would be 16 shareholders and the decedent's interest would *not* qualify as a closely held business interest.

c. Family Attribution Does Not Apply to Estates

Family attribution does not extend to a stock or partnership interest held by an estate of a member of the decedent's family. A similar result occurs under the spousal attribution rule described above.[53]

d. Interaction Between Spousal and Family Attribution Rules

Since these two rules are applied in coordination with each other, the scope of attribution is enlarged.[54]

Example 1: The decedent's brother and the brother's wife hold stock in a corporation as joint tenants (and the brother and his wife own no other stock). The decedent's brother is treated as owning his wife's stock (spousal attribution), and the decedent is treated as owning this brother's stock (family attribution). Accordingly, the decedent, his brother, and his brother's wife are treated as one shareholder. However, because family attribution is limited to the decedent, there is no attribution between spouses of brothers and sisters or between a mother-in-law or father-in-law and a daughter-in-law or son-in-law.

Example 2: If, in Example 1, the brother's wife was the decedent, there would be no attribution from her brother-in-law to her husband (because the husband is not the decedent).

3. Entity Attribution

Property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as owned proportionately by or for its shareholders, partners, and beneficiaries (but only beneficiaries having a "present interest" in a trust).[55]

a. Entity Attribution Not Limited to Decedent

Unlike family attribution, but parallel to spousal attribution, entity attribution applies whether or not the shareholder, partner, or beneficiary is the decedent.

b. Interaction Between Entity, Spousal, and Family Attribution Rules

Since these three rules are applied in coordination with each other, the scope of attribution is enlarged.[56]

Example 1: The decedent, the decedent's son, and a trust in which the decedent's daughter-in-law has the sole present interest are the stockholders of a corporation. The trust, the decedent's son, and the decedent are treated as one shareholder.

Example 2: The decedent's son has the sole present interest in a trust which owns stock in a corporation. The trust, the decedent's son, and the decedent are treated as one shareholder.

4. Elective Attribution

An executor can elect[57] to treat a partnership interest and "non-readily-tradable stock" owned by the decedent after the application of spousal, family, and entity attribution, as included in determining the value of the decedent's gross estate for purposes of the percentage qualification tests in §6166(b)(1)(B)(i) and (b)(1)(C)(i) and the aggregation rule described below.[58]

a. Definition of "Non-Readily-Tradable Stock"

Such term means stock for which there was no market on a stock exchange or in an over-the-counter market at the time of the decedent's death.[59]

b. Dual Restrictions Accompanying Elective Attribution

If an executor elects to apply the attribution rules described above, the 5-year interest only period is not available and the 4 percent reduced interest rate does not apply.[60]

E. Aggregation Rule

Interests in two or more closely held businesses can be treated as a *single* interest only if 20 percent or more of the *total value* of each business is included in the decedent's gross estate.[61] The aggregation rule does *not* require that each closely held business interest involve the same type of entity; for example, under this rule stock and partnership interests can be treated as a single interest, or a stock or partnership interest and a proprietorship could be treated as a single interest.[62]

1. Numerical Qualification Test Inapplicable

Aggregation is not available if the decedent's multiple partnership or stock interests *only* qualify under the 15-person numerical test of §6166(b)(1)(B)(ii) and (b)(1)(C)(ii).

2. Automatic Attribution for Joint Ownership Between Spouses

If the decedent and his spouse hold an interest as community property, joint tenants, tenants by

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the entirety, or tenants in common, the surviving spouse's interest is treated as having been included in the decedent's gross estate.[63]

3. Elective Attribution

The elective attribution rule described above can be applied in coordination with the aggregation rule. However, because an automatic spousal attribution rule is included in §6166(c), the necessity for elective attribution should be carefully evaluated.

F. Definition of "Carrying on a Trade or Business"

A proprietorship, partnership, or corporation must carry on a trade or business in order to qualify under §6166. This trade or business requirement has engendered numerous problems of interpretation because no definitions or other standards are contained in the statute, the regulations, or the legislative history. However, there are a number of revenue rulings, private letter rulings, and technical advice memorandums which contain standards for determining the existence of a trade or business.

1. Qualification as Sole Proprietorship

It now appears settled that the activities of an employee or agent subject to the decedent's control and supervision will be imputed to the decedent in determining whether a proprietorship is carrying on a trade or business.[64] In the case of a partnership or a corporation, the trade or business can be carried on by employees rather than the partners or the stockholders. Finally, in the case of a partnership, the trade or business also can be carried on by one or more of the partners.

2. Rental Real Estate

The longstanding and uninterrupted position of the IRS, dating back to 1959, has been that rental real estate can qualify under appropriate circumstances as a trade or business.[65] This position is amply demonstrated by the following pronouncements issued by the Revenue Service under §6166:

a. A private letter ruling issued only one year after the enactment in 1958 of §6166A, the predecessor of §6166, responded to the question of "whether the ownership and operation of real property for the production of income constitutes a trade or business within the meaning of section 6166" by holding that such determination "depends upon all the facts and circumstances of the case."[66] In that ruling, the decedent owned and managed as a sole proprietor fifteen parcels of real property for the production of rental income. Section 6166 was determined to be applicable because the decedent exercised "significant managerial responsibilities" over the 15 rental properties "held for the production of income."

b. In 1966, the Revenue Service specifically approved the availability of §6166A where the only trade or business of a corporation was the "operation of an office building."[67]

c. In 1975,[68] three companion rulings were issued to illustrate the application of §6166 in several factual settings.[69] A trade or business was found in those situations where the activities carried on "formed a part of an active enterprise producing business income rather than income solely from the ownership of property." For example, the rental properties in Rev. Rul. 75-365 failed to qualify under §6166 because the decedent directed the maintenance of his properties by "contract" rather than through his own management and maintenance organization. The rental homes in Rev. Rul. 75-367 did not constitute a trade or business because the amount of services provided to the tenants was not substantial. The distinctions drawn by the three 1975 rulings were based, in part, on a 1961 ruling under §6166 involving oil and gas properties. In Rev. Rul. 61-55,[70] the Service ruled that the ownership, exploration, development and operation of oil and gas properties constituted a trade or business under §6166, but the mere ownership of royalty interests in oil properties did not constitute a trade or business.

d. In a 1976 Technical Advice Memorandum,[71] the decedent owned stock in several corporations which, in turn, owned seven residential apartment buildings containing over 500 apartments. The corporations, through their own employees, operated, maintained and repaired each building, in addition to collecting rents, administering mortgages, and paying property taxes. The Service held that "a corporation that leases real property to others is considered to be a service enterprise and, therefore, carrying on a trade or business for purposes of section 6166 if such corporation does more than merely collect rents, administer mortgages, and pay property taxes." Accordingly, since the corporations operated, maintained, and repaired the seven apartment buldings, they were service enterprises and "at least some of the rental income" was attributable to these services. The rental properties in Rev. Rul. 75-365 were specifically distinguished because in that situation the maintenance of the properties was undertaken pursuant to a "contract" rather than by the decedent's own employees.

e. In a 1979 Technical Advice Memorandum,[72] the decedent owned land and buildings which were leased to his corporation Pursuant to the lease arrangement, the corporation was responsible for all maintenance, repairs, taxes, and insurance. In determining the applicability of §6166, the Service held that the "level of activity is the factor that distinguishes an 'active business' from mere passive ownership of income producing assets." Moreover, "this active/passive distinction was relied upon in Rev. Rul. 75-365 and Rev. Rul. 75-366," and in Rev. Rul. 75-367, where qualified assets were separated from nonqualified assets based on "sufficient business activity." The property leased by the decedent to his corporation did not qualify under §6166 because all repairs and maintenance were undertaken by his corporation and the decedent merely collected the rent.[73]

f. In a 1980 Technical Advice Memorandum,[74] the decedent was an active partner in a partnership which owned and operated an office building. The partnership, through 30 employees, provided customary services to the tenants, including maintenance, security protection, elevator and floor service, and utilities. Although prospective tenants were contacted by an unrelated corporation, final negotiations were consummated by the partners (who personally signed all leases). Requests from tenants for structural changes were contracted out where the job could be better or more economically performed by experts. The rental income was attributable both to renting office space and furnishing services. The profitability of the building "correlated to the level of the efficiency at which the building" was operated. The decedent was personally engaged in the service and ministerial aspects of the business, including supervising employees, negotiating and signing service contracts, approving the hiring of employees, securing insurance coverage, and negotiating union contracts. The Service held that the partnership was engaged in sufficient business activity by virtue of its active servicing and maintenance of the building.

g. In an April 29, 1981 Technical Advice Memorandum,[75] the decedent owned a proprietorship primarily engaged in the leasing of commercial and industrial buildings. In conducting the proprietorship, the decedent performed the following activities: purchased vacant land and constructed buildings; acquired existing buildings and repaired them; leased out, maintained and repaired all constructed and purchased buildings; hired outside contractors where special expertise was required; collected rents; and negotiated rental contracts. The operation of the decedent's real estate buildings was determined to be a trade or business because the decedent personally handled improvements, repairs, and maintenance of the properties, collected rents, and negotiated rental contracts. Thus, the decedent's management decisions "directly affected his income from the rental of the properties" and constituted "active business involvement."

h. In one May 1, 1981 Technical Advice Memorandum,[76] the decedent, as a proprietor, was personally involved in all aspects of the construction, operation, and maintenance of a complex of houses and townhouses. She performed a substantial part of the maintenance work herself and supervised work performed by her employees and contractors. Fifteen years prior to her death, the decedent became ill and her husband assumed full responsibility for the management and operation of the complex. Seven years prior to his wife's death, the husband's health began to fail, and he hired a local bank to act as his agent in the management and operation of the complex. The bank employee regularly consulted with the husband as to management policy. In determining that the operation of the complex qualified as a trade or business, the Service applied the following guideline: "The question in such cases is a factual one, and it depends on the nature and level of the business activity carried on by the proprietor, and the identity of the assets that are actually employed in the business." The Memorandum distinguished Rev. Rul. 75-365 because "the owner did not perform or supervise any [tenant] services, but merely contracted for their provision by their parties" and Rev. Rul. 75-367 because "the decedent engaged in an insubstantial amount of business activity in maintaining eight houses."

i. In another May 1, 1981 Technical Advice Memorandum,[77] the corporation in which the decedent owned his interest was in the business

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of purchasing, improving, developing, renovating, leasing and selling real property. Such activities were conducted through a staff of executives, rental personnel, legal and financial employees, and independent contractors in several cities in the United States. The corporation did not employ outside management agents but managed all of the properties itself. Purchases, sales, and financing were generally accomplished through the corporation's own employees rather than with the use of outside brokers. The Service concluded that the corporation's operation of its real estate holdings constituted a service enterprise. Thus the corporation satisfied the trade or business requirement.[78]

j. In a May 19, 1981 Technical Advice Memorandum,[79] the decedent was a stockholder in a corporation which owned, maintained and managed five warehouses. The corporation negotiated leases, collected rents, advertised for tenants, maintained the buildings and mechanical systems, provided and maintained parking and railroad siding facilities, furnished security, and modified space to suit new tenants. All activities were performed by corporate employees, with the exception of certain plumbing and electrical work where the corporation acted as a general contractor. The Service held that since the activities of the corporation's employees in operating, maintaining and repairing the warehouses constituted a "service enterprise," income was not attributable merely to the passive ownership of property. Revenue Rulings 75-365 and 75-367 were distinguished because the level of activities in those rulings were on a much smaller scale than with respect to the five warehouses. In addition, the corporation used its own employees to maintain the warehouse, whereas the proprietor in Rev. Rul. 75-365 engaged independent contractors.

In sum, in the case of rental real estate, the Service takes the position that activity is the factor that distinguishes an active business from the mere passive ownership of income-producing assets. This distinction was relied upon in the 1961 and 1975 revenue rulings and in the private letter rulings and technical advice memorandums issued by the Service.

3. *Corporate Holding Company*

According to the Service, a corporation which only owns all or part of the stock of one or more active corporations is not treated as carrying on the trade or business of its subsidiaries.[80] Based on this position, the Service has ruled that §6166 would not be available for the decedent's interest in a corporate holding company, even if the parent owned 100 percent of the stock of an operating subsidiary.[81]

The position of the Service is not necessarily required by the statute. First, the entity attribution rule could apply to attribute the assets constituting a trade or business of an active subsidiary to a passive holding company because §6166(b)(2)(C) attributes "property" from a corporation to its shareholders.[82] Second, pursuant to the mandate to issue regulations in §6166(i), the Service has the authority to prescribe rules permitting corporate holding companies to qualify under appropriate circumstances for §6166 treatment.

4. *Partnership Holding Company*

In the case of a partnership whose only asset is a partnership interest in an active partnership, the corporate holding company problem described above may be applicable, even if the upper-tier partnership is a general partner in the lower-tier partnership.[83] However, since non-§6166 judicial authorities exist for the principle that the trade or business of a partnership may be imputed to its partners,[84] a partnership holding company should be treated as satisfying the trade or business requirement.

Section 6166 itself may permit a partnership holding company to qualify for the same reasons applicable to a corporate holding company. That is, the entity attribution rule may attribute the trade or business to the upper-tier partnership, and the Service has a statutory mandate in §6166(i) to issue regulations to implement §6166.

5. *Working Interests in Oil and Gas Leases*

In a 1980 Technical Advice Memorandum[85] the IRS has taken the position that each working interest in a producing oil and gas lease, *owned by two or more persons*, represents a separate partnership interest, notwithstanding the existence of an election permitted under §761(a) not to be treated as a partnership. Thus, according to the Service, the percentage qualification test for aggregation must be satisfied as to each working interest if the decedent owns more than one working interest. The position of the Service appears to be deficient in two respects as applied to the facts in the Technical Advice Memorandum.

First, each separate lease agreement should not represent a separate partnership because the facts indicate that the decedent's numerous fractional working interests in oil and gas leases were the subject of two operating agreements. Thus, each operating agreement, rather than each lease agreement, should represent a separate partnership.

Second, the fact that the decedent owned less than a 20 percent interest in each lease (the percentage varied from 1 to 13 percent) is not relevant in applying the percentage qualification test for aggregation. Rather, the decedent's interest in the two operating agreements should be aggregated if the value of his working interests in the oil and gas leases subject to each operating agreement constituted more than 50 percent of the total value of all working interest subject to such agreement.

6. Investment Asset Exception

If a partnership or corporation carries on a trade or business, Regs. §20.6166A-2(c)(1) provides that "it is not necessary that all of the assets of the partnership or the corporation be utilized in the carrying on of the trade or business." Section 20.6166A-2(c)(2) of the regulations is to the same effect: "[T]he decedent's entire interest in the partnership, or . . . the corporation, constitutes an interest in a closely held business even though a portion of the partnership or corporate assets is used for a purpose other than the carrying on of a trade or business." It is unclear what percentage of the total assets of the partnership or corporation can be investment assets.[86]

Assuming that an appropriate percentage of business assets can be determined, there does not appear to be any requirement that the contribution of investment assets to a partnership or corporation be motivated by a bona fide business purpose.[87]

In the case of a proprietorship, the estate tax attributable to investment assets is not eligible for §6166 treatment. However, working capital can qualify as a trade or business asset.[88]

Finally, since the date for testing a stock or partnership interest as a closely held business interest is the "time immediately before the decedent's death," transfers of investment assets in "contemplation of death" should be recognized for purposes of §6166.[89]

G. Acceleration of Installment Payments

Since the privilege of paying estate taxes in installments is lost in the following circumstances, careful planning is required to prevent acceleration and to qualify, where possible, for the several exceptions.

1. Dispositions and Withdrawals

Pursuant to a 1981 change,[90] if any portion of a closely held business interest is distributed, sold, exchanged, or otherwise disposed of, or money and other property is withdrawn from the closely held business, acceleration occurs if the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50 percent of the value of such interest.[91]

Example: If an estate withdraws amounts equal to 30 percent of the decedent's interest in a closely held business and separately disposes of 20 percent of the decedent's interest in such business, acceleration will result.[92]

In the case of certain professional partnerships or corporations where the decedent's entire closely held business interest must be redeemed at death, acceleration would occur even if a long term obligation of the business is substituted for the stock or partnership interest.

a. Exception for "Excluded Property"

Acceleration by virtue of a withdrawal *never* applies to the withdrawal of "excluded property" within the meaning of Regs. §20.2032-1(d).[93] Basically, the phrase refers to property earned or accrued (or contributed) after the date of the decedent's death.

Example: A cash dividend attributable to earnings and profits accumulated after the decedent's death is not treated as a withdrawal of money or other property.[94]

Similarly, acceleration by virtue of a disposition can *never* occur in the case of a dispostion of an interest which is "excluded property."[95]

b. Exception for Death-Related Transfers

A disposition does not include a transfer of a closely held business interest by reason of the decedent's death (i.e., a transfer under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent).[96] The last of these death-related exceptions would permit distributions pursuant to a revocable *inter vivos* trust.[97]

Moreover, as a result of a 1981 change, there is no acceleration in the event of the death of any

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subsequent transferee if each transfer is to a member of the family (within the meaning of §267(c)(4)) of the transferor in such transfer.[98] No similar family restriction applies when the original decedent dies.

This change is quite important because it reverses an inequitable (and probably unintended) result under prior law.[99] In a substantial number of cases, the actuarial life expectancy of the surviving spouse will be less than 15 years. Thus, in such cases, the Congressional intent to provide a 15-year payout period is frustrated under prior law because acceleration occurred at the time of the death of the surviving spouse.

Finally, and quite importantly, this 1981 change applies to transfers after December 31, 1981, whether or not the original decedent died after the date.[100]

c. Exception for Mere Changes in Form

The regulations provide that a disposition does not include transactions which are "mere changes in form."[101] The regulations specifically provide that a disposition does not include a transfer of assets to a corporation in exchange for its stock in a transaction with respect to which *no* gain or loss is recognized pursuant to §351.[102] In addition, several private letter rulings have held that the transfer by beneficiaries of their interests in a sole proprietorship to a partnership under §721 is a mere change in the form of the business within the meaning of Regs. §20.6166A-3(e)(2).[103] Finally, a disposition does not occur where there is a change in the operation of a business from a corporate to an unincorporated form if such change does not alter materially the business or the interest of the estate in the business.[104]

However, if the shareholders do not act in concert after the liquidation, there is not a mere change in the form of the business. For example, where each shareholder individually conducts, as a proprietorship, a portion of the liquidated business, separate businesses are created and acceleration occurs.[105]

d. Exception for Certain Reorganizations

A disposition does not include an exchange of stock pursuant to a "D", "E", or "F" reorganization, or an exchange to which §355 applies (or so much of §356 as relates to §355).[106] Thus, a surrender of stock for stock pursuant to an "A," "B," or "C" reorganization will cause acceleration unless the transaction is a mere change in form.[107]

e. Exception for Section 303 Redemptions

Acceleration does not occur in the case of a distribution in redemption of stock to which §303 applies, *but only* if the amount of money and other property distributed is used to pay federal estate taxes[108] and paid on or before the first installment which becomes due after the date of distribution (or, if earlier,[109] on or before the day which is one year after the date of distribution).[110]

f. Interaction Between Aggregation and Acceleration Rules

If two or more closely held business interests are treated, pursuant to the aggregation rule, as a single interest, the acceleration rules also are applied as if a single interest existed. The value of the two interests are combined together to determine if a withdrawal or disposition occurs. One safe harbor rule results from the interaction between the aggregation and acceleration rules. The taxpayer's entire interest in one of two businesses could be disposed of without causing acceleration if the value of such interest represented less than one-third of the combined value (as included in the gross estate) of the two interests.[111]

2. *Failure to Pay Installments or Interest on Time*

In the event an installment payment or an interest payment is not timely made, the IRS has the right to accelerate the unpaid amount of estate taxes, *but* only upon notice and demand from the Service.[112] However, there is no acceleration if the delinquent payment is made within six months of its due date. When this exception is used, the 4 percent interest rate does not apply to the interest on the delinquent payment, and a 5 percent per month penalty is imposed.

The acceleration provision was extended by the 1981 legislation to delinquent payments of interest because, under prior law, if an estate did not pay interest during the initial 5 years of the 15-year period (as opposed to the remaining 10 years), there would be no acceleration of the remaining tax liability.[113]

3. *Undistributed Net Income of Decedent's Estate*

The executor, beginning in the taxable year ending on or after the due date of the first installment, must pay an amount equal to the "undistributed net income" of the estate in liquidation of the unpaid amount of estate taxes before the due date for the income tax return of the estate covering such year.[114]

III. ESTATE PLANNING OPPORTUNITIES

A. Maximization of Percentage of Closely Held Business Interests

During the taxpayer's lifetime, the value of closely held business interests as well as nonqualifying interests should be monitored on a continuous basis (i) to assure qualification with the threshold qualification requirement (35 percent of adjusted gross estate), and (ii) to maximize the portion of estate taxes eligible for installment treatment. As a result of such monitoring, gifts (including charitable gifts) or sales of nonqualifying property should be considered. Contributions of nonqualifying property to a qualifying partnership or corporation may be equally effective. Also, in valuing assets for estate tax purposes, the valuation of closely held business interests should reflect the two concerns described above.

B. Qualification as a Closely Held Business Interest

The formation and operation of a closely held business should be analyzed to determine whether the taxpayer's ownership portion qualifies as a closely held business interest.

1. *Percentage Interest versus Number of Partners or Shareholders*

In order to qualify, the taxpayer should own 20 percent or more of the capital interest of a partnership or 20 percent or more of the voting stock of a corporation, *or in the alternative*, the partnership should have 15 or fewer partners or the corporation should have 15 or fewer shareholders (taking into account the attribution rules in determining the number of owners).

2. *Capital versus Profits Interest in a Partnership*

In order to qualify, the taxpayer should own a 20 percent or more interest in *partnership capital* if the partnership has *more than* 15 partners (determining the number of partners with the benefit of the attribution rules).

3. *Voting versus Nonvoting Stock*

In order to qualify, the taxpayer should own a 20 percent or more interest in the *voting stock* if the corporation has *more than* 15 shareholders (determining the number of shareholders with the benefit of the attribution rules).

4. *Equity Interest versus Indebtedness in a Partnership or Corporation*

Since indebtedness owed to a taxpayer by a partnership or corporation does not qualify as a closely held business interest, the necessity for, and the amount of, such indebtedness should be evaluated. A recapitalization to convert indebtedness to a stock interest should be evaluated in light of the deferral benefits of §6166. Finally, a contribution of indebtedness to the capital of the partnership or corporation prior to death also can be considered where the circumstances so permit.

5. *Sale of Closely Held Business Interest Prior to Death*

The "freezing" effect for estate tax purposes of a sale of a partnership or stock interest for a long-term note prior to death should take into account the fact that the note will not qualify as a closely held business interest. On the other hand, post-sale appreciation will not be subject to estate tax.

C. Utilization of the Attribution Rules

The three sets of attribution rules (spousal, family, and entity) need to be carefully evaluated because they may allow a partnership or corporation to have additional owners without sacrificing the benefits of installment payment of estate taxes.

1. *Spousal Attribution Requires a Form of Joint Ownership*

Since spousal attribution is not limited to the decedent, it operates to reduce each pair of spouses to one partner or one shareholder. By contrast, family attribution would apply only to the decedent and the decedent's spouse. In order to utilize spousal attribution in a non-community property state, the spouses must own their stock or partnership interest as joint tenants, tenants by the entirety, or tenants in common. Although a joint tenancy or tenancy by the entirety may have its disadvantages, a tenancy in common may be the equivalent of separate ownership. Also, in order to take advantage of the interaction between spousal and family attribution (so as to include brothers-in-law and sisters-in-law), it is necessary to have some form of joint ownership between the spouses.[115]

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2. *Entity Attribution Requires a Present Interest for Trust Beneficiaries*

In establishing a trust which will be a partner or shareholder, a beneficiary must have a "present interest" in order for the stock or partnership interest owned by the trust to be treated as owned (on a proportionate basis) by such beneficiary.

3. *Necessity for Elective Attribution*

The election to apply the attribution rules should be carefully evaluated because of the dual restrictions which accompany such election (4 percent interest rate and 5-year interest only provisions would not apply). Oftentimes, the combined effect of the spousal, family, and entity attribution rules would make such an election unnecessary.

Example: If a corporation has 19 shareholders, including the decedent and his two sons and two daughters, and the stock interest of each family member is 8 percent of the voting stock of the corporation, the decedent's stock interest would qualify as a closely held business interest because the partnership (pursuant to family attribution) would be treated as having only 15 partners. Even though elective attribution would cause the decedent to own 40 percent of the voting stock and thereby satisfy the alternative 20 percent interest test (in §6166(b)(1)(C)(i)), only the decedent's 8 percent interest will count for purposes of the 35 percent adjusted gross estate requirement and the limitation on the amount of deferrable estate taxes.

D. Qualification for the Aggregation Rule

Since a taxpayer often may own more than one interest in a closely held business, careful attention must be paid to the rules permitting aggregation.

1. *Satisfaction of the 20 Percent or More Test*

The principal requirement for aggregation is that the value of each closely held business interest must equal 20 percent or more of the total value of each business; the numerical qualification test is unavailable. Accordingly, if there is leeway in choosing the taxpayer's ownership percentage, such percentage should equal or exceed 20 percent. Although estate taxes would be increased if a taxpayer's interest is increased to 20 percent only to satisfy this test, the benefits of aggregation may be more beneficial.

2. *Utilization of Spousal Attribution*

There is automatic attribution among spouses for purposes of the more than 20 percent requirement if, *and only if*, the spouses own their interest in some form of joint ownership.

3. *Necessity for Elective Attribution*

Because an automatic spousal attribution rule is included, the necessity for elective attribution should be carefully evaluated. Moreover, because elective attribution results in the loss of the 4 percent interest rate and the 5-year interest only provisions, it may be preferable for a taxpayer to own (with spousal attribution) 20 percent or more of the value of a business rather than dispersing the ownership of a business among several family members and utilizing elective attribution to satisfy the 20 percent or more requirement.

E. Satisfaction of Trade or Business Requirement

1. *Utilization of Exception for Investment Assets*

Since a partnership or corporation which is otherwise carrying on a trade or business can own investment assets, consideration should be given to placing investment assets within such active entity.

Example: A husband and wife are equal partners in a partnership carrying on an active business. The husband and wife could contribute to such partnership all or a portion of investment assets owned by them individually. Prior to the death of either spouse, distributions of investment assets from the partnership would not be taxable. However, on the death of either spouse, if aggregate withdrawals of money and other property (including investment assets) made with respect to the interest of the deceased spouse equalled or exceeded one-half of the value of the closely held business interest, acceleration will result.

2. *Qualification of Rental Real Estate as a Trade or Business*

In light of Rev. Rul. 75-365 and Rev. Rul. 75-367, if rental real estate is the sole activity, the IRS may inquire closely whether a trade or business is being carried on. However, the active-passive distinction which has been drawn in several post-1975 technical advice memorandums should provide guidance both to the Service personnel and to taxpayers and their representatives. Finally, the existence of these memorandums probably means that the Service, on audit, will not treat rental real estate as inherently an investment asset, but will apply a factual activity test to determine the existence of a trade or business.

3. Advisability of Partnership or Corporate Holding Company

If the Service's interpretation is correct, utilization of a partnership or corporation for the sole purpose of owning investment assets and interests in other partnerships or corporations may prevent qualification as a closely held business interest. Accordingly, whether or not the Service is correct, the safest approach is for the partnership or corporation in which the decedent owns an interest to carry on a trade or business directly (although it also can own investment assets and interests in partnerships or corporations).[116]

F. Utilization of Acceleration Exceptions

1. Acceleration Exception for Section 303 Redemptions Not Available to Partnerships

A corporation may be preferable to a partnership because §303 redemptions are not treated either as a disposition of stock or a withdrawal of money or other property.[117] By contrast, a redemption of a partnership interest to provide funds to pay estate taxes is counted for purposes of acceleration.

2. Acceleration Exception Not Available for Buy-out Agreements

Since acceleration occurs if 50 percent or more of the closely held business interest is sold, the typical buy-out arrangement would prevent an estate from qualifying under §6166. Acceleration would occur even if the partnership or corporation issued a long-term note to the estate that would be marketable, if at all, only at a substantial discount.

The Tax Section of the American Bar Association has recommended that acceleration should not occur to the extent that the consideration received in the disposition consists of obligations of the closely held business.[118] The obligation of the closely held business would be treated as an interest in the closely held business for purposes of applying the disposition and withdrawal acceleration rules. Thus, acceleration would occur if the aggregate of subsequent payments, distributions, sales, exchanges, or other dispositions of such obligation equalled or exceeded 50 percent of the value of such obligation. Conceivably, if the value of the obligation was equal to 50 percent of the face amount of such obligation, acceleration could occur when the estate received only 25 percent of the principal balance of the note. On the other hand, if acceleration was measured against the original value of the partnership or stock interest, there would be no acceleration until the estate received 50 percent or more of the face amount of the note.

IV. PROPOSALS FOR LEGISLATIVE CHANGES

The Economic Recovery Tax Act of 1981 made a number of significant changes in the availability and operation of §6166. Notwithstanding, §6166 continues to be burdened with numerous technical deficiencies, the continuation of which make this section a difficult estate planning tool on which to rely. In order to remedy these technical deficiencies, the following discussion will propose narrowly drawn solutions. In addition, a final legislative proposal will address whether §6166 should be restructured in a more fundamental fashion.

A. Necessity for Judicial Review

An overriding problem in this entire area is the fact that any dispute which arises under §6166 cannot be resolved in court, thereby making the IRS the sole arbiter of all controversies. This imbalance between the taxpayer and the Service needs to be remedied at the earliest possible time through the creation of a judicial forum for the resolution of all disputes arising under §6166. The declaratory judgment provision contained in the House-passed version of the Economic Recovery Tax Act of 1981 can serve as a model for legislation. However, decisions of the Tax Court should be reviewable by the circuit courts, as is the case with all other decisions issued by the Tax Court.[119]

B. Clarification of Status of Corporate and Partnership Holding Companies

In order to reflect present business practices which oftentimes utilize complex corporate and partnership holding company structures, §6166 should be clarified to permit a decedent to own a *direct* or *indirect* interest in a corporation or partnership carrying on a trade or business.[120] There is no justifiable reason for the Internal Revenue Code to exclude partnership and corporate holding companies from the benefits of §6166.

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The Congressional purpose underlying §6166 (to provide a long-term payout to estates with liquidity problems in order to prevent a forced sale to larger publicly-owned companies) is equally relevant in the case of holding companies and entities without corporate or partnership subsidiaries.

C. Closely Held Business Interest Should Include Indebtedness

Section 6166 should be amended to permit indebtedness to qualify for deferral benefits if the decedent's equity interest in the partnership or corporation, standing alone, would constitute a closely held business interest for purposes of §6166. Section 6166 should not contain a bias in favor of equity over indebtedness.

D. Elimination of Distinction Between Capital and Profits Interest in a Partnership

Under present law, if a partnership has more than 15 partners (determined by taking into account the three attribution rules), the decedent must own 20 percent or more of the total capital interest in such partnership in order to qualify for §6166. There are several reasons to amend §6166(b)(1)(B)(i) to eliminate the distinction between an interest in partnership capital and an interest in partnership profits. First, if the partnership has 15 or fewer partners, the decedent's partnership interest can qualify even if such interest is limited to partnership profits. Second, for purposes of the aggregation rule in §6166(c), the decedent must own 20 percent or more of the *total value* of each business without regard to whether the decedent's partnership interest relates to capital or profits. Finally, numerous sections of the Internal Revenue Code provide for attribution between a partner and a partnership where the partner owns a prescribed interest in either partnership profits or partnership capital.[121]

E. Elimination of Distinction Between Voting and Nonvoting Stock

Under present law, if a corporation has more than 15 shareholders (determined by applying the three attribution rules), the decedent must own 20 percent or more in value of the voting stock of such corporation in order to qualify for §6166. There are several reasons §6166(b)(1)(C)(i) should be amended to eliminate the distinction between voting and nonvoting stock. First, if the corporation has 15 or fewer shareholders, the decedent's stock interest can qualify even if such interest is comprised solely of nonvoting stock. Second, for purposes of the aggregation rule in §6166(c), the decedent must own 20 percent or more of the *total value* of each business without regard to whether the decedent's stock is voting or nonvoting. Finally, several provisions of the Internal Revenue Code provide for attribution between a shareholder and a corporation where the shareholder owns a certain minimum percentage of the value of the outstanding stock (including both voting and nonvoting stock).[122]

F. Solution to Interest As an Administration Expense

An extremely complicated situation is presented because interest throughout the 15-year period is deductible as an administration expense under §2053, but a deduction can be claimed only when the interest is actually paid or accrued. The simplest method of eliminating the complex procedures prescribed by the Service, while retaining the economic benefit of the deduction, would be to amend §2053 to exclude interest as a deduction but to reduce the interest rate to compensate for such elimination.[123] Conceivably, the 35 percent adjusted gross estate threshold requirement and the limitation on the amount of estate taxes deferrable under §6166 could be revised to take into account the fact that the adjusted gross estate will increase as a result of the proposed changes.

G. Coordination with Subchapter S Provisions

In order to preserve the historic relationship between the Subchapter S provisions and the estate tax deferral provisions, a decedent's interest in a corporation should qualify under §6166 if such entity has 25 or fewer stockholders.[124] In order to achieve additional coordination between the two provisions, the spousal attribution rules (in §6166(b)(2)(B) and §6166(c)) should be revised to eliminate the common ownership requirement and to include estates of deceased spouses.

H. Simplification of Attribution Rules

Under present law, in determining whether the 15-person numerical test is satisfied, three entity attribution rules are applicable: spousal, family and entity. In determining whether the percentage ownership test is satisfied, the executor can elect to apply these three attribution rules by giving up the 4 percent interest rate and the 5-year interest only provisions. Moreover, the attribution rules do not operate in the same fashion, since spousal and entity attribution are not limited to the decedent, whereas family attribution applies only between the decedent and members of his family. In addition, in the case of a husband and wife where one of the spouses is the decedent, both spousal and family attribution would be applicable, although spousal attribution is limited to situations in which the closely held business interest is jointly or commonly owned.

Present law should be amended to combine the spousal and family attribution rules into a single provision applicable to all owners and not just the decedent. In addition, in order to preserve the current interaction between family and spousal attribution, the definition of family should be amended to include spouses of an owner's brothers and sisters as well as spouses of such owner's lineal descendents. Finally, the entity attribution rule should be retained in its present form.

I. Expansion of Aggregation Rule to Include Numerical Test

Aggregation under §6166(c) should be permitted for each of the decedent's interests which satisfy either the numerical or percentage qualification tests. Since modern business practices often favor the creation of multiple entities, §6166 should not impose a stiffer requirement in the case of two or more entities, but provide a more lenient qualification standard where the decedent dies owning a single closely held business interest.[125]

J. Expansion of Acceleration Exceptions

Since buy-out agreements are often an essential element in the continuation of a closely held business after the death of one of the owners, §6166 should be amended to permit an estate to sell its stock or partnership interest in exchange for a note without resulting in acceleration. The American Bar Association has recommended this specific change.[126]

In addition, in order to enable buy-outs to occur prior to the death of one of the owners, §6166 should be amended to permit a note receivable from a corporation or partnership to be eligible for the deferral privileges if the decedent had died owning such interest and such interest would have qualified under §6166.

The acceleration exception for §303 redemptions should be expanded to permit the proceeds of such redemption to be used for any of the purposes enumerated in §303(a).[127] Under current law, a §303 redemption can include amounts sufficient to cover federal and state death taxes, interest on such death taxes, and funeral and administration expenses under §2053, whereas §6166(g)(1)(B) is limited to federal estate taxes.

In addition, the acceleration exception should be expanded to provide equivalent treatment for partnerships. There is no justification for permitting an estate to receive funds from a closely held corporation to pay enumerated expenses without causing acceleration, but to deny that privilege to partnerships. Acceleration is not justified in either case because the estate must pay such expenses with the funds it receives from the entity.

The acceleration exception in §6166(g)(1)(C) should be expanded to include all reorganizations under §368 if the stock received by the decedent's estate (or heirs) would have qualified as a closely held business interest if owned by the decedent on the date of his death or constitutes non-readily-tradable stock within the meaning of §6166(b)(7)(B). In effect, closely held businesses should be allowed to be acquired by unrelated closely held businesses without causing acceleration.[128]

Finally, the acceleration exception for *subsequent* death-related transfers should be amended to repeal the family limitation.[129] When the original decedent dies, §6166 is available whether or not the decedent leaves any portion of the estate to non-family members. However, on the death of an heir of the original decedent, the acceleration exception is available only if the subsequent transferee is a member of the transferor's family. There are many situations in which business associates (including employees) and charitable organizations are beneficiaries of an estate. In effect, under present law, an heir of the original decedent is penalized if the closely held business interest is left, in whole or in part, to such business colleagues or charitable organizations.

K. Should Section 6166 Be Restructured?

Section 6166, as presently structured, may not necessarily represent the most effective means of addressing the liquidity problems faced by estates comprised principally of closely held business interests. The definition of a closely held business interest is based either on the number of

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owners or the decedent's percentage interest in such business, coupled with the requirement that such entity carry on a trade or business. Thus, illiquidity is presumed only if the mechanical statutory requirements are satisfied.

It is possible that §6166 would operate more efficiently if a complex analysis was made of each of the assets of the closely held business to determine if any of such assets are both liquid and not reasonably necessary for the operation of the trade or business. Presumably, these types of assets would not qualify for §6166 treatment. However, such an analysis most probably would be quite complex and would lead to numerous factual controversies with the IRS. In addition, any liquid assets which are held by the closely held business are at the risk of that business and the withdrawal of those assets may cause acceleration if large enough in relation to the value of the decedent's closely held business interest. Finally, if the decedent's estate is not the sole or controlling owner of the business, there can be no guaranty that such business would distribute liquid assets to the estate. In light of these concerns, a more effective method of restructuring the statute would be to change the rules governing contributions to, and distributions from, a closely held business.

With respect to contrbutions, the special situation involving wholesale transfers of investment assets to a closely held business could be effectively remedied by utilizing the approach contained in §341(e)(7). Thus, §6166 could be amended to make it unavailable to the extent attributable to any amount received by a partnership or corporation "if it appears that there was not a bona fide business purpose for the transaction in respect of which such amount was received."

The acceleration rules may be too generous in that they permit liquid assets to be withdrawn from the business and retained by the estate without causing acceleration if the amount of the withdrawal is less than 50 percent of the value of the closely held business interest. Probably a better approach would be to require the estate to use 50 percent of each distribution (including "excluded property") in payment of specified obligations (including taxes and related interest). Thus, instead of the current system whereby the estate retains the first 50 percent and the second 50 percent goes to the payment of taxes, each distribution would be split equally between the estate and the tax and related liabilities. In addition, the lack of coordination with §303 would be corrected by permitting the estate to use 50 percent of each distribution to pay any of the items described in §303(a)(1) and (2) (federal and state death taxes, interest on such taxes, and funeral and administration expenses.)[30]

Finally, to the extent an estate used more than 50 percent of any distribution to pay amounts described in §303(a)(1) and (2), the estate would be permitted to retain such excess out of the next distribution. In this fashion, the statute would equalize the treatment between estates which utilize distributions to pay estate taxes and related expenses and estates which pay these amounts with other assets.

FOOTNOTES

[1]P.L. 97-34, sec. 422.

[2]The literature under §6166, prior to the 1981 amendments, is very extensive. In particular, three articles should be consulted: Hood, Chalstrom, Brown, "Special Elections: The Use of Sections 6166, 6166A And 303 Of The Internal Revenue Code," 47 U. Mo.-Kan. City L. Rev. 485 (1979); Curran, Jr., "Estate Planning for Owners of Closely Held Corporations: A Critical View of Code Sections 303, 6166 and 6166A," 20 B. C. L Rev. 648 (1979); and Abramson, "Closely Held Business — Installment Payment of Estate Tax," 1981-2 TMEGJ 4 (1981).

[3]Generation-skipping taxes are not eligible for the benefits of §6166. §2621(b).

[4]§6166(a)(1), as amended by P.L. 97-34, sec. 422(a)(1).

[5]§6166(a)(1)

[6]§6166(a)(2). In computing the fraction with respect to a proprietor, the value of the closely held business interest is the net amount a purchaser would pay for the interest, not the total value of the assets of the proprietorship Rev. Rul. 80-202, 1980-2 C.B. 363.

[7]§6166(f)(1)

[8]§6166(f)(2).

[9]§6601(j)(1) and (2).

[10]2010(a), as amended by P.L. 97-34, sec. 401(a).

[11]Each installment payment of estate taxes reduces the "4 percent portion" on a proportionate basis. §6601(j)(3). See Regs. §20-6166-1(i), Example 3, for an illustration.

[12]As prescribed in §6621(c), as amended by P.L. 97-34, sec. 711(b).

[13]§6601(e)(2).

[14]§6166(b)(6). The amount of the gross estate is affected by an election under §2032 to use the alternate valuation date or an election under §2032A to utilize actual use valuation for a farm or other business real property. The gross estate would be augmented by assets, including closely held business interests, includible pursuant to §2035-2038.

[15]§6166(b)(6)

[16]See *Estate of Bahr v. Comr.*, 68 T.C. 74 (1977), acq., 1978-1 C.B. 1, and Rev. Rul. 78-125, 1978-1 C B. 292.

[17]Regs. §20.2053-1(b)(3).

[18]Rev. Rul. 80-250, 1980-2 C.B. 278.

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Senator SYMMS. I wish to thank all of the members on the panel. I really appreciate the effort that you have put together which will be very helpful for this committee in formulating the legislation.

I would like to mention also that we will keep the record open for 30 days on the hearing. If you wish to make further comments after having heard Treasury's testimony this morning, we would appreciate those comments also.

I want to thank you all very much for very concise testimony, and also the addendum which will be part of the record which will be helpful to the committee also. Thank you very much.

I guess we are ready now for Mr. David R. Brink, president of the American Bar Association, and Mr. Bernard Barnett, chairman of the Federal Tax Division's Task Force for Estate and Gift Tax Reform, for the Federal Tax Division of the American Institute of Certified Public Accountants.

Welcome to the committee, and go right ahead, Mr. Brink.

STATEMENT OF DAVID R. BRINK, PRESIDENT, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION; AND JACKSON M. BRUCE, DIVISION DIRECTOR, PROBATE AND TRUST, SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

Mr. BRINK. Mr. Charman, thank you.

My name is David R. Brink. I am president of the American Bar Association. I am accompanied here by John S. Nolan, chairman of our section of taxation, and Jackson M. Bruce, division director of our section of real property, probate and trust law.

I am here to testify in support of S. 1695 which would repeal the tax on generation-skipping transfers. I have filed a full formal statement on behalf of the ABA, but with your permission, we will make a fairly brief, informal oral statement.

Senator SYMMS. Your entire statement will be made part of the record.

Mr. BRINK. Thank you.

I might say that Mr. Glickman, whose views were expressed to me for the first time this morning, really should have made my job easy because he and I seem to agree on the premises, but I think we do not have agreement as to the conclusions that follow from those premises.

I really testify today in two capacities. The first is my official capacity on behalf of the ABA. The ABA has 280,000 members, representing every segment and point of view of American lawyers. Its policymaking body is a 385-person house of delegates, whose members also hold many diverse views. It is, believe me, unusual and remarkable when they all agree on anything. But on August 11, 1981, they voted unanimously that the generation-skipping tax should be repealed.

My unofficial capacity is that, when I am able to practice law, which currently is seldom, for more than 30 years I have practiced in the field of estate planning, probate, trusts, and taxation. In my capacity as a private practitioner, my job is partly to help clients achieve legitimate tax savings. But, I am not a professional tax hater. I fully knowledge the revenue needs of running the country and, sometimes with less enthusiasm, the occasional use of the tax laws purely to serve social policy. Frankly, I am embarrassed to bill a client for my time spent in trying to understand and avoid the hidden traps of this most complex, obscure, and financially insignificant of all tax laws. My personal conclusion is that in all my years of practice, I have never seen a tax that, as much as the generation-skipping tax, so strongly cries out for repeal.

The generally recognized tests of a good tax law are: Is it a significant revenue measure? Can it be administered effectively? Does it serve a valid policy? The generation-skipping tax dismally fails, not one, but all of those tests. There is no way, in my opinion, that this fundamentally bad tax can be patched up and masquerade as a desirable tax.

The tax is not a significant revenue measure. Even when passed in 1976, it was expected to generate only about $280 million annually, and then only years in the future, when the law became fully effective and many living or yet unborn persons had died. That sum would be a lot of money to you and me, and all of us, but even if the money were available now, instead of in the distant future, it would represent only 3.8 percent of current Federal transfer tax revenues and, note this, only 0.046, stated in terms of percent, of all Federal revenues. Infinitesimal as that may seem, that eventual revenue estimate now must be greatly decreased because of the changes in the tax law effected by the Economy Recovery Tax Act of 1981, just passed by Congress. Some current estimates are that the generation-skipping tax now will actually raise only about one-half of the comparatively minuscule revenue projected in 1976. If the costs to Government of administering and policing what I think Mr. Glickman said was a controversial, complex and obscure law, are deducted, even without deducting the legal and accounting costs to actual and potential affected citizens, it becomes clear, I think, that the future net revenue would hardly pay the Treasury's light bill.

The generation-skipping tax cannot be effectively administered. Neither Government nor taxpayers and their advisers have the capability of recognizing and responding to all the infinite series of occurrences that might cause a taxable event under the generation-skipping tax law. Even those experts, either in Government or representing clients, who think after 5 years of intensive study that they understand most of the applications of the law, always turn out to be in disagreement on many points. We do know only that taxable events can be either taxable terminations or taxable distributions and those terms are defined for this purpose in such a way that the tax may be triggered by events having nothing to do with terminations, distributions, deaths, or transfers as any of us have known and would recognize those terms. The tax is essentially treated as being on an addition to the estate of a person who may be still living, newly deceased, or deceased for many years, who may even be identified only after a long succession of events, or who may have actually received nothing whatsoever out of the transfer taxed. It imposes burdens of recordkeeping, constant vigilance over events, and continuous legal advice that neither Government nor individuals can provide, and I think Mr. Glickman's testimony supports that statement. There is no agreement on many questions of computing the tax. As was said today, 5 years after the generation-skipping tax, the Treasury has not been able to produce tax return forms, reporting forms, or published regulations on how to compute the tax. Because neither Government nor taxpayers can cope with the administration of the tax, both the well-intended and the not-so-well intended may escape the tax. That is not, I suggest, the kind of precedent to set in even 1 minute, part of an American tax system that depends on voluntary reporting and efficient governmental tax administration.

The generation-skipping tax serves no valid policy. The original policy was said to be to extract a tax "at reasonably uniform intervals" and "generation by generation." The actual law often does neither. Some have thought that the unstated policy behind the tax was to prevent accumulation of capital in private hands. But the small amount of revenue produced and our enactment of other measures to stimulate renewed private capital investment belie that purpose. The policy might have been to penalize the very rich. If so, it often misses its mark because those whose families don't need additional lifetime benefits can employ devices called skip overs, by-passes, or layering to avoid the tax on immediately ensuing generations. That seems to leave the burden squarely on the successful middle class, represented in large part by farmers and small businessmen. Such a policy is also inconsistent with the most recently expressed intent of Congress. In the Economic Recovery Act of 1981, we reduced the impact of transfer taxes and simplified administration by raising credits or exemption equivalents, eliminating limits on tax-free transfers to spouses, liberalizing exclusions on lifetime transfers and reducing rates on high-bracket estates. That had the calculated purpose of lowering the heavy fiscal burden and simplifying life for the same taxpayer on whom we try to impose this unworkable tax.

The fact is that this tax serves no current policy, is imposed on the wrong people in an almost unenforceable way, is terribly costly for the Government and clients, and produces little revenue.

The generation-skipping tax law is known to some as the relief act for lawyers, accountants, and treasury staff. The lawyers, certainly, don't want it. The accountants, I believe, don't want it. The Treasury staff, according to its proposal that we heard in sort of vague outline form today, say that we can somehow patch it up. The Treasury staff may want the old shirt patched up, but a tattered garment that doesn't fit anyone isn't worth the embroidery. It ought to be thrown out.

We urge the repeal of the generation-skipping tax and the support of S. 1695.

I would like to comment just for a moment on the amendments to section 6166. Those are under study in our Tax Section, and I believe in our real property, probate, and trust law section. We may have helpful proposals with regard to that. We do not have a position, but we would like to submit one at a later time.

Thank you very much, Mr. Chairman.

[Statement of Mr. Brink follows:]

STATEMENT OF DAVID R. BRINK
PRESIDENT OF THE AMERICAN BAR ASSOCIATION

My name is David R. Brink. I am President of the American Bar Association, and I am accompanied by John S. Nolan, Chairman of the Association's Section of Taxation, and Jackson M. Bruce, Jr., a Director of the Probate and Trust Division of the Association's Section of Real Property, Probate and Trust Law.

I realize that this hearing has been called for the purpose of considering a number of issues in the federal transfer tax area. However, with your permission, I intend to confine my testimony this morning to a single federal transfer tax issue of overriding importance - an issue which, more than any other in the federal transfer tax area, calls for immediate Congressional action.

The issue to which I am alluding is the repeal of the federal tax on certain generation-skipping transfers. The American Bar Association has devoted a substantial amount of time, talent and effort to this issue over a period of several years, and I am grateful for this opportunity to share with you the Association's position on the matter.

The Association Supports Repeal of the Generation-Skipping Tax

The American Bar Association, with membership in excess of 275,000 attorneys, strongly supports the immediate repeal of the federal tax on generation-skipping transfers. After several years of detailed study, the Association's Sections of Taxation and Real Property, Probate and Trust Law have recommended that Chapter 13 be repealed. On August 11, 1981, a formal resolution advocating such repeal was adopted by the unanimous vote of the Association's House of Delegates.

The Association wishes to commend you, Mr. Chairman, for introducing S. 1695. This bill has the Association's complete support.

The Association is fully aware of the gravity of this matter and of the implications of the position it takes. The Association realizes that a call for repeal of an entire federal tax concept should be a position of last resort at which one arrives only after careful and thorough investigation. I can assure you, however, that the Association has assumed its pro-repeal position only after years of study and analysis. Furthermore, the Association has consistently cooperated with Congress and the Department of the Treasury in the attempted implementation of the generation-skipping tax concept. Although there are many examples of this cooperation, I will cite only one as evidence of the point. After a five year wait, the first substantive regulations under Chapter 13 were finally published on January 2 of this year. These regulations spanned nine pages in the Federal Register, and they were loaded with problems and unaddressed issues. The Association submitted 136 single-spaced pages of technical (and critical) commentary to the Treasury Department in reaction to these nine pages of regulatory material.

The several reasons for the Association's pro-repeal position are set forth in some detail in the following sections of this statement. The Association has examined, and is prepared to address, the three fundamental questions that must always be answered in an exercise of this nature. Is the tax significant from a revenue perspective? Can the tax be administered effectively both in terms of cost and in terms of compliance? Does the tax serve the purposes intended for it by Congress? Regretfully, the Association is forced to answer all three of these questions in the negative.

Does the Generation-Skipping Tax Have Any Revenue Significance?

History tells us that, in the main, the reason for the enactment of federal transfer taxes has been the generation of revenue. Thus, it seems fitting to begin the examination of Chapter 13 by assessing its revenue impact. According to a study prepared by the Staff of the Joint Committee in 1976, the short-range estimate of generation-skipping tax revenue was nil and the long-range estimate was

$280 million annually. See Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 21 (Comm. Print 1976). These projections assumed a unified credit of $47,000, and, as you know, the amount of that credit has been dramatically increased by the Economic Recovery Tax Act of 1981 so that, for taxable years beginning in 1987, the allowable unified credit will be $192,800, more than four times the amount of unified credit assumed by the Staff of the Joint Committee in its 1976 revenue projections.

The Association realizes that to some extent this increased unified credit may be used by the Chapter 13 "deemed transferor" for his or her own federal estate and gift tax purposes. Nevertheless, if one were to factor this increased unified credit into the Chapter 13 revenue projections, it seems clear that the long-range revenue estimate would be reduced below the $280 million figure advanced in 1976. Even assuming the now obsolete $280 million long-range estimate, the generation-skipping tax, seen in the grand scheme of federal revenue, represents a virtual nullity. According to a recent study conducted by the Staff of the Joint Committee, all federal transfer taxes in the aggregate will produce an estimated $7.2 billion in 1981, only slightly over one percent of total federal revenues. See 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). If the now too high $280 million projection of long-range generation-skipping tax revenue were assumed to be available in 1981 instead of twenty years down the road, it would represent only 3.8 percent of aggregate 1981 federal transfer tax revenues and only .00046 percent of total 1981 federal revenues.

In short, the tax on generation-skipping transfers has no meaningful revenue significance and cannot be defended on revenue grounds.

Can the Generation-Skipping Tax Be Effectively Administered?

In the view of the American Bar Association, the most damning features of Chapter 13 are revealed by considering whether the tax can be effectively administered. Analysis of this issue must focus on two considerations. First, what is the cost to government of the administration of this tax, and can that cost be justified by reference to policies served by the tax? Second, and perhaps more important, can the tax be adequately and fairly enforced? As to both of these considerations, the Association sees nothing but trouble ahead, trouble that will breed disrespect for our voluntary compliance tax system.

Let us examine first what is perhaps the easier of the two questions just raised. What is the cost to government of the administration of this tax and can that cost be justified by reference to policies served by the tax?

In order to collect the generation-skipping tax, the government must develop the capacity to recognize the Chapter 13 taxable event and to compute the Chapter 13 tax. In neither endeavor can the government succeed, and the cost of trying will be enormous.

First, in order to identify the Chapter 13 taxable event, the Internal Revenue Code tells us to look for something called a "generation-skipping transfer." See IRC §2601. Generation-skipping transfers come in two varieties: taxable terminations and taxable distributions. See IRC §2611(a). Unfortunately, both varieties can occur by reason of events so subtle and discreet in nature, and so unlike anything known in the federal estate and gift tax areas, as to go unnoticed by the taxpayers in question, by their professional advisors and by the government.

In the context of taxable terminations, for example, many taxpayers will never understand that the resignation, removal or death of a trustee may be a generation-skipping transfer. These people, rightly or wrongly, will always be surprised that an event so seemingly unrelated to the devolution of property can trigger a transfer tax liability. Conversely, many will never fathom that certain taxable terminations are not taxable events either because of the application of a confusing doctrine called the "separate share rule" or because of the application of one of the four complex postponement rules spawned by IRC §2613(b).

Turning to taxable distributions, scores of complexities may hide the taxable event from the taxpayer and the government. One might think this odd inasmuch as, compared to taxable terminations, the taxable distributions concept appears at first blush simple and straightforward. After all, something is actually distributed to someone, and that should be enough of a red flag to alert everyone to the possibility of a taxable event. Unfortunately, however, that is not always so. For example, there is an "income only" exception to this taxable distributions rule, and many distributees may believe themselves to be protected by that exception when, in fact, they are not. Indeed, one may receive accounting income from a generation-skipping trust which by reason of subsequent events is, in a most complicated way, deemed to be principal. The circumstances which work this recharacterization are not only beyond the control of the distributee, but may not be understood by the trustee who is supposed to notify the distributee of the switch.

Most of the development of this "income only" exception has been thrust upon the Treasury Department, and, predictably, as with the taxable termination problems cited above, the regulations' writers have failed to untie the Gordian knot. I would refer you in this regard to the American Bar Association's 136 page commentary which I mentioned earlier. This Commentary treats at some length several unanswered (and perhaps unanswerable) questions in the "income only" exception area.

The point of all of this is that, like it or not, right or wrong, taxpayers and their professional advisors will often not be cognizant that a Chapter 13 taxable event has occurred. This places an especially heavy burden upon the government (if Chapter 13 is to be a viable tax system) to have sufficient information to insure that it will know when a Chapter 13 taxable event has taken place. But will the government know? Can it know?

The answer seems to us to be clearly, "No!" In order to police Chapter 13 effectively, the government would have to devise a system to keep track of all trust beneficiaries, all trustees and all others holding "powers" under the untold thousands of "generation-skipping trusts" in existence from time to time. The government would have to know when each interest or power under each such trust terminates and when each trustee dies or leaves office. It would have to 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.

And the adventure does not end with trusts. The government would have to have access to similar information with respect to the multitude of "generation-skipping trust equivalent" arrangements subject to the Chapter 13 tax. Unfortunately, at this point there is not even general agreement regarding which non-trust arrangements merit treatment as trust equivalents. For example, violent reaction was recently generated by the Treasury's announcement that, in certain circumstances, probate estates and custodianships under Uniform Gift to Minors Acts will be considered generation-skipping trust equivalents even though to most observers these arrangements seem too fixed in character, too finite in duration and too far removed from any sort of conduct to which Chapter 13 may have been directed to deserve such classification.

Even if the government could derive the means to obtain and store all of the data required to identify the Chapter 13 taxable event, there would be a second overwhelming administrative chore facing government - properly computing the Chapter 13 tax. Here, as in no other place in Chapter 13, the government seems bound to be confounded by an inherent weakness in the generation-skipping tax concept.

In order to compute the Chapter 13 tax, one must find the so-called "deemed transferor" with respect to the generation-skipping transfer in question. To find this deemed transferor, one must first find the "transferees".

(because one gets to the deemed transferor only by reference to these transferee individuals).

Chapter 13 does not define "transferee." Congress left that crucial job to the Treasury Department. In the proposed regulations issued on January 2 of this year, Treasury failed to develop rules that permit transferee identification in all cases. This is small wonder in view of the limitless variety of discretionary interests possible under the common law trust.

Suppose, however, that the transferees can be determined, and, through them, the identity of the deemed transferor can be discovered. Because the Chapter 13 tax is computed by reference to certain tax attributes of the deemed transferor, the government must know all about the deemed transferor's federal gift, estate and generation-skipping tax history. While, clearly, this information is within the government's grasp, what may not be so apparent is that the information must be retained and stored for years and years after the deemed transferor has died, a retention problem not encountered prior to Chapter 13.

Furthermore, the government must be prepared to share this information with Form 706-B tax return preparers. Why? IRC §2603(a)(2)(A) requires it. Of course, this further increases the cost of administering Chapter 13.

Moreover, the sharing of deemed transferor information with taxpayers is a circumstance tailor-made for disagreement and controversy. Even a taxpayer who realizes that a generation-skipping transfer has occurred may not be able physically to locate the deemed transferor. Indeed, there are many instances where the deemed transferor has absolutely nothing to do with the generation-skipping trust in question, making such location extremely difficult. Or if a taxpayer can physically locate the deemed transferor, that deemed transferor may be unwilling to share the needed transfer tax history information with the taxpayer. When, as will often be the case, the taxpayer cannot get the needed information from the deemed transferor, the taxpayer is forced to ask the government for help, and the government is obligated to incur the expense of responding.

But is the taxpayer protected if he relies on the information the government supplies? If the taxpayer is a trustee, he is certainly protected from the IRS, but he is not necessarily protected from generation-skipping trust beneficiaries. Indeed, such beneficiaries may seek to surcharge the trustee-taxpayer, claiming that he has a fiduciary duty to verify that the information provided by the government is accurate. To avoid the possibility of surcharge, Chapter 13 trustee-taxpayers may, in many cases, feel obliged to put the government to the further expense of explaining just how the information provided was derived.

All of this not only inflates the cost of Chapter 13 administration, but, at the same time raises very troublesome Constitutional and practical problems. Commentators have expressed significant concern about the invasion of the deemed transferor's right to privacy that is necessitated by Chapter 13 and about the gradual deterioration of our voluntary tax assessment system that may result from the Chapter 13 mode of computing tax.[1]

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[1]See in this regard Hartley and Fitzpatrick, "Tax Information Disclosures under the Generation-skipping Tax: Due Process v. Right of Privacy," 32 U. of Fla. L. Rev. 62-94 (1980), wherein at page 94 the authors conclude:

> The invasion of the deemed transferor's privacy virtually necessitated by the generation-skipping tax structure and countenanced by Sec. 6103 may lead to valid questioning of the constitutionality of Chapter 13. Furthermore, knowledge that their tax information may be involuntarily disclosed to other individuals under Chapter 13 provisions may cause taxpayers to be less complete in their disclosures to the government thereby causing a gradual deterioration of our voluntary tax assessment system.
>
> Thus, although Congress may have the constitutional authority to impose a tax system requiring disclosure of tax information of the deemed transferor, Congress should consider whether it is willing to risk this potential chilling effect on the self-assessment system. The seriousness of these problems warrants congressional consideration of alternative methods of taxing generation-skipping transfers or, at least, statutory safeguards for the deemed transferor's privacy rights.

Where does this leave us with respect to the question of the cost of Chapter 13 administration? First, I think it is clear that the cost of a proper administrative effort would be mind-boggling. Second, no matter what resources are devoted to the task, it is doubtful that the government can ever derive and maintain the needed information.

This brings us to the second question raised at the beginning of this section of my statement. Can the tax be adequately and fairly enforced? To some degree, we have already answered this question in the foregoing discussion of the costs of Chapter 13 tax administration. From that discussion, it emerges clearly that the government alone cannot insure the full and fair enforcement of Chapter 13. The task is simply beyond government's means.

In my earlier remarks, I also suggested that, in view of certain Chapter 13 complexities, taxpayers could not be counted upon voluntarily to comply with Chapter 13 in every instance (or, for that matter, in lots of instances). There can be no doubt that Chapter 13 is among the most ultra-complex and sophisticated tax concepts this country has ever known. Legal scholars are in complete agreement on this point. I want to stress, however, that it is not simply because Chapter 13 is very complicated that the American Bar Association opposes it. This tax is of very widespread application. Every estate planner is forced to contend with its intricacies each time he or she sits down to draft a will or trust agreement. And, as mentioned in my prior remarks, the tax applies beyond the realm of trusts in the context of that vast multitude of non-trust arrangements known as "trust equivalents."

This combination of hypercomplexity and widespread application convinces me that there always will be vast numbers of taxpayers who will observe Chapter 13 in the breach out of simple, and, I think, forgiveable, ignorance. Even more troublesome, there always will be individuals who deliberately will fail to self-assess a Chapter 13 tax because they understand the government's inability to enforce the tax fully. To the American Bar Association, this seems the sort of situation that should be avoided at all cost, a situation that strikes destructively at the very heart of our American tax system.

In addition, the monumental complexity of this Chapter 13 tax may well be producing a sad side-effect almost as deleterious as the disrespect for our voluntary compliance system just suggested. The preparation of wills and trusts should not be the sole province of those precious few tax "experts" who have the resources to devote substantial time to the mastery of something like the generation-skipping tax. Many attorneys rightfully deliver will and trust services to hundreds of thousands of clients sorely in need of testamentary planning. If these practitioners cannot serve their clients without substantial fear of breaching some Chapter 13 tenet, they may develop a reluctance to perform these kinds of needed legal services.

In short, we conclude regretfully and with great concern that Chapter 13 cannot be administered adequately and fairly.

<u>Does the Generation-Skipping Tax Serve Its Intended Purpose?</u>

When the generation-skipping tax was enacted in 1976, Congress said that it hoped by Chapter 13 to insure the extraction of federal transfer tax from generation-skipping trust property "at reasonably uniform intervals" and "generation by generation." Clearly, the tax does not function with such regularity. Rather, the Chapter 13 taxable event is arrhythmic and arbitrary, often triggered by events having nothing to do with the devolution of property from generation to generation.

Congress said that the Chapter 13 tax "would be substantially equivalent to the estate and gift tax which would have been imposed if the property had actually been transferred outright to each successive generation." As it turns out, not only can the tax sometimes be assessed at a generation level at which there is no one with any beneficial interest in the property, but also the tax is by no means equivalent to the federal estate and gift taxes. In some respects, an attempt has been made to create equivalence between the generation-skipping tax and the federal estate tax, although the equivalence is far from complete. In no respect has an effort been made to establish a measure of equivalence between the generation-skipping tax and the federal gift tax.

Congress said that it intended that Chapter 13 would operate in a "neutral" fashion in the context of trusts so that, on the one hand, "there [would] be no tax advantage available in setting up trusts" and, presumably, on the other hand, the "many legitimate non-tax purposes for establishing trusts" would be protected. You received substantial testimony at your May 1 and June 5 hearings suggesting that, in actual practice, Chapter 13 has had an adverse, rather than a neutral, effect upon trusts. Not only has this tax precipitated significant additional expense in the administration of the trust form of business enterprise but, in addition, it may well have acted as a discouragement to individuals who might otherwise have established such entities.

Some have said that the generation-skipping tax was needed because clever estate planners "were making a monkey out of the estate tax" by establishing generation-skipping trusts. Well, suppose a father establishes a trust for the benefit of his son, his grandson and his great-grandson and instructs the trustee to pay any part or all of the income or principal of the trust to any one or more of these descendants as the trustee decides appropriate for their respective maintenance and medical care. This trust is a generation-skipping trust. Now suppose further that the trustee never pays a nickel to the son because, in the trustee's judgment, it is never once during the son's life appropriate to make a distribution for the son's maintenance or medical care. Clearly, the son's death is, nevertheless, a taxable termination, and a generation-skipping tax is assessed against the entire trust property with the son as deemed transferor. . . . .

But what did the son ever get? He never received a cent from the trust; he never had a right to demand a cent from the trust. He could not, in the normal case, borrow funds from a bank using the trust as collateral. Why should the entire trust be taxed at his death as though he owned the trust property outright and it sat piled on top of the other assets that formed his gross estate for federal estate tax purposes? He had nothing of measurable value and yet the generation-skipping tax operates as though he owned the entire trust property. In this example, is the creator of the trust "making a monkey out of the federal estate tax" or is it the other way around?

There is some suggestion in the legislative history behind Chapter 13 that only wealthy Americans could afford to establish generation-skipping trusts and that, therefore, Chapter 13 would impact primarily upon America's wealthy people, but not upon most average Americans. Nothing could be further from the truth, as it turns out. Ironically, it is only the very wealthy who can afford to avoid Chapter 13 by means of layering techniques of estate planning that actually bypass generations for which adequate financial provision has already been made.

It is not America's very wealthy people, but rather average middle-class people, who get Chapter 13 in the neck. These middle Americans are the people who cannot afford to bypass their children in their estate planning by passing property directly to grandchildren or more remote descendants. These are the people who, assuming they get knowledgeable counsel, see their estate planning preferences warped in reaction to Chapter 13 and see their estate planning costs soar. These are the people whose descendants will all too often pay the Chapter 13 price because some nuance of so-called "grandchild exclusion" is violated or because of the virtual impossibility of complying with the so-called IRC §2613(e)(1) exception. It is the middle class, not the wealthy, who have the most to fear from the generation-skipping tax.

Can "Patch-Up" Save Chapter 13?

There may be some good social policy to be served by a complement to our federal estate and gift tax system. If and when Congress articulates that policy with the requisite precision, we feel convinced that a mammoth tax system like Chapter 13 will not be required to deal with the matter.

In our view, Chapter 13's weaknesses are inherent and, therefore, cannot be "patched up." The Association feels strongly that to the extent that Congress determines that there are useful purposes to be served by some extension of the federal estate and gift tax systems, it would be far better to return to square one and build from scratch to achieve those purposes rather than attempt to get to the right result through Chapter 13 transformation.

We remember all too well the initial response of the Treasury Department to the call for carryover basis repeal. The idea floated at that time was simply to slap a big exemption on the mess so that only a few would have to wrestle with the problems. We think similar thinking in the Chapter 13 context would be untenable. A bad tax is no better if applied to fewer taxpayers.

Clearly, Chapter 13 could be improved in many, many ways. But when this improvement process was completed, the same problems outlined above would still plague the system. Hypercomplexity and unenforceability would still conspire to discredit the tax and, with it, our voluntary compliance system. At a time when Americans are begging for tax simplification, Chapter 13's complexity would still register off the chart. At a time when America so desparately needs incentives to capital formation, Chapter 13 would still be shattering capital aggregations under trusts at irregular and often arbitrary intervals.

Patch-up is not the answer to the Chapter 13 problem. The answer is repeal.

Why Must Congress Act Quickly?

There are two Chapter 13 problems of particular urgency. One relates to the Chapter 13 effective date rule. The other relates to the Chapter 13 filing requirements.

The Chapter 13 effective date rule provides a transitional period with respect to certain ambulatory wills and revocable trusts. Thanks to Senator Symms, this period, which would have expired at the end of 1981, has been extended for an additional year. See Section 428 of the Economic Recovery Tax Act of 1981. Unfortunately, this extension creates a tragic tension between Chapter 13 and the many worthwhile federal estate and gift tax reforms also contained in the Economic Recovery Tax Act of 1981. For example, in order to be eligible for the new unlimited marital deduction benefits, one must, in the formula marital context, draft a new marital bequest at some time on or after September 13, 1981. But putting pen to paper to achieve this new marital deduction result, may, as to wills and trusts executed before June 12, 1976, result in forfeiture of Chapter 13 transitional period grace. In short, Chapter 13 acts as an impediment to the implementation of the recent estate tax reforms that this Subcommittee fought so hard to achieve.

The Chapter 13 tax return situation is most serious. The first returns were due on October 15, but, alas, the government has not yet released a Chapter 13 tax return form. Nor has the government published a single regulation regarding how to compute the tax. More than five years have elapsed since the first generation-skipping transfer could have occurred, and even now these rudiments of the reporting system remain unattended, in all probability because they baffle the government just as much as they puzzle all of us.

The difficulties created by the two problem areas just mentioned are in urgent need of attention and would, of course, be eliminated by the expeditious repeal of Chapter 13.

A Technical Point About S. 1695

The federal tax on certain generation-skipping transfers involves not only Chapter 13 but certain other provisions of the Internal Revenue Code as well. We respectfully suggest that it would be proper to amend S. 1695 to call for repeal not only of Chapter 13 but also of IRC §§303(d), 691(c)(3) and 2013(g). In addition, if this suggestion is adopted, it would become appropriate also to direct that Subsections (c)(4) and (c)(5) of IRC §691 be renumbered as Subsections (c)(3) and (c)(4), respectively.

Conclusion

In summation, the American Bar Association advocates the immediate repeal of the federal generation-skipping tax and supports S. 1695 to accomplish such repeal.

We appreciate this opportunity to present the Association's views on this very important question, and we want you to know that the Association stands ready and willing to assist Congress in this matter in any way you deem we may be useful.

Senator SYMMS. Thank you very much, Mr. Brink.

I might note, I certainly appreciate your cooperation and your testimony. To my knowledge, at least in the time I have been on this committee, this is the first time we have had the president of the American Bar Association here, and we welcome the opportunity to hear directly from the president.

Mr. BRINK. Thank you. I feel strongly about this subject.

Senator SYMMS. Good. I gathered that we don't need to put you down as undecided that is for certain.

Now we would like to hear from Bernard Barnett, who is the chairman of the Federal Tax Division's Task Force for Estate and Gift Tax Reform, Federal Tax Division of the American Institute of Certified Public Accountants.

Mr. Barnett.

STATEMENT OF BERNARD BARNETT, CHAIRMAN, TASK FORCE FOR ESTATE AND GIFT TAX REFORM, FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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

I represent more than 175,000 CPA's, most of whom spend a substantial portion of their time in dealing with Federal tax matters, including estate, gift, and generation-skipping taxes.

Mr. Chairman, the Federal Tax Division of the American Institute of CPA's readily admits that it made a grievous mistake when 12 years, as Mr. Glickman has testified, we endorsed some form of a generation-skipping tax. I think, to state the late Mayor La Guardia of New York: "When we make a mistake, we make a beaut." But I think that it is fair to say that Congress made an even greater mistake by enacting chapter 13 as part of the Tax Reform Act of 1976.

We believe that the wording of that statute is so ambiguous and uncertain, and, as Mr. Glickman has testified, the complexity so totally unwarranted that it is impossible to understand. It is also so costly and difficult to administer that we believe it is economically disruptive, while being equitable nor effective in raising revenue. In a few words, it is not cost effective. We favor its repeal and support S. 1695 to that end.

When Congress enacted this law to prevent certain perceived abuses of our estate and gift tax laws, it never intended to raise significant amounts of revenue, but hopefully by closing these perceived abuses, the revenue inflow of the Treasury would be protected, and the credibility of our self-assessment of our tax system would be enhanced.

I don't think we have to consider now whether the abuses were perceived or real. We do not believe that they were real. But because of the fact that the changes, and these substantial changes made by the Economic Recovery Tax Act of 1981 in the estate and gift tax laws have so diminished the scope and effect of the estate and gift tax, we feel that any abuses of them must obviously have become much less significant.

As a practical matter, the generation-skipping tax will evidently apply to relatively few estates. However, when any tax practitioner is engaged in estate planning, he will have to bear in mind all the complexities, and all of the potential pitfalls of chapter 13. While a very wealthy individual can afford to spend a few extra thousand dollars to avoid the generation-skipping transfer tax, for those who do not pay any estate or gift tax, any extra cost is obviously completely wasted.

As difficult as the tax is for taxpayers and practitioners, we foresee the problems being much worse for those charged with enforcing the law. The Internal Revenue Service has, as we know, limited resources, and to have to squander some of its most skilled and effective personnel on the impossible task of patrolling this veritable swamp must be considered an extravagance it cannot afford.

We are concerned that because this law will be almost impossible to enforce, it will be frequently ignored, thus tending to undermine the credibility and the effectiveness of our voluntary compliance system.

In conclusion, Mr. Chairman, for 5 years we have withheld comment on this law in the hope that order could be brought out of chaos, and the generation-skipping transfer tax could be shown to be an effective, and efficient part of our tax law. Now, however, we are convinced that it is not and can, in fact, never become such.

We believe that this tax has been shown to be ineffective, inequitable, and wasteful. Its problems cannot be remedied through regulations or tinkering with the law. We believe that its continuing in force would undermine the viability of our tax system at a time when that system is already being challenged by noncompliance.

We admit we made a mistake. I think it is time for everyone to admit they made a mistake, and to repeal chapter 13.

Before concluding, I would like to take this opportunity to express our support of section 2 of S. 1733, which provides for the use of declaratory judgments by the Tax Court in section 6166 issues. The details of our comments are in the written comments, which have been already supplied to the subcommittee. Any other proposed revisions of section 6166 are under study currently, and we will submit them to you as soon as they are available.

Thank you very much.

[Statement of Mr. Barnett follows:]

Statement of Bernard Barnett

on Behalf of

American Institute of Certified Public Accountants

Good morning! I am Bernard Barnett. I appear before you today as chairman of the AICPA Federal Tax Division's Task Force on Estate and Gift Tax Reform. In this capacity I represent 175,000 CPAs, many of whom spend a substantial portion of their time in dealing with federal tax matters, including the estate, gift and generation skipping taxes.

The Federal Tax Division of the American Institute of CPAs is convinced that a mistake was made when Congress enacted the Generation Skipping Transfer Tax as part of its Tax Reform Act of 1976. We believe that the wording of this statute (Chapter 13 of the Internal Revenue Code) is so ambiguous and uncertain, and the tax so difficult to administer, that it is economically disruptive while being neither equitable nor effective in raising revenue.

Congress enacted this law to prevent certain perceived abuses of our gift and estate tax laws. While it was never intended to raise significant amounts of revenue directly, it was hoped that by foreclosing those perceived abuses the Generation Skipping Transfer Tax would both protect the revenue inflow to the Treasury and strengthen the credibility of our self-assessment tax system as being fair and even-handed.

We need not now consider whether the perceived abuses that led to the enactment of the Generation Skipping Transfer Tax were in fact abuses needing remedy. Because the changes to the estate and gift tax laws contained in the Economic Recovery Tax Act of 1981 have so diminished the scope and effect of the gift and estate taxes themselves, any abuses of them must also have become much less significant. Furthermore, there is convincing evidence that Chapter 13 never was effective in foreclosing abuse of the gift and estate tax laws in any case.

The basic problem of Chapter 13 derives from its extreme complexity being compounded by the uncertainty of having many new terms and concepts introduced into the law without benefit of statutory definition. Because of this, it is possible for a sophisticated tax planner to totally avoid the Generation Skipping Transfer Tax when dealing with the estate of a very wealthy individual, while at the same time a tax practitioner who is not super-specialized in this area of the law can inadvertently stumble into traps with dire and unforseen consequences. It would be possible to solve either the complexity or the uncertainty in the law, but only at the expense of amplifying the problems presented by the other.

It took four and a half years for the Treasury to issue the first substantive regulations concerning the Generation Skipping Transfer Tax, and those regulations are only the first installment on a system of regulations and rulings that can be expected to grow to heroic proportions. While those first regulations display an incredible investment of time and effort by talented persons who truly did the best job they possibly could to make the law workable, the regulations have been harshly criticized by those who would have to live and work with them as creating more problems than they solved.

Even though, as a practical matter, the Generation Skipping Transfer Tax will not apply to most estates (since most individuals will not pay gift taxes and their estates will not pay estate taxes after the changes in the Economic Recovery Tax Act of 1981 are effective), whenever a tax practitioner is doing estate planning he will have to keep in mind all the potential pitfalls of Chapter 13. While for the very wealthy individual the extra thousands of dollars spent avoiding the Generation Skipping Transfer Tax may be inconsequential, for those who do not eventually pay gift or estate taxes this extra cost must be considered wasteful.

As difficult as the Generation Skipping Transfer Tax may be for taxpayers and practitioners, we foresee the problems being worse for those charged with enforcing this law. The Internal Revenue Service has limited resources, and to have to squander some of its most skilled and effective personnel on the impossible task of patrolling this veritable swamp must be considered an extravagance it cannot

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afford. We are concerned that because this law will be almost impossible to enforce it will be frequently ignored, thus tending to undermine the credibility and effectiveness of our voluntary compliance tax system.

For five years we have withheld comment on this law in the hope that order could be brought out of chaos and the Generation Skipping Transfer Tax could be shown to be an efficient and effective part of our tax law. Now, however, we are convinced that it is not, and can, in fact, never become such. We believe that the Generation Skipping Transfer Tax has been shown to be ineffective, inequitable and wasteful. Its problems cannot be remedied through regulations or tinkering with the law. We believe that its continuing in force would undermine the viability of our tax system at a time when that system is already being challenged by non-compliance. It is time to admit that a mistake was made, and to repeal Chapter 13.

Before concluding this morning, I would like to take this opportunity to express support of Section 2 of S. 1733. Section 2 of this bill provides for the use of declaratory judgments by the Tax Court in issues relating to the installment payments of estate tax.

Under current law, the Tax Court has no jurisdictional basis to review the Internal Revenue Service's interpretation of Section 6166. We believe this result is undesirable for numerious reasons.

Section 6166 provides for an extension of time for payment of estate taxes where the estate consists largely of an interest in a closely held business. This section enables the surviving family to retain the small business enterprise and pay the estate tax obligation over several years. In the absence of this relief, many family businesses would have to be liquidated in order to pay estate taxes.

The scope and utility of this section is now being challenged by the Internal Revenue Service on technical grounds. Through use of its interpretative powers, the Service threatens to vitiate its effectiveness. This fact is demonstrated in a technical advice memorandum issued by the Internal Revenue Service earlier this year. See Letter Ruling 8130175 (May 1, 1981). The Internal Revenue Service ruled that a holding company was not carrying on a trade or business by merely holding the stock of its wholly-owned subsidiaries, even though the subsidiaries were actively engaged in trades or businesses. The Service held that the level of activity is the factor that distinguishes an "active business" from mere passive ownership of income-producing activities. Citing a line of published rulings, the Service held that the ownership of a stock interest in an active subsidiary, in and of itself, was not sufficient activity to constitute the carrying on of a trade or business for purposes of Section 6166.

We believe it was the intent of Congress to allow the benefits of Section 6166 regardless of the form of the decedent's ownership interest, whether direct or indirect. However, under present law a judical forum is not available to taxpayers to resolve disputes with the Internal Revenue Service regarding Section 6166. Technically, this is because no deficiency of the estate tax liability exists, but rather an issue as to the period of payment of the liability.

Over the past few years, Congress has demonstrated a willingness to provide the Tax Court with the power to issue declaratory judgments where the tranditional remedies found in deficiency and refund proceedings were inadequate to protect taxpayers from erroneous Service action. This fact is evidenced by the Tax Court's current use of this power in the areas of employee retirement plans, tax exempt organizations, and the transfer of property from the United States in Section 367 transfers.

It is our belief that this power should be extended to include conflicts arising out of the applicability of Section 6166. Otherwise, taxpayers will not be afforded a fair and adequate remedy in the Tax Court from erroneous Service action.

Accordingly, we urge your support in helping to enact the judicial relief contemplated in S. 1733 regarding 6166 determinations.

We are in the process of reviewing other proposals relating to Section 6166, Section 303, and Section 2032A, some of which we dealt with in the proposals before this Subcommittee today. When we complete our review of those matters, we may submit further comments to you.

Senator SYMMS. Thank you very much, Mr. Barnett. I appreciate your testimony also, and your entire statement, which you made some summaries of, will be part of the record. So it will all be there for the use of the committee and the committee staff.

One question that I did not ask the Treasury, which I am sorry I didn't, was whether or not if Congress repealed the generation-skipping tax, if Treasury would actually recommend to the President that he veto such legislation.

I will do that, but after hearing your testimony, if I were to bet on it, I would bet that Ronald Reagan would not veto this legislation, despite what some of the people at Treasury might try to justify, because I am sure that if you tried to get the President to read that complicated testimony the Treasury presented this morning, he would say, "Anything that complicated cannot be good to anybody but tax accountants and lawyers," which he would then have all on his side.

You both make excellent points, and we appreciate your testimony. We appreciate having this as part of our record. We will push ahead with enthusiasm to repeat the generation-skipping tax at the first possible moment.

Did either of the other two gentlemen wish to make comments?

Mr. BRINK. I don't think so.

Senator SYMMS. Well, thank you very much.

We now call up a panel of Timonthy Baetz, Raymond Reister, William Warren, Clare Springs, Raymond Young, Neal Block, Douglas Keyt, Donald Thumond, and Marshall Zissman.

The committee will be in recess while you are getting seated here.

[Recess.]

Senator SYMMS. I see that we have a full lineup here.

Timothy Baetz, do you wish to go first?

Mr. BAETZ. Yes.

Senator SYMMS. Go right ahead.

STATEMENT OF TIMOTHY BAETZ, ATTORNEY, ILLINOIS STATE BAR ASSOCIATION

Mr. BAETZ. I am Tim Baetz. I am an attorney in Chicago, and I am here on behalf of the 25,000 lawyers who comprise the Illinois State Bar Association. Our association has been here before to testify on the question of chapter 13 repeal.

I am here today to underscore the remarks made by our representative on June 5, and to thank you, Mr. Chairman, for introducing S. 1695. That bill has the wholehearted support of our Association.

Senator SYMMS. I might say that your entire statement and all of your entire statements will be made part of the record.

Go ahead, Tim.

Mr. BAETZ. I was pleased to hear Mr. Glickman's remarks this morning. I have waited 5 years to hear the Treasury's position. I have waited 5 years for them to react to our commentaries which have become, over time, more and more shrill. I think Mr. Glickman made a noble effort to tack jelly to a tree, and I think he comes up short.

Mr. Glickman admitted quite properly that chapter 13 is very complex. We are all glad to hear that the Treasury knows that, too. But then, he went on to point out that section 2032(a) is very complex, without informing all of us that 2032(a) is by its very nature much different and much more finite.

In Illinois, we can recognize a farm, but we are not embarrassed to admit to you this morning that all too many of us all too often, even with the Treasury proposals, will not be able to recognize the chapter 13 taxable event. That concerns us a great deal. It tends to foster disrespect for our voluntary compliance tax system.

In addition, we have never said that we don't like chapter 13 simply because it is complex. That complexity conspires with very widespread application. That conspiracy is what troubles us. That is what creates the problem. Indeed, in my view the Treasury proposals, while they might contract the net somewhat, still leave altogether too many arrangements within the purview of chapter 13, and do not make the problem go away.

Mr. Glickman put great emphasis on the thing we call "the lineal descendant exclusion. It is found buried in section 2613(e)(1). What he failed to tell you is that, as a practical matter, that exclusion is never available.

No one can draft to make that exclusion available to his client, this because there are gift over requirements there of a Byzantine nature. We always take the trouble in our estate planning to provide gifts over, and by doing so we forfeit the (e)(1) exclusion.

Mr. Glickman suggested that he wanted a system that worked on a more long-range basis so we got closer to a generation-by-generation effect. The elimination of the powers rule, although noble, will not do that job. You will continue to have an arhythmic effect simply by reference to interests.

In addition, if, as Mr. Glickman proposes, Treasury intends to exempt all otherwise taxable events that occur before two people in the first younger generation die, I think we create some form of intellectual dishonesty. I see no difference, really, in terms of the generation-by-generation rhythm of this thing between a death that occurs a minute before those two deaths, and one that occurs after.

I am not surprised that Mr. Glickman wants to beef up the grandchild exclusion, and throw floors under this mess. But a bad tax is no better if it applies to somewhat fewer taxpayers.

Mr. Glickman mentioned that he likes the effective date rule, and told you that it applies in certain fashion to irrevocable trusts. What he didn't tell you is that the Treasury Department has turned certain irrevocable trusts into revocable trusts.

The long and the short of it is that Mr. Glickman wants us to live under water for a longer period of time, while Treasury tries to make a silk purse out of chapter 13. We beg all of you to instead do the only right thing, kill it.

Thank you.

[Statement of Mr. Baetz follows:]

STATEMENT OF W. TIMOTHY BAETZ
ON BEHALF OF THE ILLINOIS STATE BAR ASSOCIATION
FOR THE HEARING ON CERTAIN FEDERAL TRANSFER TAX ISSUES
HELD BY THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE
November 4, 1981

Mr. Chairman and Members of the Subcommittee:

My name is W. Timothy Baetz. I am representing the 25,000 members of the Illinois State Bar Association.

Some time ago, our Association adopted a resolution calling for the immediate and complete repeal of the federal tax on certain generation-skipping transfers. Our representative appeared at your June 5, 1981, hearing to explain the reasons for this position. I am here this morning to underscore those reasons and to emphasize that circumstances have developed which make the repeal of the generation-skipping tax not only appropriate but urgent.

The Association Wholeheartedly Supports S. 1695

The Illinois State Bar Association wishes to thank you, Mr. Chairman, for introducing S. 1695. This bill deserves immediate Congressional attention and has our Association's complete support.

The Call For Chapter 13 Repeal Has Widespread Support

The Illinois State Bar Association was one of the first professional organizations to conclude that the generation-skipping tax does not deserve a place in our federal transfer tax system. However, I think it is important to note that we are far from alone in beseeching you to repeal this tax. The dangers and inherent debilities of Chapter 13 are now being widely acclaimed. Our attorney brethren are here today on behalf of national attorney organizations and state and local bar associations from all over the country. In addition, our colleagues in the accounting and banking professions are represented at this hearing, as are several affected taxpayer groups. Each of us may view Chapter 13 from a different perspective, but it is clear that all of us see the same dilemma and advocate the same solution. Rarely, I think, has there been such unanimity in a federal tax matter of such magnitude.

Why Is the Need For Repeal So Urgent?

Several circumstances have developed in a way that injects a strain of urgency into the call for Chapter 13 repeal. Some of these circumstances were predictable and inevitable; others were not.

It has been predicted for some time, for example, that the tax reporting system required by Chapter 13 must eventually fall of its own weight. There is now ample evidence that just such an unfortunate occurrence has come to pass. The Treasury Department has failed to issue a single regulation regarding how to compute the tax, although more than five years have elapsed since the first taxable generation-skipping transfer could have occurred. In view of the hypercomplexity of Chapter 13 tax computation, it is not surprising that the matter continues to puzzle the government as it puzzles all of us who must assist taxpayers in the exercise.

Moreover, even if one were confident of his or her ability to compute the Chapter 13 tax correctly, one would, at the moment, be hard pressed to convey that computation to the government via a generation-skipping tax return. Although the first five years' worth of generation-skipping transfers were supposed to be reported on October 15, 1981, no tax return form was then available for such purpose, and, indeed, even as we speak today, the government has not yet released such a form to the public. For the precious few who know a generation-skipping taxable event when they see one, this situation presents a frightening dilemma. These folks have goods to take to market and no cart in which to make delivery, and, as you know, the failure to make delivery of these particular goods in a timely fashion can result in severe penalties not only for the taxpayer but also for the taxpayer's professional advisor. Clearly, this facet of Chapter 13 administration may now be classed as in the critical stage.

It has also been predicted that, because the Chapter 13 taxable event is so difficult to comprehend and so unlike other federal transfer taxable events, it will go unnoticed by large numbers of taxpayers. Again, this circumstance seems to be coming to pass on a grand scale, and, as it unfolds, concern for the integrity of our self-assessment tax system mounts. As evidence of this dilemma, I offer the results of a recent survey of 534 banks conducted by the American Bankers Association. Of all of these banks surveyed, only four had paid some Chapter 13 tax with respect to trusts they administered. It is almost beyond belief that so few Chapter 13 taxable events could have occurred under what must be literally hundreds of thousands of trusts.

Of especially critical importance in the Chapter 13 dilemma is another development which, frankly, none of us could have predicted when we appeared before you on June 5. As you know, Section 428 of the recently enacted Economic Recovery Tax Act of 1981 extends the Chapter 13 transitional rule period one extra year. This rule applies to wills and revocable trusts in existence on June 11, 1976, and provides, in essence, that Chapter 13 will not apply to generation-skipping trusts created under such wills and revocable trusts if (1) the creator of the instrument in question dies before January 1, 1983 (January 1, 1982, before Section 428) and (2) that instrument is not amended at any time after June 11, 1976, in a way that creates, or increases the amount of, any generation-skipping transfer.

While this extension of the transitional period was obviously well-intentioned, what has, unfortunately, come to pass is that the extension has "frozen" a number of pre-June 12, 1976, wills and revocable trusts at a time when the creators of these instruments are anxious to amend them in order to secure worthwhile federal estate tax improvements also introduced in the Economic Recovery Tax Act of 1981. As an example, many creators of pre-June 12, 1976, wills and revocable trusts are quite properly desirous of availing themselves of the new unlimited federal estate tax marital deduction that members of this Subcommittee fought so hard to secure. And yet, when the marital bequest is framed, as is quite often the case, in terms of a formula, the new law requires that the document providing such bequest be amended after September 13, 1981, in order to be eligible for unlimited marital deduction treatment. Fearing that such amendment would result in forfeiture of Chapter 13 transitional rule protection, many people have opted to "stand pat," thus placing Chapter 13 in direct conflict with the federal estate tax purposes served by ERTA '81. This is an undesirable and, we are sure, an unintended new implication of the generation-skipping tax, but one which could be (and should be) corrected by expeditious enactment of S. 1695.

"Patch Up" Is Not the Answer

Advocating the repeal of an entire federal tax concept is serious business, and the Illinois State Bar Association is well aware that no useful purpose is served in the federal tax area by a Queen of Hearts whose immediate response to any problem is "Off with their heads!" I can assure you that, in the Chapter 13 situation, the Association has arrived at its pro-repeal position only after years of study and analysis and only after investigating thoroughly and rejecting the other options.

No one doubts that in a number of technical respects Chapter 13 could be vastly improved. But, in the view of our Association, this "patch up" process makes no sense at all. Even if Chapter 13 were "improved" technically, it would still be a bad tax, and this because its weaknesses are inherent. No amount of "patch up" can purge these weaknesses; they comprise the essence of the system. It would be far better, if Congress determines that there is some useful purpose to be served by a complement to the federal estate and gift tax systems, to start again from square one rather than to try to make a silk purse out of Chapter 13.

This point cannot be overemphasized, especially when one remembers the painful and counterproductive "patch up" exercise through which we all were put in connection with a thing called carryover basis. First, the idea was floated that a big dollar floor ought to be constructed so that only a few "super wealthy" taxpayers would have to wrestle with the problems of the system. Well, obviously the response, proper in the carryover context and just as proper with the generation-skipping tax, had to be that a bad tax is no less a disgrace when applied to fewer taxpayers. Next, proposal after proposal was offered, each addressing one technical feature of the system or another. Countless hours were consumed explaining that these proposals left the inherent weaknesses of the system untouched; we had to prove over and over that, as long as there was a carryover basis system, these weaknesses necessarily were present. They were indigenous to the system.

Hopefully, the government and the taxpaying community will not be put to a similar test in the Chapter 13 context. The result would clearly be the same as with carryover basis. The dangers and fatal weaknesses of Chapter 13 lie at the very core of the concept. As long as we have the concept, we have the problems, and the longer we live with the concept, the greater the threat that we do irreparable damage to our voluntary compliance system and to the natural and worthwhile dispositive preferences of affected taxpayers.

The Inherent Weaknesses of Chapter 13

There is general agreement that Chapter 13 is hypercomplex. Scholars have referred to the generation-skipping tax as "seemingly incomprehensible"[1] and "astonishingly complex and sophisticated."[2] Indeed, the Chapter 13 concept has even been analogized to the works of Rube Goldberg.[3] But there are several portions of the Internal Revenue Code that are viewed as hypercomplex, and, therefore, it seems to us not enough to focus on complexity alone as an inherent Chapter 13 deficiency.

What makes Chapter 13's hypercomplexity so damning is the very wide application of the generation-skipping tax system. Chapter 13 applies to all kinds of trusts - trusts created under wills, trusts created by separate _inter vivos_ agreement, trusts created by middle Americans as well as by the wealthy, trusts created before the enactment of Chapter 13 as well as those created since, trusts under which money or property is actually distributed to beneficiaries and trusts under which no such distribution occurs. Chapter 13 also applies to all sorts of non-trust arrangements - arrangements branded "generation-skipping trust equivalents" because

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1. Professor G. P. Verbit, "Annals of Tax Reform: The Generation-Skipping Transfer," 25 _UCLA L. Rev._ 700, 737 (1978).
2. Professor W. W. Lancaster, Jr., "Traps and Opportunities in the Generation-Skipping Transfer Tax," 32 _Ark. L. Rev._ 611, 615 (1979).
3. See Professors R. B. Stephens and D. Calfee, "Skip to M' Loo," 32 _Tax L. Rev._ 443, 447 (1977).

they are deemed to have "substantially the same effect as a generation-skipping trust." See IRC §2611(d)(1). Apparently, the Treasury Department is convinced that this latter group even includes certain estates and custodial arrangements under Uniform Gift to Minors Acts.

It is not an exaggeration to say that an estate planner must grapple with the Chapter 13 concept each and every time he or she sits down to draw a will or a trust. And this suggests an inherent weakness in the generation-skipping tax because it is sheer folly to expect each and every will and trust draftsperson in this country to be fluent in the intricacies of Chapter 13. Many, predictably and justifiably, will never understand how the system works, opening two avenues of conduct, neither of which we think Congress will view as desirable.

On the one hand, a great many draftspersons will continue to deliver will and trust preparation services oblivious to the Chapter 13 implications of their handiwork. As a result, it seems to us inevitable that Chapter 13 benefits (such as the grandchild exclusion) will be forfeited in all too many cases and, perhaps even worse, Chapter 13 taxable events will be unwittingly built into too many estate plans, and as they occur, will go unnoticed all too often.

On the other hand, many draftspersons will learn just enough about Chapter 13 to realize that it is loaded with technicalities beyond the kin of all but a handful of "experts." These folks, sensitive to the problems that could arise out of the stubbing of one's professional toe on one of these technicalities, may develop a reluctance to continue to deliver will and trust drafting services to many Americans sorely in need of this kind of assistance. This "chilling effect" is neither proper nor healthy.

Beyond the problems just addressed, Chapter 13's hypercomplexity exascerbates another inherent weakness of the system - namely, the tax computation and reporting requirements. At the heart of this aspect of the generation-skipping tax lies the difficulty of recognizing the taxable event and acquiring the data necessary to compute and report the tax attributable to that event. In no other respect is the inherent instability of Chapter 13 quite so apparent.

First, the taxable event is often so subtle and discreet in nature as to go unnoticed. Taxable distributions and taxable terminations can both occur by reason of events not directly associated with what, formerly, was the hallmark of federal transfer taxation, namely, the devolution of property.

Second, even when the taxable event is recognized, it may be impossible, as a practical matter, properly and timely to report and pay the tax attributable to that event. In order to discharge Chapter 13 reporting and payment responsibilities, the taxpayer first must identify the "deemed transferor" with respect to the generation-skipping transfer in question. In order to make such identification, the taxpayer must determine the "transferees" with respect to the subject transfer, an exercise that, in the context of discretionary trusts (and most trusts are discretionary trusts), apparently continues, not surprisingly, to baffle the Treasury Department. Proposed regulations addressing the "transferee" issue fail to pinpoint the transferees in a number of common and important cases.

Even when the transferees can be found and, through them, the deemed transferor can be identified, the tax reporting problem is far from solved. In order to compute the tax due, the taxpayer must know the entire estate, gift and generation-skipping tax history of the deemed transferor as well as the deemed transferor's state of health (is he dead or alive?) and taxpayer identification number. What makes this task so difficult is that the deemed transferor in a number of cases will not be a beneficiary of the generation-skipping trust in question, and his whereabouts will be totally unknown to the taxpayer. In addition, even if the deemed transferor can be located, he or she may be understandably unwilling, on grounds of privacy, to share the needed information with the taxpayer.

Well, what can the taxpayer do when the deemed transferor is not willing to (or, if dead, cannot) supply the information required. According to IRC §2603(a)(2), the taxpayer can demand the needed information from the government - but, apparently, only if the taxpayer is a trustee. There seems to be no recourse for the taxpayer who is not a trustee (e.g.: the distributee of a taxable distribution), and this poor soul is left swinging slowly in the breeze, an absolutely egregious result.

But suppose the taxpayer is lucky enough to be a trustee. At least in this circumstance you would think that we are about to get to an acceptable answer. Well, don't believe it for a minute! Sure, if this trustee-taxpayer relies on information supplied by the government, he or she is protected from the Internal Revenue Service. But it is by no means clear that he or she is protected from the trust's beneficiaries. These beneficiaries may sue the trustee-taxpayer, saying, in effect, why did you believe what the government told you? You had a fiduciary duty to verify that the information provided by the government was accurate and complete.

Sensitive to this possibility of surcharge, trustee-taxpayers may often put the government to the task of proving the validity of supplied information. Not only will this kind of controversy be expensive and time consuming, it may be embarrassing as well because it is virtually impossible for the government always to have at its command all of the information it is required to share with

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Chapter 13 trustee-taxpayers. As an example, it is necessary for the government to have access to the federal estate tax returns of many deemed transferors who died long, long ago. Until Chapter 13 was enacted, there was no reason for the government to retain these returns for long periods after the decedents' deaths. How now can such information be resurrected?

You must remember that up to this point we have been assuming that the taxpayer (or his professional advisor) understands the maze that must be negotiated to complete the Chapter 13 tax reporting process. When you factor in that in many cases such understanding will be absent, imagine the confusion! More important, imagine the magnitude of the possibility for growing disrespect of our voluntary compliance tax system.

The cost to government of attempting to enforce this generation-skipping tax will be enormous. Think of the mountains of data that must be acquired, sorted, analyzed, stored and periodically retrieved. Think of the army of government personnel who must be trained for and devoted to this complex system.

But the great sadness is that, no matter what the quantum of government effort, there must necessarily be shortfall. This job is simply beyond the means of the government alone, regardless how earnest its effort may be.

Clearly, the government will have to rely on the taxpayers' help to a great extent, and, as we have already suggested, that help will not be forthcoming. In large part, the absence of taxpayer self-assessment will be attributable to forgiveable ignorance, but, alas, we must point out that some of the non-compliance will clearly be attributable to the foulest of motives. Without a doubt, some taxpayers will fail to report Chapter 13 tax, knowing that it is due, but realizing that there is a good chance that their oversight will go undetected (or, if detected, will not breed penalties if ignorance is feinted).

This situation is of the greatest concern to us. It is a necessary consequence of Chapter 13. It arises from inherent shortcomings in the system and cannot be expunged by any form of "patch up."

Will Repeal Threaten the Integrity of Our Federal Transfer Tax System?

What evil does the generation-skipping tax address? What did Congress say that it intended to do when it enacted Chapter 13?

At first blush, one might assume that in 1976 Congress concluded that the skipping of generations for federal transfer tax purposes was, in and of itself, evil. But an understanding of Chapter 13 and the underlying legislative history clearly demonstrates that this was not the case. Transfers that, in fact, totally skip generations, as when a grandfather leaves his estate directly to his grandson, fall completely outside the scope of Chapter 13. Only transfers that do not actually skip one or more younger generations are subject to Chapter 13. To some, this may seem ironic, but at the very least it substantiates that, in Congress' view, not all generation-skipping transfers are evil.

Congress said in 1976 that the purpose of federal transfer taxation was "not only to raise revenue, but also to do so in a manner which has as nearly as possible a uniform effect, generation by generation." Congress further said that "these policies of revenue raising and equal treatment are best served where the transfer taxes...are imposed, on the average, at reasonably uniform intervals."

Anyone who has worked with Chapter 13 knows that it impacts at anything but "reasonably uniform intervals" "generation by generation." The events which trigger the tax need have nothing to do with the actual devolution of property from one generation to the next. These events may occur at close intervals that are neither "reasonably uniform" nor coordinated with the "generation by generation" rhythm that Congress envisioned.

Congress said that "generation-skipping...reduces the progressive effect of the transfer taxes, since families with moderate levels of accumulated wealth may pay as much or more in cumulative transfer taxes as wealthier families who utilize generation-skipping devices." The clear implication is, of course, that Chapter 13 will impact primarily on "wealthier" Americans, and nothing could be further from the truth. Wealthier Americans are the only ones who can afford to circumvent Chapter 13 by actually and completely bypassing younger generations in the estate planning process. It is "moderate" or middle Americans who, because they cannot afford this luxury, have to contend with Chapter 13.

Congress said that the generation-skipping tax "would 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." Unfortunately, Chapter 13 is far from "equivalent" in technical terms to the federal estate tax, although, admittedly, some measure of equivalence has been attempted. Chapter 13 is in no way equivalent to the federal gift tax, and the statute does not evidence even a meager attempt to establish some form of parity.

Congress said it was not attempting by the enactment of Chapter 13 to punish trusts, but rather it wanted "the tax laws [to] be neutral" in the trust context. At your May 1 and June 5 hearings and again this morning you have received ample testimony that, in practice, Chapter 13 has been anything but "neutral" in its effect upon trusts.

The prospect of Chapter 13 has added significant cost to the preparation and administration of trusts. Worse, it has been responsible for a substantial amount of warping of dispositive preferences as planners twist and turn tortuously in reaction to the Chapter 13 rules.

But, if so much has gone wrong, what is the purpose that merits a Chapter 13 or something like it? Frankly, the answer to this question is difficult to divine. Why, for instance, should the entire trust property be subject to Chapter 13 tax (as it is) simply because a beneficiary had a very limited interest in the trust property for a very short time? Why should the entire trust property be subject to Chapter 13 tax (as it is) when a trustee holds a power over that property through the exercise of which he cannot benefit himself or anyone he is legally obligated to support? On an even more dramatic note, why should the entire trust property be subject to Chapter 13 tax (as it is) at the death of a potential beneficiary who never received a nickel from the trust at any time during his life, never had a right to receive a nickel from the trust at any time during his life and never could pledge the trust property to secure a bank loan at any time during his life?

The legislative history underpinning Chapter 13 does not provide answers to these important questions, and, without such answers, it is impossible to state with the requisite precision exactly which arrangements, if any, are conceived by Congress to be abusive. However, if and when these and other similar questions are addressed in detail, we believe that the answers will not suggest the need for a system as monumentally complex and pervasive as that embodied by Chapter 13.

Conclusion

Living with Chapter 13 is becoming intolerable. Hopefully, this hearing will sound the death knell for this misbegotten concept.

The Illinois State Bar Association wholeheartedly supports S. 1695 as the proper means to rid our federal transfer tax system of this dangerously deficient generation-skipping tax. For the sake of government and taxpayers alike, we pray that enactment of S. 1695 comes at the earliest possible moment.

Senator SYMMS. Thank you very much for very excellent testimony. Your testimony reminds me that I failed to mention to our last two witnesses, what I had said to the Senator Curtis was with is open to all the witnesses. Our record will be kept open for 30 days, and those that wish to comment on Treasury's testimony this morning, we would welcome that comment.

You certainly handled yourself very well on your comments of Treasury's testimony, and I appreciate having them. I am sorry that you were not up here to ask Treasury some questions.

Mr. Reister, please go right ahead.

STATEMENT OF RAYMOND A. REISTER, VICE CHAIRMAN, COMMITTEE ON ESTATE AND GIFT TAXATION OF THE AMERICAN COLLEGE OF PROBATE COUNSEL

Mr. REISTER. Thank you, Mr. Chairman.

My name is Raymond Reister, and I am an attorney at law from Minneapolis, Minn., where I have specialized in the practice of probate and trust law and related tax matters for approximately 25 years.

I appear as vice chairman of the Committee on Estate and Gift Taxation of the American College of Probate Counsel in place of Mr. John Wallace, our chairman, who could not be present today. Mr. Arthur Peter, the immediate past president of the college and a practicing lawyer in Washington, accompanies me today, and is also here this morning on behalf of the college.

The American College of Probate Counsel was founded approximately 30 years ago and currently has a membership of over 2,300 lawyers. Our membership is diversified from solo practitioners to partners in the largest firms in the country. We have members in every State and all of the principal cities, as well as many members in the rural areas and smaller communities.

While many of us in the college specialize in the area of probate and trust laws, others conduct a more general practice. However, the common purpose of all of our members is our desire that the probate and transfer laws be improved, and that the probate and transfer tax system operate as fairly, efficiently, and inexpensively as possible.

For that purpose, we have appeared before the Congress on numerous occasions over the last 5 years, and once again appreciate the opportunity to present our views as practicing lawyers in this area, to this committee.

Based on the experience of our members and our diversified national practice, the college overwhelmingly believes that chapter 13, the generation-skipping tax, should be repealed.

This tax was, as you know, first adopted in 1976, when it was believed that the generation-skipping trusts caused inequalities. To overcome that inequality, chapter 13 was adopted, and we believe has failed.

As has been testified today, it is incalculably complex, bafflingly so, and this complexity is illustrated by some very commonplace examples set forth in our statement. Sadly, these examples illustrate only simple problems.

When family plans become more complicated, infinitely more complicated problems and complexities arise. Is it any wonder, then, that this statute has been described as the "land of metaphor and make-believe."

As has been stated, besides complexity there are other reasons why chapter 13 should be repealed. First, this chapter was designed to eliminate inequalities, but it, itself, causes inequalities and injustices, as has just been described by Mr. Baetz. Therefore, this is another reason why it should be repealed.

Similarly, transfers such as gift under the Uniform Gifts to Minors Act, the power of an executor to distribute income during probate administration can be treated, under current regulations, as producing generation-skipping transfers. Certainly, these are inequalities and are not what Congress intended.

As noted, with reduction of the death taxes through the 1981 act, the reason and purpose for chapter 13 has been correspondingly reduced.

As I think the bankers will testify to, chapter 13 creates an administrative nightmare. We will not go into all the recordkeeping details, but do emphasize that the compliance with these requirements are expensive and burdensome. Even more importantly the noncompliance caused by the improbable situations when the tax is imposed, and the inability of most trustees and lawyers to understand chapter 13, undermine the principle of self-assessment and self-enforcement basic to our tax system.

Finally, as recognized, it is not a revenue producing device, and has fallen, as Mr. Brink has stated, primarily on the successful middle class. The very wealthy can afford to transfer their wealth directly to their grandchildren or great grandchildren or use complex devices like the layering trust.

On the other hand, persons of more moderate means must devote their wealth to the benefit of their wives and children. As a result the tax falls on that group in particular. Moreover, this group perhaps does not have the opportunity to retain the sophisticated counsel necessary to avoid the imposition of the tax.

For the above reasons, many of which are based on the experience of our college, we recommend that chapter 13 be repealed effective as of its original effective date. In this regard, we suggest that the Treasury policy of patch up is not appropriate. We are concerned that if studies are undertaken, that these studies will continue for a great period of time, and in the meantime it will be difficult and very expensive, if not impossible, to try to plan for these possible changes.

If it is necessary that there be some sort of a complimentary transfer tax for generation skipping, we recommend that this topic be studied and new provisions submitted to the committee as independent proposals. In this area, we should be glad to try to assist as practicing lawyers in the development of those proposals.

Thank you very much.

[Statement of Mr. Reister follows:]

SUMMARY OF TESTIMONY
OF RAYMOND A. REISTER
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

November 4, 1981

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 including competent tax practitioners and any legislative action should be postponed until their recommendations are received.

The College recommends that to provide the relief intended by §6166 a preferential interest rate be established for deferred estate tax liability. The College supports legislation providing for judicial review in orderly fashion of disputes under §6166 and recommends that the other technical issues designed to make §6166 more workable be studied by a similar study group.

TESTIMONY
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

November 4, 1981

This statement has been prepared by the Estate and Gift Tax Committee of the American College of Probate Counsel (the "College"). The positions presented have been approved by the Board of Regents of the College and are submitted at the 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 of the College and the membership of the Estate and Gift Tax Committee of the College are listed on Exhibit A to this statement.

The College is grateful for the opportunity to appear at this hearing and to express the views of its membership concerning the transfer tax legislation now pending before this Subcommittee. The College has more than 2,300 member lawyers who specialize in the practice of trust and estate law and related tax matters. A major purpose of the College from its inception more than thirty years ago has been to foster improvements and reforms 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 transfer tax laws represent the most complex and expensive aspect of our system of property disposition. We welcome and accept once again the challenge of working with the Congress to find ways of ameliorating the unduly harsh impact of these laws on our clients.

Repeal of Generation-Skipping

Chapter 13 of the Internal Revenue Code was adopted as part of the Tax Reform Act of 1976 for the purpose of correcting certain inequities thought to exist in transfer tax treatment through the use of multi-generational transfers, commonly known as "generation-skipping trusts." The effective date of Chapter 13 was June 11, 1976, except for transfers governed by the so-called "transition rules." These include (a) transfers under trusts that were irrevocable on that date and (b) in the case of decedents dying before January 1, 1982, transfers under instruments in existence on June 11, 1976 not later amended to create or increase any generation-skipping transfer. By the Economic Recovery Tax Act of 1981 ("ERTA"), the January 1, 1982 date was extended to January 1, 1983 for the purpose of allowing the Congress the opportunity to reconsider Chapter 13.

After the enactment of ERTA, Senator Symms introduced

S.1695 which repeals Chapter 13 in its entirety. For the following reasons, the American College of Probate Counsel supports S.1695:

First, Chapter 13 and its implementation are incredibly complex. There are at least 14 key defined terms, as well as numerous other important terms not defined. At eight places in Chapter 13, Congress delegated to the Secretary rule-making authority and, although Chapter 13 has been in effect since June 11, 1976, no final regulations have been issued in response to this delegation except those dealing with the effective date of the transition rules. Chapter 13 also contains numerous exceptions and special rules, making it even more perplexing to understand and difficult to administer.[1]

The following commonplace example demonstrates the level of complexity involved in routine estate planning: Husband (H) is survived by his wife (W), a son (S) who also has a son (grandson), and by two granddaughters, the children of his deceased daughter. H's will creates a trust for W for her lifetime and, on her death, the trust is to be divided into two equal parts: a) one part passing outright to S if he survives W or, if he does not, to S's son and b) a second part is divided into two equal shares which are then distributed to the granddaughters.

1. It is perhaps ironic that S.1695 repeals this most difficult and complex statute in one sentence.

S is to be the trustee during his mother's lifetime with the discretionary powers to distribute income and principal for her general welfare. No person other than W has a beneficial interest in the trust during W's lifetime. Upon W's death or if S dies or resigns as trustee before her death, a "taxable termination" has occurred.

To reach that conclusion, the following analysis is required: A person who has a "present or future power" in the trust is a "beneficiary;" a power to alter enjoyment of the corpus of the trust is such a "power;" S's power is presently exercisable in favor of W and is therefor presumably a "present" power although "present" is nowhere defined in the statute; accordingly, S by possessing the "power" to distribute principal to his mother, is a "beneficiary" of the trust;[2] since S is a generation younger than H, he is defined as a "younger generation beneficiary". H's grandchildren are "younger generation beneficiaries" of the trust because of their interests in the trust at W's death and are of a generation younger than S's generation. Since S's death or resignation during W's lifetime or W's death causes the termination of a present..."power in a generation-skipping trust of any younger generation beneficiary who is assigned to

2. This is true even if the power is restricted by a standard limited to the wife's health or support. However if the power is limited to such standard, the "nominal interest rules" applicable to the deferral provisions discussed later may produce a different result.

any generation older than the generation assignment of any other person who is a younger generation beneficiary of that trust"... that termination is a "taxable termination" under §2613(b)(1).

If W dies while S is still acting as trustee, the taxable termination will occur at W's death and a tax will be imposed on the one-half of the assets passing to the granddaughters. Thus S's one-half of the assets passes to him tax free, but the granddaughters' one-half is subject to tax under Chapter 13.[3]

Under the proposed regulations published in the Federal Register on January 2, 1981, if S dies during W's lifetime, a generation-skipping tax may be imposed on the entire trust at S's death while W is living. The statute provides for the postponement of the tax upon the termination of the interest of a younger generation beneficiary when a beneficiary of an older generation has or acquires a present interest. However, this provision is subject to the rule-making power of the Secretary. In his proposed regulations the Secretary has taken the position that there is no postponement for the payment of tax if the interest is "nominal" as defined in those regulations. W's interest will be "nominal" unless at least 5% of the value of the trust is distributed to W during each tax year of the trust. If in any year the amount distributed is less than 5%, the tax will be imposed. If the trustee should fail to make an annual

3. The "grandchild's exclusion" is available to shelter the first $250,000 in assets passing to the granddaughters.

"5%" payment he inadvertently causes a tax. Moreover, if the tax is imposed while W is still living, because of her continuing interest it has been questioned whether the grandchildren's exclusion is available to minimize that tax.

Although H was the original transferor of the trust, S will be the "deemed transferor" of the assets distributed to his son and S's deceased sister will be the "deemed transferor" of any assets distributed to her daughters. Since S is defined as the deemed transferor of the portion of the trust passing to his issue and the deceased daughter is the deemed transferor of the portion passing to her issue, the amount of tax to be paid (again subject to the grandchildren's exclusion) is the amount that the trust would have had to pay if the amount of the generation-skipping transfer had been added to their respective estates.

Now let us assume that S does not resign or die before W and the trust instrument provides that at W's death S is bypassed and the assets are instead retained in trusts for S's son and the granddaughters. S continues to serve as trustee of those trusts with the same discretionary powers over principal and income. Even though S's power may be used to benefit his son by distributing trust principal to him, this power is expressly excluded from the definition of a power. As we saw at W's death, a generation-skipping tax will be imposed due to S's powers as trustee during W's lifetime and will not be deferred for the period during which he possesses discretionary powers over his son's trust because S is no longer a "younger generation beneficiary". On the other hand, if S never possessed a power to distribute principal during W's lifetime but only possessed a power to distribute principal to his son and nieces, there will be no generation-skipping tax at all.

Sadly, these examples illustrate only simple problems. When family plans suggest more complicated arrangements, infinitely more complex problems are involved. Is it any wonder then that this statute has been described as the "land of metaphor and make believe?"[4]

Second, Chapter 13, designed to eliminate inequalities, creates other inequalities and injustices by subjecting many "transfers" to tax in cases where it is doubtful Congress desired that result. As we saw in the first example, a tax will be imposed on assets passing to H's granddaughters merely because their uncle had the power to make discretionary distributions of principal to W. We also saw that, under the proposed regulations, if S resigned as trustee while W is living, a tax could be imposed without any grandchildren's exclusion but if that resignation occurs after her death, the grandchildren's exclusion will be available.

The grandchildren's exclusion causes further inequality. If H's will provides that principal of his residuary trust can

4. See Stephens and Calfee, "Skip to M'Loo," 32 <u>Tax L. Rev</u>. 443, 450 (1977).

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be distributed to W, S or any of H's grandchildren, and $250,000 of assets are distributed to the first granddaughter, those assets avoid tax under the grandchildren's exclusion. When a second $250,000 of assets is distributed to the second granddaughter, she takes those assets fully subject to tax.

Finally, as interpreted by current proposed regulations, transfers such as gifts made under the Uniform Gifts to Minors Act or the power of an executor to allocate and distribute income earned during probate administration among legatees entitled to outright distributions, can be treated as producing generation-skipping taxes.

Third, Chapter 13, as presently constituted, creates an administrative nightmare. Banks and individual trustees, as well as the IRS, are required to maintain elaborate records and to file forms. Even though Chapter 13 has been effective for over five years and the proposed regulations require that returns for taxable distributions and terminations which have occurred during this five year period be filed by October 15, 1981 the form (706B) on which to report generation-skipping transfers and to compute the tax has yet to be issued, and the filing day has recently been extended to February 1, 1982.

Compliance with record-keeping requirements that can literally span decades imposes burdensome and expensive obligations on fiduciaries. Even more dangerous perhaps is the non-compliance caused by the improbable situations when the tax is imposed and the inability of most trustees and lawyers to understand the baffling complexity of Chapter 13. This situation undermines the principles of self-assessment and self-enforcement basic to our tax system.

Fourth, it is conceded that anticipated revenues to be derived from the tax are extremely slight. Even more troublesome is the fact that such payments will be made primarily by the moderately wealthy taxpayer who uses the trust device for family and business purposes and not for tax avoidance. These taxpayers are also more likely to be advised by professionals who are not familiar with the traps within Chapter 13.

The very wealthy are able to avoid the tax through outright gifts to descendants or through the use of extremely complex "layering" trusts. Persons of moderate means, however, cannot bypass their spouses and children in the disposition of their wealth and, therefore, their trusts are particularly susceptible to inclusion under Chapter 13. In conclusion, Chapter 13's purpose is lost.

As demonstrated, avoiding the tax requires extremely careful and meticulous analysis by estate planning lawyers. This planning is necessarily expensive and can create or neglect hidden traps and inadvertent errors. In the cause of such planning it is impossible to know the eventual value of the estate or the changes which might occur in the family situation. Consequently, many estate plans are forced to become too elaborate or too restrictive. In the first example common sense dictates that S be the trustee for his mother's trust, but planning, on the other hand, may require that discretionary powers be vested in strangers or corporate fiduciaries, contrary to the family wishes. In effect, good tax planning produces expensive and often cumbersome and unwanted estate plans for taxpayers never intended to come within the scope of the tax.

In 1976 the Congress was persuaded that a problem of fairness existed with regard to the tax treatment of multi-generational skipping transfers and in response adopted Chapter 13. As shown, Chapter 13 itself produces inequities and unfairness, as well as enormous complexities and the other expensive and intrusive disadvantages described above. In other words, Chapter 13 is a perfect example of tax overkill.

The generation-skipping tax was specifically intended to prevent estate tax avoidance. The reduction (in many cases, the elimination) of transfer taxes by ERTA, reduces or eliminates the danger of inequality through the use of multi-generational transfers. The justification for retaining Chapter 13 is correspondingly further reduced, particularly when weighted against all of its other disadvantages.

For the above reasons, many of which are based on the experience of members of the College and their practices, the

American College of Probate Counsel again respectfully recommends that Chapter 13 be repealed as of its original effective date.

In so doing, we recognize the existence of the problem of multi-generational transfers and suggest that the Congress may wish to consider further study to determine the true extent of the problem. In the College's view, it is imperative that lawyers actually practicing in the area of estate planning be represented in any such study, and the College will, of course, be gratified to participate in such study.

Section 6166 Deferral

For many years Congress has been aware that the impact of estate taxes on small business owners and their families has become more and more onerous. Both the 1976 and 1981 tax acts contain major changes intended to alleviate the liquidity problems of estates consisting of substantial small business holdings. ERTA, for example, combines Section 6166 and Section 6166A and reduces the percentage limitation of such holdings required to qualify installment payment of estate taxes to 35%. A qualifying estate may then postpone tax payments for five years before beginning installment payments, and during the five year period the interest on the first $1,000,000 worth of closely held interests is paid at the rate of 4%.

The hope was that the earnings of the business during the period of deferred payments would be sufficient to pay the taxes. When adopted in 1976, these relief provisions were hailed as a major benefit to closely held businesses.

In the opinion of the College, changes in the interest rates have destroyed the relief intended by Congress. Assume, for example, an unmarried decedent dying in 1982 with an estate valued at $3,000,000, $2,000,000 of which represents interests in a closely held business. The Federal Estate Tax (after application of credits) is $1,046,000, and the portion qualifying for deferral under §6166 is $697,333. Under §6601(j) the "4% portion" is $283,000 ($345,800 - $62,800), and the balance of $414,333 will, under the new interest rates just announced, be taxed beginning February 1, 1982 at the annual "adjusted" rate of 20%. At that rate the yearly interest will be $82,866. By 1987 the estate tax will be reduced to $901,000, $600,666 of that amount will qualify for §6166 deferral treatment, of which only $153,000 ($345,800 - $192,800) will constitute the "4% portion", leaving $447,666 subject to interest at the adjusted rate. At 20%, that interest will be $89,533 per year.

It is clear that many closely held businesses will not be able to generate sufficient earnings to cover the necessary interest payments and, after the five year period, the yearly installments.

The College is generally opposed to the principle of different estate tax rates for different kinds of assets but believes that some additional relief is needed to prevent the forced sales of closely held businesses, particularly on the death of a surviving spouse. Accordingly, if §6166 is to be effective as a relief measure as intended, the interest burden will have to be reduced. Among the possibilities: (a) set the interest rate at a flat preferential rate or at a percentage of the adjusted rate; (b) increase the 4% portion either by a fixed amount or to a percentage of the tax attributable to the closely held business; or (c) provide that the credit is not first applicable in its entirety to the "4% portion".

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 Section 6166; 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.

The IRS has now concluded that post-death interest paid on deferred estate tax installments is an allowable administration expense deduction under §2053. As such, that interest may be claimed as either an income tax deduction on the estate's income tax return or as an estate tax deduction.

When the interest is claimed as an estate tax deduction numerous problems arise. The IRS takes the position that the deduction is allowable only as the interest is paid, and that the executor must file a supplemental estate tax return following each payment of interest, at which time a recomputation of the unpaid estate tax liability and interest is made. In addition to the complexity of this procedure, substantive problems are created because the amount of the adjusted gross estate is constantly being reduced. This may result, in recomputation of charitable deduction amounts, and it affects the applicable threshold tests. Further, in every case the amount of estate tax which can be deferred is affected, since the adjusted gross estate is the denominator in the determining fraction.

Several simple solutions to the post-death interest problem have been proposed. First, in lieu of granting an estate tax deduction for post-death interest there would be a forgiveness of a portion of the interest at a stated rate. An even simpler solution would be to deny post-death interest on the unpaid estate tax installments as a deduction for estate tax purposes, and in lieu grant an additionl favorable preferential interest rate on all deferred estate tax payments.

In addition to interest, the College believes that a number of other §6166 problems should be addressed by the Congress. We favor, for example, legislation providing for judicial review for disputes under that Section. We hope that the legislation for this purpose will allow for an orderly audit as does §2 of S.1733, introduced by Senator Symms. On the other hand, we recognize that in some instances unless those determinations are made in the early stages of estate administration, an executor, when faced with the possibility of a 20% interest rate and a final adverse determination, may hesitate to make the election to which the estate might otherwise be entitled. The College has, unfortunately, not as yet had an opportunity to consider carefully the details of S.1733 and what methods may be best designed to allow judicial review of the questions on which qualification depends.

Other proposals for technical changes in §6166 presently before this Committee include items dealing with clarification of the status of corporate and partnership holding companies, the inclusion of indebtedness in meeting the threshold requirements, the elimination of distinction between voting and non-voting stock, simplification of attribution rules and the exemption from the acceleration rules in the case of a sale of stock or a partnership interest by an estate in exchange for note.

Again because of the short time period, the College has not had sufficient opportunity to study carefully these problems and proposed solutions. We are anxious to do so and hope that we, as practicing lawyers, may participate in the consideration being given to these issues and welcome the opportunity to assist the Congress in their resolution.

THE AMERICAN COLLEGE OF PROBATE COUNSEL

EXECUTIVE COMMITTEE

President

Milton Greenfield, Jr.
Greenfield, Davidson, Mandelstamm & Voorhees
721 Olive Street
Suite 1516
St. Louis, Missouri 63101
314/241-5735

President-Elect

Rudolph O. Schwartz
R. O. Schwartz & Assoc., S.C.
801 York Street
Manitowoc, Wisconsin 54220
414/682-6139

Vice-President

George H. Nofer
Schnader, Harrison, Segal & Lewis
1719 Packard Building
Philadelphia, Pennsylvania 19102
215/988-2464

Secretary

J. Thomas Eubank
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
713/229-1234

Treasurer

Luther J. Avery
Bancroft, Avery & McAlister
601 Montgomery Street, Suite 900
San Francisco, California 94111
415/788-8855

EXHIBIT "A"

Executive Committee Cont.

Past-President

Arthur Peter, Jr.
Hamel, Park, McCabe & Saunders
1776 F Street, N.W.
Washington, D.C. 20006
202/785-1234

Joe C. Foster, Jr.
Fraser, Trebilcock, Davis & Foster, P.C.
10th Floor, Michigan National Tower
Lansing, Michigan 48933
517/372-0235

Harold Fallon
Weston, Hurd, Fallon, Paisley & Howley
25th Floor, Terminal Tower
Cleveland, Ohio 44113
216/241-6602

William P. Sutter
Hopkins, Sutter, Mulroy, Davis & Cromartie
5200, One First National Plaza
Chicago, Illinois 60603
312/558-6616

THE AMERICAN COLLEGE OF PROBATE COUNSEL

ESTATE AND GIFT TAX COMMITTEE

Edward B. Benjamin, Jr.
Jones, Walker, Waechter, Poitevent, Carrere & Denegre
Louisiana & Southern Life Building
225 Baronne Street
New Orleans, Louisiana 70112
504/581-6641

Frank S. Berall
Copp, Koletsky & Berall
111 Pearl Street
Suite 320
Hartford, Connecticut 06103
203/249-5261

Doris D. Blazek
Covington & Burling
888 Sixteenth Street, N.W.
Washington, D.C. 20006
202/626-5640

Russell G. Buchanan
Hutchinson, Buchanan, McClure & Dotson
111 North Dodge Street
Post Office Box 617
Algona, Iowa 50511
515/295-3567

Professor Regis W. Campfield
7544 Oakcliff
Dallas, Texas 75240

Dave L. Cornfeld
Husch, Eppenberger, Donahue, Elson & Cornfeld
100 North Broadway
St. Louis, Missouri 63102
314/421-4800

J. Thomas Eubank
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
713/229-1234

Estate and Gift Tax Committee, Cont.

William F. Gigray, Jr.
Gigray, Miller, Downen & Weston
9th & Dearborn Streets
Post Office Box 640
Caldwell, Idaho 83605
208/459-0091

George J. Hauptfuhrer, Jr.
Dechert, Price & Rhoads
3400 Centre Square West
1500 Market Street
Philadelphia, Pennsylvania 19102
215/972-3454

Philip J. Hirsch
Proskauer, Rose, Goetz & Mendelsohn
300 Park Avenue
New York, New York 10022
212/593-9212

Charles B. Kniskern, Jr.
Kimbrell, Hamann, Jennings, Womack, Carlson & Kniskern
Suite 900
Brickell Centre
799 Brickell Plaza
Miami, Florida 33131
305/358-8181

Ira H. Lustgarten
Wilkie, Farr & Gallagher
One Citicorp Center
153 East 53rd Street
New York, New York 10022
212/935-8000

Malcolm A. Moore
Davis, Wright, Todd, Riese & Jones
4200 Seattle First National Bank Building
Seattle, Washington 98154
206/622-3150

Arthur Peter, Jr.
Hamel, Park, McCabe & Saunders
1776 F Street, N.W.
Washington, D.C. 20006
202/785-1234

Estate and Gift Tax Committee, Cont.

Raymond A. Reister
Dorsey, Windhorst, Hannaford, Whitney & Halladay
2200 First National Bank Building
Minneapolis, Minnesota 55402
612/340-2732

William P. Sutter
Hopkins, Sutter, Mulroym, Davis & Cromartie
5200, One First National Plaza
Chicago, Illinois 60603
312/558-6616

Thomas P. Sweeney
Richards, Layton & Finger
Post Office Box 551
Wilmington, Delaware 19899
302/658-6541

L. Henry Gissel, Jr.
Fulbright & Jaworski
800 Bank of the Southwest Building
Houston, Texas 77002
713/651-5151

Senator SYMMS. Thank you very much for excellent testimony. Your entire statement will be made part of our record.

Now we turn to Mr. William Warren.

STATEMENT OF WILLIAM B. WARREN, CHAIRMAN, COMMITTEE ON TAXATION OF THE TRUSTS AND ESTATES LAW SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. WARREN. Thank you, Mr. Chairman.

My name is William Warren, and I am appearing on behalf of the Trusts and Estates Law Section of the New York State Bar Association.

Our association has 33,000 members, of whom 3,500 are members of the trusts and estates law section. My purpose in being here today is to advise that our section is 100 percent behind your efforts for the repeal of chapter 13.

I have prepared a written statement in conjunction with Mr. Ira Lustgarten, who is the former chairman of our section, and I would request that that go into the record, and I simply be permitted to make a few informal remarks prompted in part by Mr. Glickman.

Senator SYMMS. Without objection, that shall be done.

Mr. WARREN. Thank you, sir.

Mr. Glickman asks us to assume that the generation-skipping transfer tax should remain on the books in order to preserve the integrity of the transfer tax system. He doesn't explain how it preserves the integrity of the system, and I would suggest that it does just the opposite.

How can a tax preserve integrity when there isn't a draftsman at this table who cannot prepare a trust that will never be subject to the tax for the foreseeable or unforeseeable future, except perhaps in the case of a natural catastrophe of a type which none of us contemplates occurring.

The only people who will be subject to the tax are the unwary who will be trapped by the complexities of the tax, and who cannot afford counsel that will show them the way around it. I don't think that the preservation of such a tax on the books maintains in any way the integrity of our transfer tax system, or of our tax system as a whole.

It is the view of our section that the tax should be repealed because it is too complex, it is administratively unworkable, and its transitional rules have imposed a moratorium on estate planning, both tax related and nontax related, of persons having trusts that were in effect on June 11, 1976.

In other words, most changes in beneficiaries in such wills cannot be made, even if tax avoidance plays absolutely no role, because the changes might increase a generation-skipping transfer and attract a tax if death occurs before 1983.

It is our opinion that the defects in the tax cannot be cured by another round of patch up legislation. This has been tried and failed.

As to the point of complexity, some may say that we lawyers are trained and paid to comprehend complexities, and to explain them to our clients. To this we would say, there is a limit, and this limit has clearly been reached by the generation-skipping transfer tax. Just observe the historical record.

The tax was enacted in 1976, yet the Treasury was unable to come up with proposed regulations until 4½ years later, and those regulations were generally felt by all of those who submitted comments to be unsatisfactory in many respects.

The American Bankers, the College of Probate Counsel, and the Tax Section of the New York State Bar Association, among others, recommended that these regulations be withdrawn and revised.

In other words, a complete rewrite was needed, and not just a patch up. Now 5 years have passed, and the Treasury still hasn't revised their regulations, and we submit that this inability to patch up the regulations argues that it will be impossible to patch up the statute.

Now, from what does the complexity of the tax stem? There are many reasons. I think that one of the principal reasons is that the tax attempts to reach too far. It attempts not only to tax beneficial interests, but also to tax fiduciary powers.

It was incredible to me when the tax was enacted that an incidence of taxation could simply be the death of a trustee who has absolutely no interest in the trust, who simply has the discretionary power to pay principal and income among unrelated parties.

The service attempted to patch up this provision but, as Mr. Baetz pointed out, they have not succeeded in doing it, so that even now unless we are extremely careful in naming individual trustees, the designation of an attorney or a business associate as a trustee can lead to dire tax consequences which don't serve any policy whatsoever.

I would like to close by pointing out that the Economic Recovery Tax Act has added to the reasons why repeal is required. By phasing in a unified credit for a $600,000 exempt amount, the number of estate tax returns will be vastly reduced. Therefore, you will not be able to get the information needed to prepare the generation-skipping tax returns in many respects.

I note that some of the constructive patch up that was suggested by Mr. Glickman today would remove the necessity of getting information from estate tax returns. We would support a measure such as that, but there are just too many such changes that have to be made to have them made in a patch up statute such as is suggested by Mr. Glickman.

For these reasons, we submit that your bill should be passed, and we want to thank you and express the gratitude of the New York State Bar Association to you for all your hard work, and your enlightened efforts in this area.

[Statement of Mr. Warren follows:]

Testimony to be presented
by William B. Warren, Esq.

STATEMENT

on

S. 1695 - REPEAL OF THE GENERATION-SKIPPING TRANSFER TAX

by the

TRUSTS AND ESTATES LAW SECTION,
NEW YORK STATE BAR ASSOCIATION

before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION,
SENATE FINANCE COMMITTEE

WEDNESDAY, NOVEMBER 4, 1981

* * * * *

This statement has been prepared on behalf of the Trusts and Estates Law Section of the New York State Bar Association. The Association has a current membership of 33,000 attorneys, of whom 3,524 are members of the Trusts and Estates Law Section. It is submitted to the Subcommittee on Estate and Gift Taxation in connection with its hearings on S. 1695 - Repeal of the Generation-Skipping Transfer Tax - Chapter 13 of the Internal Revenue Code of 1954.

SUMMARY OF PRINCIPAL POINTS

1. As enacted, the Generation-Skipping Transfer Tax (hereinafter "GSTT") contains complexities and concepts which even the most sophisticated practitioners have thus far been unable to understand, let alone explain to their clients. In more than five years, the Internal Revenue Service has not

been able, by its proposed regulations, to produce satisfactory explanations of the substantive part of the statute and such final regulations as have been forthcoming (dealing with the transitional rules) are now largely obsolete as a result of the enactment of the Economic Recovery Tax Act.

2. Our Section takes no position at this time as to the social desirability of such a tax. However, the Section believes that the present format, by imposing a tax on not only economic interests but trustees' powers as well, is too all-embracing to be workable. Because of the broad scope of the current scheme, the numerous faults in the statute defy remedy by the sort of legislative "patch-up" which some commentators have advocated. Further, it is unlikely that a complete overhaul could be accomplished prior to the current effective date deadline of January 1, 1983.

3. Many organizations have submitted detailed comments on the proposed regulations dealing with the substantive provisions of GSTT (see, e.g. comments by the American Bankers Association and by the Tax Section of the New York State Bar Association). It is all too easy to list a parade of horrors demonstrating situations in which the tax is not imposed where perhaps it should be or is imposed where clearly it should not be. A glaring illustration of this is the provision in the proposed regulations which would impose the tax on gifts to minors under the Uniform Gifts to Minors Act.

4. Administration of the tax would be difficult in many situations because of the new increased unified credit for transfer taxes. After 1986 there will be no Federal estate tax return required with respect to transfers aggregating less than approximately $600,000. Since GSTT builds upon the estate tax posture of the deemed transferor (usually the parent of the trust beneficiary), it will often prove impossible to determine how the tax should be computed.

5. The Economic Recovery Tax Act provided great incentive for the rearrangement of estate plans to take advantage of the unlimited marital deduction and the qualified terminable interest property trust. For at least two months, practitioners have wrestled with the problem of how to make these new benefits available to their clients without jeopardizing the protection of certain instruments under the GSTT transitional rules. There has as yet been no guidance from the Service as to how this may be done and much estate planning will remain in limbo until January 1, 1983 because of the confusion. It seems incongruous for the Congress to have mitigated the effect of transfer taxation while it remains virtually impossible to take advantage of the liberalization because of the existence of the GSTT. Repeal, not further moratorium, is the only solution to this dilemma.

6. For all of the above reasons, GSTT should be repealed. If this Committee believes that national policy

requires the reenactment of a tax on generation-skipping transfers, a simplified and more effective statutory scheme should be developed. The Trusts and Estates Law Section of the New York State Bar Association would be glad to participate in any study group that may be organized for the purpose of investigating the need for and development of such legislation if it is found to be needed.

Ira H. Lustgarten
Member, Committee on
Taxation and former
Chairman of the Trusts
& Estates Law Section
of the New York State
Bar Association

William B. Warren
Chairman, Committee on
Taxation of the Section

Senator SYMMS. Thank you very much.

I want to thank all the members of the panel for coming from out of town. I note that our next witness, Ms. Springs, came from San Francisco. We are glad to have you here.

STATEMENT OF CLARE H. SPRINGS, ATTORNEY, ESTATE PLANNING, TRUST AND PROBATE LAW SECTION, CALIFORNIA STATE BAR ASSOCIATION

Ms. SPRINGS. I am Clare Springs, as you mentioned, and I am a member of the State Bar of California. I am here representing the estate planning, trust and probate law section of that association. There are 4,000 members of that section of the bar, and they have voted by written ballot overwhelmingly in favor of repeal of this statute.

They favor the repeal of the statute because of its technical complexity, which has been discussed in depth today. Their conclusion after 5 years of grappling with this statute is that it simply will not work.

While chapter 13 was supposed to catch the wealthy, almost every estate plan which contains a trust requires chapter 13 tax planning. This complexity is going to breed noncompliance on the part of the attorney and the taxpayer alike. This is not rebellion. It is simply an inability on the part of many estate planners to understand the nuances of chapter 13.

Attorneys and other tax practitioners offer considerable assistance to the Government in the enforcement and collection of Federal estate and gift taxes. This cooperative effort between the estate planning community and the Government is not likely to exist with chapter 13. This is in part because attorneys do not follow the day-to-day operations of trusts. Because they don't, they are not going to know when taxable events occur, and they are not going to be in a position to advise trustees that at least returns must be filed, if not taxes paid.

Attorneys have been unable to devise any scheme to keep track of the many different events which might trigger taxes, and to keep track of the tax history of the deemed transferor. Without the assistance of the private sector, the entire burden of enforcement of this tax is going to fall on the Government's back.

To administer the tax is going to require storage of massive amounts of cumulative data. This will be difficult to obtain in the first place, and to keep up to date as well. Even if the Government is able to administer the tax, the cost may well exceed the revenue generated.

In addition, chapter 13 does not achieve its objective. The wealthy can still avoid taxes by hopping over generations, and in large trusts, where there is substantial income, by making distributions of income because income is exempt from chapter 13.

The middle sector of Americans, on the other hand, not realizing the dangers of chapter 13, and employing nonspecialists for their estate planning, will frequently find themselves ensnared inadvertently in a chapter 13 net. Thus, the rich will get richer, and the poor will get poorer, and chapter 13 misses its mark.

For all these reasons and many more, which we don't have time to go into, California estate planning attorneys urge Congress to reexamine the issue of the taxation of generation-skipping transfers. As presently written, chapter 13 presents an unworkable scheme of taxation, which produces, (1), an unreasonable burden on the taxpayer and his advisors, (2), an unfair imposition of tax, and (3) an onerous administrative burden on the Government, all for an insignificant amount of revenue.

These problems are substantial and uncorrectable. Only wholesale repeal will alleviate them, and California practitioners strongly urge Congress to take that step.

Thank you.

[Statement of Ms. Springs follows:]

STATEMENT OF CLARE H. SPRINGS
ON BEHALF OF THE STATE BAR OF CALIFORNIA
ESTATE PLANNING, TRUST AND PROBATE LAW SECTION
FOR THE HEARING ON REPEAL OF GENERATION-SKIPPING TRANSFER TAX
HELD BY THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE COMMITTEE ON FINANCE OF THE UNITED STATES SENATE

November 4, 1981

Mr. Chairman and Members of the Committee:

My name is Clare H. Springs, and I am here today as a member of the State Bar of California, representing the Estate Planning, Trust and Probate Law Section, of which there are more than 4,000 members. I am a member of the Section's Executive Committee, and I am a partner specializing in estate planning, tax and probate matters, in the San Francisco law firm of Dinkelspiel, Donovan & Reder.

The State Bar of California Section on Estate Planning, Trust and Probate Law is grateful for this opportunity to testify in connection with the Committee's consideration of repeal of Chapter 13 of the Internal Revenue Code of 1954, as amended, known as the generation-skipping transfer tax.

<u>What Does California Think of Chapter 13?</u>

After five years of grappling with the provisions of Chapter 13, California estate planning attorneys have concluded that, regardless of the policy reasons behind its enactment, Chapter 13 is so technically complex that it is unworkable for either the taxpayer or the tax collector. In addition, the tax is imposed on many persons whom Congress did not intend to tax and, in many instances, is not imposed on transfers by the wealthy as was intended. Finally, the burden on the estate planning professionals to assist the government in enforcing Chapter 13 is not practical or financially feasible.

These conclusions are supported by the poll of more than 4,000 California estate planning attorneys taken in September, 1981. These 4,000 attorneys are not experts. Rather, the group is comprised of many attorneys who do occasional estate planning and belong to the Section as a means of keeping up to date in the area. Of those polled, an overwhelming 85% favored repeal of Chapter 13, 13% favored retention but with major changes to simplify its application but, not surprisingly, less than 1% favored retention of Chapter 13 in its present state. Clearly, the poll indicates the frustration of California attorneys who are trying to plan for and administer the tax. One San Francisco attorney summed up the feelings of many when he wrote,

> "The provisions of the law are so archaic, complex and incomprehensible that they would be laughable, but for the tears. Whoever conceived of the generation-skipping tax should be locked up and kept away from any pen, ink or dictating equipment for the rest of their lives".

Indeed, the issue has stirred such strong sentiment that it has transcended the specialty area of practice and a proposal to urge repeal of the generation-skipping transfer taxes is presently before the Board of Governors of California's State Bar. If the results of the Section's poll are any indication, the State Bar, speaking for its more than 70,000 attorneys, will vote overwhelmingly in favor of repeal. This vote on the part of the State Bar has been mandated only because of the grass roots ground swell of support for repeal that is evident throughout the California legal community.

In this statement the Section intends to address the practical reasons why the statute will not work. It does not purpose to state any position with respect to the policy reasons behind the enactment of Chapter 13.

Why Should Chapter 13 Be Repealed?

A. It is Too Complex.

The ground swell of support for repeal is due in large part to what practicing attorneys view as a morass of new terminology and concepts involving hypothetical transfers and transferors. Practicing attorneys have tried to learn the concepts and master the statute. This effort is evidenced by the fact that California's active Continuing Education of the Bar (C.E.B.) has offered more than 800 three or six-hour programs in the past five years which have included yet another attempt to explain Chapter 13 to the practicing attorneys. More such programs are planned for 1982. According to C.E.B., the topic has been discussed as much as any other and more than most, and there is continual demand for more programs on it. Yet, after five years these practitioners' efforts have only led them to the conclusion that it will not work.

Others have previously testified to the new conceptual basis, the new terminology and the change in meaning of common place estate planning terms. Indeed, for example, it is difficult for some to understand how a hypothetical transfer in which no property changes hands can trigger a taxable event. How does one explain that to be a beneficiary does not require having a beneficial interest in the traditional sense of that term? Not only are these new concepts difficult for attorneys to grasp, but clients are completely baffled by this change in traditional thinking. One client commented to me after I explained the generation-skipping tax consequences of a particular plan that he felt as though someone had told him the earth was flat after all.

1. Complexity Has Chilling Effect on Attorneys.

Although the complexity of Chapter 13 has been dismissed by some as irrelevant because the tax is imposed only on the super-rich, this ignores the fact that almost every estate plan which includes a trust must be planned with generation-skipping in mind. Many taxpayers with no intention of creating generation-skipping trusts may find their estates caught within the net of Chapter 13 because, among other things, there is an unusual sequence of death within the family unit or the trust is technically flawed so that it does not avoid the tax when otherwise possible.

It is generally conceded that it is preferable to die with a will than without one. Not only does the preparation of a will require an individual to give some semblance of order to his affairs, but it also provides his family with an expression of his intentions. Many attorneys prepare wills, trusts and related testamentary documents on an occasional basis for clients. These are not the specialists who testify before you today nor the draftsmen of the super-rich; these attorneys represent the clients with small and medium-sized estates. While Congress has substantially reduced the need for these attorneys to understand the federal estate tax law because of the increased unified credit and other changes recently enacted, the need to understand Chapter 13 remains. These practitioners cannot devote the inordinate amount of time required to make Chapter 13 part of their working knowledge of the tax law. Yet, if they do not, they run the risk of causing substantial damage to their clients. Only those clients who realize the damage will resort to malpractice claims against the attorneys. Even these clients may be thwarted in collecting against their attorneys. As you may know, the California Supreme Court has held that it is not malpractice for an attorney to run afoul of the Rule Against Perpetuities because it is too difficult to understand. It is conceivable that the California courts would apply the same reasoning to absolve attorneys from liability for not understanding the finer points of Chapter 13. The result is a chilling effect on the preparation of testamentary documents by those attorneys who know enough to know they do not understand Chapter 13, or the imposition of an unnecessary tax on the clients of those who do not.

Two examples will illustrate the ease with which one may inadvertently tangle with Chapter 13 in preparing simple trust wills which I speculate is the estate planning format used by most members of this committee. First, many individuals do not want property passing outright to minor grandchildren in the event that a child dies prematurely. So, in lieu of outright disposition, a trust is provided for such grandchildren until they reach a specified age. If that trust is not properly drafted, the grandchild's exclusion of $250,000 will not be exempted from Chapter 13 taxes upon the child's death. The lack of qualification of the grandchild's exclusion will cause many trusts of nominal value to be clutched by the grasping tentacles of Chapter 13. Second, if a person who is named trustee has no beneficial interest in the trust except as a potential remainderman in the unlikely event that all other family members in succeeding generations predecease him, the trustee's resignation or death will trigger a generation-skipping transfer requiring the filing of a return and the possible imposition of tax. Furthermore, the tax is imposed on the trustee's death or resignation despite the facts that 1) all family members do not predecease the trustee; 2) the trustee will never receive one penny from the trust; and 3) no transfer of trust property occurs upon the trustee's death or resignation. In this example, it is worth noting that even if the trust qualified for the grandchild's exclusion, the trust might be sheltered from actual payment of tax, but this does not avoid the fact that a taxable event has occurred for which the trustee is required to file a tax return. It is these traps for the unwary which exist throughout Chapter 13 that cause malpractice concerns within the legal profession. Gradually as malpractice claims begin to surface, more and more attorneys will refuse to draft even simple trust wills for fear of running afoul of these rules.

2. Complexity Forces Distortion of Estate Plans.

General speaking, the public interest is not served when people let the tax tail wag the dog, particularly in the estate and gift tax area. On the contrary, public policy is best served when testators consider what is best for family members without being unduly influenced by the tax consequences. Yet, Chapter 13 has the opposite result; the tax tail is wagging the dog.

The frustration felt by much of the legal community is beginning to extend to the public at large as the generation-skipping consequences of their dispositive schemes are explained to them. Many are distorting their estate plans to avoid not only the imposition of the tax but also any involvement with the tax because taxpayers cannot understand it. For example, testators are making outright bequests when they actually believe that a trust would be more suitable for the protection of the beneficiary, particularly in the case of young adults who have not yet demonstrated the maturity to manage valuable assets.

General powers of appointment are being given to beneficiaries to qualify for the grandchild's exclusion when the testator does not otherwise want to give a young grandchild the power to divert the property from immediate family members, perhaps, even diverting it to radical political or religious groups which often attract the young and immature.

The selection of the trustee has been distorted in many cases where generation-skipping is far from the testator's mind, but because of the relationship of the trustee to the testator, adverse tax consequences are produced which could be avoided by naming another person as trustee. To illustrate, if you were the owner of a closely-held business, you might prefer to name a trusted and valued employee as trustee because of the employee's intimate familiarity with the business as well as with the your intentions. However, selection of the employee will incur a generation-skipping tax upon the employee's death or resignation as trustee because the employee is treated as subordinate to the testator or grantor. A similar situation exists when certain family members are designated as trustee. Because of Chapter 13, testators are shying away from designating those persons as trustees who because of their particular knowledge of the testator's affairs and family, would be the most suitable to serve in that position. The selection of a particular trustee merely to avoid the imposition of tax is generally not in anyone's best interests.

Finally, the use of spray trusts which permit a trustee to distribute income and/or principal to many family members in various generations has been sharply curtailed because of the Chapter 13 taxes. Spray trusts have traditionally allowed testators of limited or moderate means to provide for the needs of specific family members in different generations based on circumstances existing at a particular time. The reduced use of the spray trust as a tool in planning small and moderate-sized estates because of fear of additional taxes is unfortunate and not what Congress intended. We have a pending matter in our office in which a terminally ill client with an estate of about $500,000 has refrained from using a spray trust in her will because of the potential generation-skipping tax. The result will be that her son and grandchildren will remain on the welfare rolls and receive other government benefits instead of the income from the trust which will be accumulated until the grandchildren are adults. While an unusual situation, it highlights the bizarre results inadvertently caused by Chapter 13.

B. <u>Complexity Will Breed Noncompliance</u>.

The complexity and seeming unfairness of Chapter 13 breeds frustration and anger on the part of attorneys and taxpayers alike. This frustration and anger will in time spawn noncompliance with the law which, in turn, will threaten our voluntary tax system.

1. <u>Attorneys Will Be Unable to Enforce the Statute</u>.

At the present time, attorneys and other tax practitioners render considerable assistance to the government in the enforcement and collection of the estate and gift tax. While most people understand the requirements of filing annual income tax returns, they do not understand the rules governing estate tax and gift tax. Rather, as it is an occasional tax, taxpayers rely on their attorneys or accountants to advise them in this regard. Without this advice, it is difficult to estimate how much revenue would be lost because taxpayers did not file the required returns.

Unfortunately, this cooperative team attitude between the government and the estate planning community is not likely to extend to generation-skipping taxes. This is not a question of rebellion, if anything it is a question of allocation of time. After a certain point many attorneys who understand estate and gift tax reasonably well but are not experts, will not have the additional time or will give up trying to learn Chapter 13 because of its highly technical nature and because the government has made it clear that the tax is meant to apply only to the very wealthy. In other words, if one does not have wealthy estate planning clients, one need not worry about Chapter 13. That has been the government's public relations "pitch" from the start. Other estate planners who are not lulled by policy statements into a false sense of security will still be unable take the time to understand the nuances of what triggers a taxable event and, therefore, will not file the informational returns at the proper time, if at all. Still others will ignore the filing requirement as long as there is unused grandchild's exclusion available to shelter the distribution from tax. Without the informational returns, it is difficult to see how the government will know a trust with potential generation-skipping consequences even exists, much less when a tax is incurred.

2. Trustees Will Lack Requisite Knowledge To Comply.

Noncompliance will also occur because the trustee, with little or no knowledge of the tax law, will fail to inform his attorney or accountant of certain crucial events such as a distribution of trust principal to a grandchild for school tuition, the death of a beneficiary if the trust continues without interruption, or, particularly, the death of a family member who is not a beneficiary (but may be the deemed transferor) since such information to the uninformed trustee would not be relevant. Yet, each of these events, as well as many others, may trigger a generation-skipping transfer tax or, at least, a filing requirement. It may be months or years before someone with a requisite knowledge of the law, as well as the facts, will put these seemingly unimportant events together and inform the trustee or distributee of his tax liability.

Surely, one would think this part of the problem could be solved. On the contrary, for those of us who have worked extensively with Chapter 13, our conclusion is it cannot; the problems are inherent. No amount of "patch-up" is going to educate non-professional trustees to the myriad of sequences of events that will cause a taxable event, nor to the need to stockpile information in anticipation of the taxable event.

3. Private Sector Lacks Means To Inform Chapter 13 Trustees and Beneficiaries.

It is impossible to conceive of any system that could keep track of all the possible events which, if they occurred, might trigger the tax. Even more difficult would be a system to keep track of those persons from whom information will be required to determine applicable tax rate, i.e. the deemed transferors and, more importantly, their cumulative transfer tax history. Even if the estate planning attorneys were able to develop such a system, it would be a time-consuming project to keep up to date, for which clients would most assuredly be unwilling to underwrite the cost. You can almost hear the client -- "If the tax law is so poorly written that Uncle Sam can't enforce it, then I'll be damned if I'm going to spend my after-tax dollars enforcing it for him". Some attorneys in California have tried to develop a checklist to be given to

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all trustees and beneficiaries which lists those types of events which might trigger generation-skipping transfer taxes. However, this approach is not feasible because there are too many variables in the statute.

Many attorneys being unable either to learn the law or, once learned, to devise a policing system, will simply ignore the whole matter and trust that the complexity of the law will protect them from malpractice and even possibly from having the generation-skipping transfer detected by the government. Signs of such behavior are readily apparent today to any estate planning specialist who is called upon to review wills prepared by others. Although a number of Chapter 13 drafting problems are manifest, the most common and probably the most immediately serious problem for the general public is the failure to qualify for the grandchild's exclusion. In many instances, this failure will result in a substantial tax bite, from $94,500 to $125,000 if the deemed transferor has used his entire unified credit. With proper qualification, this tax could be avoided.

The failure to qualify for the grandchild's exclusion will only be aggravated as estates of $600,000 or less (or in our community property context, estates of $1,200,000 or less) do not require federal estate tax planning. In these estates it is unlikely the draftsman will consider, much less plan for, Chapter 13 tax liability when no other federal transfer tax liability exists. Thus, as attorneys and taxpayers refuse to devote the time and energy to learn a law which seemingly can result in such arbitrary and incomprehensible impositions of tax, the integrity of the entire federal transfer tax system may be jeopardized by taxpayer noncompliance.

C. Government Cannot Adequately Enforce.

Given the foreseeable lack of cooperation from taxpayers and their advisors, the government will have to bear the full responsibility for policing all potential generation-skipping transfers.

1. Administrative Burden Too Great?

This will require storage facilities for massive amounts of cumulative data and armies of trained personnel to collect and administer the data and to respond to requests for information. Existing personnel will not be sufficient for this formidable task.

Besides the sheer quantity of the data to be stored, the kind of information required will oftentimes be difficult to obtain or keep up to date. For instance, the individual trustee's employment history will have to be current because his employment may determine whether he is a beneficiary of the trust. Information concerning all additional contributions to the trust, including accumulations of income, will have to be collected and tallied. The estate and gift tax history and current location of all potential deemed transferors, even those who may have died many years before the trust was established, will have to be retained until the identity of the actual deemed transferor becomes known. Any loan to a beneficiary which the beneficiary has secured by his interest in the trust will have to be analyzed. Any power of appointment, special or general, inter vivos or testamentary, including those that require the consent of an unrelated third person, will have to be catalogued and held until its exercise. Having collected and maintained this voluminous data, often for many years, when the time comes, it may all have been for naught. The government will have incurred the expense of storing the data but on the day of reckoning, the deemed transferor still has unused unified credit to shelter any Chapter 13 tax. Thus, no revenue is generated but substantial administrative cost has been incurred.

Even if the more obvious administrative problems of Chapter 13 can be solved, there remains the problem of the "deemed transferor", described rather aptly by one commentator:

> "The deemed transferor is the leading man. He is what it's all about. In Cole Porter's words, he's 'The Top.' He is all over the place in Chapter 13 [and yet, he may be nowhere]. He has proved it is not necessary to be a Baptist to be reborn; when physically dead, he is fiscally vigorous. Even while lacking in ectoplasm, he is more colorful than a mere Chapter 11 decedent or Chapter 12 donor." (Insertion added)1/

Much of the stored information will concern this colorful, fiscally vigorous person deemed to be the transferor.

1/ Stephens, Maxfield and Lind, Federal Estate and Gift Taxation, §13.02, (1978).

The deemed transferor's importance is that his highest marginal transfer tax rate will determine the rate of taxation on the generation-skipping transfers attributable to him. Yet, he may never have had an interest in the trust. If living, he may not wish to disclose his tax history or, if deceased, his tax history may be unobtainable.

Frequently the identity of the deemed transferor cannot be determined until a taxable event occurs and the transferee is identified. It is essential to the operation of Chapter 13 that the government have the tax information about the deemed transferor. To do so means that information about all potential deemed transferors should be maintained until the actual transferee is known. To obtain the information from the deemed transferor will not be sufficient. To illustrate, a trustee required to file a Chapter 13 return obtains limited liability for payment of the tax only by requesting and relying upon the government's disclosure of the deemed transferor's tax rate. Even if the trustee can obtain the information directly from the deemed transferor, reliance on this source of information will afford the trustee no protection. Any prudent and well-advised trustee will, therefore, request such information from the government. Assuming the government has the data to determine the applicable tax rate, is it enough for the trustee to request just the tax rate or does he have a fiduciary duty to go behind the tax rate to the underlying data to determine for himself the accuracy of the rate?

If he has such a duty, does the Internal Revenue Service have an obligation to disclose the underlying data? Some commentators have argued that to accept without question the reasonableness and accuracy of the rates supplied by the Service would be a breach of the trustee's fiduciary duty because he has the duty to defend the trust against unjust claims. On the other hand, if the deemed transferor is living, is his constitutional right to privacy violated by the disclosure of information released by the Service?

Another problem arises if the deemed transferor has not used his entire unified credit in his inter vivos and testamentary transfers. The unused portion may be applied against the tax on any generation-skipping transfers of which he is deemed to be the transferor. However, it is likely in this situation that the deemed transferor's representative will not have filed a federal estate tax return. How will the Service know how much of the unified credit remains unused? This will become a more serious problem as the phase-in period to a full unified credit of $192,800 occurs. It is noteworthy that given the difference between the generation-skipping exclusion of $250,000 and the $600,000 exemption equivalent from federal estate tax and the increased annual exclusion from gift tax, there may be many instances where generation-skipping tax is incurred but the deemed transferor has filed no federal estate or gift tax returns.

2. Will The Cost Exceed The Revenue?

Even if the administrative task of collection and storage is successfully dealt with, how much is it going to cost the taxpayers to collect and update this data? Surely more than the projected revenue of $400 million realized in the first twenty years. Even this modest projection made several years ago will have to be reduced as the increased unified credit and rate reduction under the Economic Recovery Tax Act of 1981 are phased-in.

In addition, one wonders how much Chapter 13 revenue will be offset by the income tax deductions for fees paid to attorneys, accountants and others for preparing one or more of the three tax returns and for professional tax planning fees, particularly when there is no tax generated.

The cost of administration and enforcement would appear to be monumental in proportion to the tax to be collected. In this period of reducing government spending, the exorbitant expenditure of tax dollars to collect what will be a miniscule amount of tax cannot be defended. Congress cannot have intended to enact a revenue statute in which the costs, direct and indirect, may reduce the revenue to nearly nothing and quite possibly create an overall loss to the government.

Does Chapter 13 Accomplish Its Objective?

In enacting Chapter 13, Congress intended to limit unduly large accumulations of wealth within the family unit. This has not and will not be accomplished by this statute.

A. The Rich Get Richer.

The wealthy will, have and are avoiding the tax entirely by hopping over generations of beneficiaries. Even when generation-skipping trusts are created, in larger trusts there will be sufficient income to distribute income only to more than one younger generation and income distributions are exempt from Chapter 13. It is only in the smaller trusts that distribution of principal will be required because the income will be insufficient for this purpose. So "the rich get richer and the poor get poorer" and Chapter 13 misses its mark.

B. The Poor Get Poorer.

While the very wealthy may have escaped the Chapter 13 net, many transfers in moderate-sized estates will inadvertently be dragged into it. The lack of qualification for the grandchild's exclusion will subject the trust to Chapter 13. Inartful selection of trustees may also snag unsuspecting taxpayers in Chapter 13. Accordingly, the very wealthy will frequently be able to avoid Chapter 13 while many middle level taxpayers who have more than $250,000, but not millions, to pass in some form to younger generations will find themselves subjected to Chapter 13.

Conclusion

The State Bar Section does not intend to address the policy reasons for the enactment of Chapter 13. Rather, the foregoing comments are intended to point up a few of the many reasons why, as a practical matter, Chapter 13 will not accomplish its objectives. The complexity of the law will push the entire burden of administration of the tax onto the government's back, whereas the burden for administration of other transfer taxes is shared by taxpayer and government alike. The shifting of the burden is due in large part to the inherent complexity of the law which cannot be simplified by any "bandaid" approach to the present statute.

Many taxpayers whom Congress never intended to catch in the Chapter 13 net nevertheless will find themselves inadvertently entangled in it. The very wealthy will still be able to escape it with careful planning.

If our self-assessment system of tax is to survive and stay healthy, Congress must reexamine the issue of whether and how to tax generation-skipping transfers. Chapter 13 in its present state creates an unworkable scheme of tax which produces an unreasonable burden on the taxpayer and his advisers, an unfair imposition of tax and an onerous administrative charge on the government, all for an insignificant amount of revenue. These problems are substantial and uncorrectable and only wholesale repeal will alleviate them. California practitioners urge Congress to take that step.

Respectfully Submitted,

Clare H. Springs

Clare H. Springs
For the State Bar of California Estate
Planning, Trust and Probate Law Section

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Senator SYMMS. Thank you very much, Ms. Springs. We appreciate your testimony.

We will now go from San Francisco to Boston.

Mr. Raymond Young.

STATEMENT OF RAYMOND YOUNG, PRESIDENT, BOSTON BAR ASSOCATION, ON BEHALF OF THE PROBATE COMMITTEE

Mr. YOUNG. Thank you, Mr. Chairman.

I am president of the Boston Bar Association, and to paraphrase a remark that you made to David Brink, I believe it is the first time that the president of the Boston Bar Association has ever addressed this committee.

Senator SYMMS. We appreciate having you here. We have a couple of repeaters who are here today. I think Tim Baetz was here in June, and also Don Thurmond who will testify. We are glad to have those of you here for the first time.

I think, Don Thurmond, you have been here twice.

Mr. THURMOND. Yes.

Senator SYMMS. We appreciate that.

Go right ahead.

Mr. YOUNG. I appear at the request of the probate committee of the Boston Bar Association. As you may know, Boston has something of a reputation and tradition for probate and trust work. The probate committee is composed of counsel to corporate fiduciaries, to private individual trustees, and private individual trustees themselves are something of a Boston phenomenon, to counsel to fiduciaries, and to counsel who work with clients on estate planning matters.

This committee, as you can imagine, does not always agree on everything, but they voted unanimously last week to support the outright and immediate repeal of the generation-skipping tax, and requested me to come down to present their views.

The chief reason involved is the totally unrealistic burdensome complexity of this tax and its administration. It is our opinion that perhaps no more than 5 percent of all the lawyers in this country, and perhaps even more like 1 percent of the lawyers in this country, can begin to understand and apply this tax.

We are deeply concerned about what that will mean if this tax goes into effect, because we suspect that it is a situation where 95 percent or more of the situations that would be subject to it will just never be reported because of sheer unability to understand and know that the occasion exists.

We think that this is a disaster, would be a disaster for tax administration in this country, and for respect for law in this country. We also comment that it would lead to the rather bizarre result that if you happen to go to a good lawyer, who was sensitive to these problems and aware of them, you would end up paying more tax, and you might be better advised financially to go to a not so good lawyer. We also think that that would be deplorable if ignorance was what the lawyer had to serve for his client.

For all these reasons, and the other reasons that have been advocated here today, we urge immediate and outright repeal.

Thank you, Mr. Chairman.

Senator SYMMS. Thank you very much for your very concise statement. I certainly agree, as a nonlawyer, most of the tax code is complicated for we layman anyway, but this is so complicated that it does not make sense at all. I can certainly appreciate the dilemma that a professional attorney is in, realizing that it is your obligation to give your client the best legal advice of what the law is, knowing well that the best legal advice may, in fact, complicate their estate problems.

Every avenue points that the only possible answer to this is outright repeal. I hope that after Treasury has a chance to look at the quality of the distinguished witnesses we have here today, and who you all represent, and the numbers of people who are experts saying this, maybe it will penetrate through the armor at the Treasury, and we will make some headway.

I thank you very much.

Now we want to hear from Neal Block of Chicago, Ill., from Baker, McKenzie, on behalf of the Chicago Bar Association.

STATEMENT OF NEAL J. BLOCK, BAKER & MCKENZIE, ON BEHALF OF THE CHICAGO BAR ASSOCIATION

Mr. BLOCK. Mr. Chairman, my name is Neal Block, and I am here today on behalf of the Chicago Bar Association, an association of 16,200 attorney members.

My purpose in appearing before you today is to underscore the importance which the Chicago Bar Association places upon the approval of Senate bill 1695, which would repeal chapter 13 of the Internal Revenue Code.

The Chicago Bar Association's position was arrived at after extensive consideration by, and unanimous vote of four separate committees of, the Chicago Bar Association, including its board of managers, the Chicago Bar Association's governing body. So I speak on behalf of the entire bar here today.

Briefly, the association has found it necessary to go on record as being opposed to the provisions of chapter 13 because:

One, the Chicago Bar Association is concerned with the increasing complexity which has developed in the Internal Revenue Code. The generation-skipping transfer tax adds considerably more complexity to an area which should remain comprehensible to a vast majority of taxpayers and their counsel: that is, the normal estate and gift tax consequences which arise from standard provisions contained in a will or trust document.

Two, the attorneys who practice as general practitioners commonly draft the vast majority of this nation's wills and trust documents. If we are to continue to rely on these individuals to continue to perform their tasks as scriveners, we must avoid highly complex provisions such as those contained in chapter 13 of the code. The general practitioner must not effectively be legislated out of this area.

Three, after an exhaustive review of the code provisions and ascertaining the information which will be required in order to comply with those provisions, the Chicago Bar Association is now convinced that even the professional trustee, with the advice of competent counsel, will be unable to:

(a) Ascertain if there has been a taxable termination which would trigger a generation skipping transfer tax, and

(b) Assuming that he is able to identify such a taxable termination, gather the essential information which he will need to properly prepare the necessary returns and compute the tax which is due.

Four, because of those problems, and other difficulties, there is an increased danger of what we shall call voluntary non-compliance. Code provisions which result in disrespect for their mandates can only have a severe negative impact on compliance with other provisions of the Internal Revenue Code, and that should be taken into account also.

Five, while the association takes no position on questions which are inherently those of policy, the association questions whether sufficient attention has been given to the probable fallout of chapter 13 with respect to those individuals who understandably plan their estates in an effort to minimize Federal taxes.

Succinctly stated hopefully, the question is whether chapter 13 encourages the transfer of property in a manner which is undesirable from a perspective of the national concern. For example, is it in fact desirable for the Internal Revenue Code to favor a testator's leaving property to his grandchildren, rather than first providing for the well-being of his children.

I question whether the Treasury Department's proposed solution to expand the types of transfers subject to tax has been examined from the point of view of what that will do in terms of estate and gift tax planning.

Finally, the Chicago Bar Association wishes to emphasize that its overriding concern is that any piece of legislation be capable of being both understood and complied with. In its present state, this legislation accomplishes neither objective. Nor is the association aware of any manner in which patchwork changes can be made in order to correct its defects.

Consequently, it is the position of the Chicago Bar Association that Senate bill No. 1695 be enacted.

Thank you.

[Statement of Mr. Block follows:]

STATEMENT OF NEAL J. BLOCK
ON BEHALF OF THE CHICAGO BAR ASSOCIATION
BEFORE THE SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
RE S. 1695

November 4, 1981

Mr. Chairman and Members of the Committee:

My name is Neal J. Block and I am here today on behalf of the Chicago Bar Association, an association of 16,200 attorney members. I am Chairman of the Committee on Federal Taxation of the Association, and I am a partner in the Chicago law firm of Baker & McKenzie.

Subject Matter to Which My Remarks Are Directed

My purpose in appearing before you today is to underscore the importance which the Chicago Bar Association places upon the approval of S. 1695 which would repeal Chapter 13 of the Internal Revenue Code of 1954 as amended.

The proposition which I have been asked to bring before this Committee has been extensively discussed by various committees of the Chicago Bar Association. The position of the Chicago Bar Association that Chapter 13 be repealed has been presented to and unanimously approved by the Probate Practice Committee, the Estate and Gift Tax Division of the Federal Taxation Committee of the Chicago Bar Association, the Executive Committee of the Committee on Federal Taxation and the Board of Managers of the Chicago Bar Association.

My remarks today are in substance the same as those which were presented to the subcommittee on estate and gift taxation of the Committee on Finance of the United States Senate on June 5, 1981, by W. Timothy Baetz, who was representing the

Chicago Bar Association at that time. Those remarks are, in large part, repeated here today since they remain pertinent, and, if anything, underscore the urgency which exists for repeal of Chapter 13.

The Chicago Bar Association is grateful for this opportunity to testify in connection with the 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 Trust Law Committee has exchanged numerous papers in an effort to master the provisions of the tax. The more we have studied, the more concerned we have become. It is apparent to us that there are fundamental problems created by this tax which are insolvable. We are concerned that the inability of those who are responsible for implementing the mandate of Congress to master this tax's requirements will threaten this nation's voluntary compliance tax system. The result will be substantial and counter-productive expenditures of time and effort both by the federal government and by a great many concientous taxpayers.

With these thoughts in mind, the Association last spring unanimously passed a resolution supporting repeal of the tax on certain generation-skipping transfers upon the unanimous recommendation of each of the Committees mentioned at the beginning of this presentation. A great many other professional organizations and trade associations have done likewise.

<u>Need for Immediate Attention</u>

As the following remarks will indicate, there is an immediate need for Congressional action as to the generation-skipping tax. The Chicago Bar Association is hopeful that Congress will decide at an early date to repeal the tax on certain generation-skipping transfers.

Revenue Effect

At the outset, it should be emphasized that the Chicago Bar Association takes no position as to whether any transfer should or should not be the subject of taxation. We note, however, that 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 is projected to have no revenue effect in its early years and only $280 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. It is theoretically possible that remedial legislation could be designed to eliminate its many technical deficiencies. The problem with such remedial legislation, however, is that Chapter 13 would be even more complex, inhibiting 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 the general practitioner and small trust company who respectively draft and implement the majority of this country's wills and trusts cannot be expected to grasp the essential provisions of this act and recognize when and how it applies. Yet these provisions impact taxpayers at all levels.

Significantly, 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 of 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-randing 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. Thus one more activity will be removed from the quiver of the general practitioner and the specialist with his normally higher rates will carve out yet another territory. Even as to those attorneys who enjoy the status of expert, Chapter 13 presents insurmountable difficulties.

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.

<u>Threat to the Voluntary Compliance Tax System</u>

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.

<u>Can the Tax be Effectively Enforced?</u>

The reporting of Chapter 13 tax liability on Form 706-B was to 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)] was June 30, 1981. 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 preexisting 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.

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 disassociated from the "transfer" in question.

There has been no attempt to build gift tax equivalance into Chapter 13. See in this regard, Friedman, "Corrective Legislation Neededu 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, even under the recently enacted rates, equals the amount of trust property involved. A combined tax rate 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. Further the question arises as to whether the anticipated increase in direct bequests to grandchildren of a testator will result in undue economic leverage of children over their parents. The needy child of a decendent may well be left without the support he might otherwise have received.

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.

Summary

The Chicago Bar Association does not intend to take a position on the policy reasons for Chapter 13. The Association consciously tries to avoid questions which are primarily of a political nature. Rather, by the foregoing remarks, the

Association's intent is solely 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,

Neal J. Block
For the Chicago Bar Association

Senator SYMMS. Thank you very much, Neal. I appreciate your testimony.

Douglas Keyt is next. Welcome to the committee, Doug.

STATEMENT OF DOUGLAS S. KEYT, VICE PRESIDENT OF NORTHERN TRUST CO. FOR THE CORPORATE FIDUCIARIES ASSOCIATION OF ILLINOIS

Mr. KEYT. Thank you, Mr. Chairman.

My name is Douglas Keyt. I am a vice president in the trust department of the Northern Trust Co. in Chicago, Ill.

I am pleased to be here today to represent the Corporate Fiduciaries Association of Illinois. This organization is an unincorporated association with a member of 60 State and federally chartered trust institutions located in Chicago and throughout the State. Altogether, our members administer more than 85 percent of the total assets held in personal trusts and estates in Illinois.

I might add that our group is also the group that is responsible for the nuts-and-bolts administration of the generation-skipping transfer tax.

Our membership includes such major Chicago financial institutions as the First National Bank of Chicago, Continental Illinois National Bank & Trust Co., the Harris Trust & Savings Bank, as well as my own organization, the Northern Trust Co.

The combined asset value of personal trusts in the State administered by these four trust institutions exceeds $18 billion. More importantly, of the remaining 56 association members, 10 administer personal trust assets valued at between $100 million and $325 million, and 46 of them administer personal trust assets valued at less than $100 million.

My purpose in coming here today is to attempt to describe for you some of the administrative difficulties our members, both large and small, have experienced since the generation-skipping transfer tax was enacted nearly 5 years ago.

We respectfully suggest that these provisions are so complex that they are incapable of administration or enforcement by the legal community, the accounting profession, the Internal Revenue Service, let alone the thousands of individual as well as corporate fiduciaries located throughout Illinois and the United States.

The first major point I would like to call to the committee's attention is the fact that as a result of the recently enacted increases in the Federal estate tax return filing requirements, the IRS will not be able to obtain or provide information needed to prepare generation-skipping transfer tax returns.

A trustee or distributee who is required to file a form 706B, may request from the IRS pertinent data needed to prepare the return and compute the 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 706B, otherwise the failure to obtain the necessary information will not be considered reasonable cause for failure to file a timely return or pay the tax that is due.

Under the Economic Recovery Tax Act, the level at which an estate tax return must be filed increases ultimately to $600,000 in 1987. If the present structure of the generation-skipping transfer tax is retained, this will mean that the tax must be calculated at the deemed transferor's marginal estate tax rate.

If the deemed transferor does not have an estate of $600,000, then an estate tax return will naturally not have to be filed. Consequently, in subsequent years, when information is requested regarding the deemed transferor's estate, it simply will not be available. The IRS will not be able to carry out its mandate as mandated by Congress under the 1976 Tax Reform Act.

I would like to now turn to another major point that is of great concern to our membership, and that is the fact that the generation-skipping transfer tax does not accomplish its intended purposes, and unfairly discriminates against those of moderate means who cannot afford alternative estate planning techniques.

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 wealthier individuals with estates of $1 million or more, the generation-skipping transfer tax does not and will not accomplish this purpose. This is due to the fact that there are a number of estate-planning techniques, which have been pointed out earlier today, which wealthy people can employ.

Last, I would like to bring to the committee's attention the expense that the public and the IRS must necessarily and has already incurred in attempting to administer chapter 13. It is excessive and cannot be justified on the basis of revenue.

You may be interested to know that over the past 4½ years, I and members of my staff at the Northern Trust Co. have spent in excess of 3,500 hours attempting to understand and apply the generation-skipping tax statute and regulations.

In addition to this, our 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 modest rate of $50 per hour, this represents an expense to the Northern Trust Co. alone, and to its customers, of over $400,000.

What is the result of all this effort? So far, out of 7,000 accounts which we administer, we have found four trusts that will be subject to the generation-skipping transfer when they terminate at some undetermined time in the future. We have found 11 which might be subject to generation-skipping, depending on the order of the deaths of the current beneficiaries. However, after all of this effort and expense, we have yet to identify our first taxable termination or taxable distribution.

I would conclude by stating that the rest of our membership, consisting of the other 3 large fiduciaries in Illinois, as well as the other 56 members of the association around the State of Illinois, have yet to find 1 transfer that has generated payment of a tax. Only two returns have yet to be filed.

Therefore, we respectfully urge that chapter 13 is administratively unenforceable, and strongly support repeal of chapter 13.

Thank you.

[Statement of Mr. Keyt follows:]

CORPORATE FIDUCIARIES ASSOCIATION
of ILLINOIS

When responding, please direct all replies to:
50 South La Salle Street
Chicago, Illinois 60675

CHICAGO, ILLINOIS 60690

TESTIMONY OF DOUGLAS S. KEYT
ON BEHALF OF THE
CORPORATE FIDUCIARIES ASSOCIATION OF ILLINOIS
IN SUPPORT OF THE REPEAL OF THE GENERATION-SKIPPING TRANSFER TAX
BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
FINANCE COMMITTEE, UNITED STATES SENATE - NOVEMBER 4, 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.

I am here today to represent the Corporate Fiduciaries Association of Illinois. This organization is an unincorporated association with a membership of 60 state and federally chartered trust institutions located in Chicago and throughout Illinois. Altogether, our members administer more than 85% of the total assets held in personal trusts and estates in Illinois.

Our membership includes such major Chicago financial institutions as The Continental Illinois National Bank and Trust Company, The First National Bank of Chicago, The Harris Trust and Savings Bank, as well as my own organization, The Northern Trust Company. The total combined asset value of personal trusts and estates administered by these four trust institutions is well in excess

CORPORATE FIDUCIARIES ASSOCIATION
of ILLINOIS

of $15 billion. The Northern Trust Company, through its Trust Department in Chicago and its trust affiliates in Florida and Arizona, administers personal trust assets valued at nearly $6 billion. More importantly, of the remaining 56 association members, 10 administer personal trust assets valued at between $100 million and $325 million and 46 of them administer personal trusts valued at less than $100 million.

My purpose in coming here today is to describe for you some of the administrative difficulties our members, both large and small, have experienced since the generation-skipping transfer tax 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 by the legal community, the accounting profession or the Internal Revenue Service, let alone the thousands of individual and corporate fiduciaries located in Illinois and throughout the United States.

THE GENERATION-SKIPPING TRANSFER TAX PROVISIONS ARE EXTREMELY COMPLEX.

On May 1, 1981, the Joint Committee on Taxation Staff published a pamphlet setting forth the background and description of various estate and gift tax bills that were being considered by your Subcommittee at that time. The description of the generation-skipping transfer tax contained in this pamphlet is deceptively simple. For example, the pamphlet states in Part II, Paragraph 7:

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"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."

The generation-skipping transfer tax provisions are far from simple. To the contrary, they are extremely complex.

In order to demonstrate some of these complexities for you, permit me to guide you through the analytical process that must be followed in order to determine whether the provisions of Chapter 13 apply:

1) <u>Each and every trust must be reviewed to determine if it is grandfathered under various transitional rules.</u> 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" or exempted 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, 1983. Thus, each and every trust must be reviewed, classified and, in the case of revocable trusts, monitored continuously with regard to application of these transitional rules.

2) <u>Even if a trust is "grandfathered," any actual or constructive additions made to the trust after June 11, 1976 must be identified and accounted for separately.</u> Generally, an actual or constructive addition to a trust after June 11, 1976 will be subject to the provisions of Chapter 13 and must be accounted for separately in order to avoid the generation-skipping taint with respect to "grandfathered" assets. These additions can occur in a multiplicity of ways. Some examples are as follows:

- A gift by a donor in 1981 of the $3,000 annual exclusion amount to an irrevocable gift trust created prior to June 11, 1976.
- Designation after June 11, 1976 of an insurance trust executed prior to June 12, 1976 as beneficiary of a life insurance policy.

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- Pour over after January 1, 1983 of a typical marital trust in default of the exercise of a general power of appointment where the trust was created pursuant to a will or trust agreement which is "grandfathered."
- Assets of an estate which are poured over pursuant to to a will executed after June 11, 1976, to a "grandfathered" revocable or irrevocable trust.
- Property which 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, additions which are subject to generation-skipping must be segregated from "grandfathered" assets which aren't. As a consequence, separate and costly accounts and records must then be set-up and maintained.

3) All present and potential future beneficiaries, known and unknown, born or unborn, must be identified in order to avoid unintended generation-skipping tax results. Identification of all possible present and future beneficiaries of a trust frequently can be a very time consuming and difficult task. 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 information regarding the age and relationship of each and every one of these individuals must be maintained in order to avoid the possibility of making payments that will have unintended results under the generation-skipping transfer tax provisions. This is an extremely complex, time consuming, and expensive process.

4) Once all permissible beneficiaries have been identified, the exact nature of the interest or power possessed by each of them must be determined. This step is necessary, of course, due to the fact that certain limited interests or powers will not be subject to Chapter 13. If any of you are knowledgeable about future interests under English common law, you know that the required legal analysis can be extremely difficult. For example, is the beneficiary's interest vested or contingent? Is he merely a permissible recipient of income or corpus? Does he have the power to alter the beneficial enjoyment of income or principal? Or, is his power limited solely to the management of trust property?

5) All beneficiaries must be assigned to a generation on the basis of age or relationship to the grantor. This must be done in order to determine whether a payment to a particular beneficiary will be a generation-skipping transfer. Such a trans-

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fer, of course, occurs whenever there is a distribution of corpus to a "younger generation beneficiary" who is younger than any other "younger generation beneficiary." In order to be a "younger generation beneficiary" he must be assigned to a generation younger than that of the grantor.

Distributions of corpus occur when payments to 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, the process of assigning each and every beneficiary to a generation is a time consuming process and is just one more example of the burdensome nature of this tax.

6) <u>The identity of the "deemed transferor" and his relationship to the grantor must be determined in order to calculate the generation-skipping tax.</u> This is necessary due to the fact that generation-skipping tax is calculated on the basis of the "deemed transferor's" marginal estate tax rate. What is particularly onerous about this step is the fact that the "deemed transferor" does not necessarily have to be alive when the taxable event occurs and need not ever have had any interest in the trust. The "deemed transferor" concept, which has been critized by many practitioners as being inequitable, causes administrative nightmares. An example of the illogical results that can occur under this concept is the case where a family member creates a trust with income for the benefit of his nephew and remainder to his great-

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grandson. Common sense would suggest that the "deemed transferor" in this case would be the nephew since he is the only person who ever benefited from the trust. Not so! Instead, the "deemed transferor" is the grandchild of the grantor (who is also the parent of the great-grandson). This is so even though the grandchild never enjoyed any beneficial interst in the trust. Clearly this is an illogical result which Congress could not have intended.

7) After all of the basic generation-skipping information has been gathered and it has been determined that a generation-skipping transfer has occurred, complex tax returns must be then prepared and filed. This is required even though no tax liability results from the generation-skipping transfer! Form 706-B(1) is an information return which must be completed by the trustee for all "taxable terminations" or "taxable distributions" and filed with the Internal Revenue Service Center where the distributee, 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, which as most recently proposed is a 9-page 8-schedule form, prepared and filed even though no tax liability results from a given

transfer. This is true even though the $250,000 grandchild exclusion or the estate or gift tax unified credit may exempt the transfer from tax.

If you or your staff are interested in gaining a greater understanding of this tax or a better appreciation for its complexities, I refer you to 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.

CHAPTER 13 IS SO COMPLEX THAT EVEN THE I.R.S. IS UNABLE TO ADMINISTER IT EFFECTIVELY.

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 commentary. Other comments submitted by professional groups such as the Chicago Bar Association and the American Bankers Association were equally voluminous.

The I.R.S. has been unable to draft in a timely fashion the forms needed to report generation-skipping transfers. The initial date of February 5, 1981 for filing supposedly simple information returns, Forms 706-B(1) and B(2) was first postponed until June 30,

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1981 and then postponed a second time to August 15, 1981. The actual "Generation-Skipping Transfer Tax Return," Form 706-B, which is the form on which any actual tax liability would be calculated still has not been issued even though the first due date for filing returns was October 15, 1981.

The extreme complexity of generation-skipping was acknowledged by the I.R.S. 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 wherein he stated:

> "The fact that the tax is extraordinarily complex results in forms which are more complex that 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 corporate or individual trustees 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 administered or enforced. Therefore, we strongly urge that Chapter 13 be repealed.

AS A RESULT OF THE RECENTLY ENACTED INCREASES IN FEDERAL ESTATE TAX RETURN FILING REQUIREMENTS, THE I.R.S. WILL NOT BE ABLE TO OBTAIN OR PROVIDE INFORMATION NEEDED TO PREPARE GENERATION-SKIPPING TRANSFER TAX RETURNS.

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 any tax that may be due.

Under the Economic Recovery Tax Act of 1981, the level at which an estate tax return must be filed increases along with the increase in the federal estate and gift tax unified credit. In 1982, only those estates valued at $225,000 or more need file a federal estate tax return. This amount, of course, increases over the next five years until it reaches $600,000 in 1987. As noted earlier, the generation-skipping transfer tax is calculated on the basis of the "deemed transferor's" marginal estate tax rate. If the "deemed transferor" does not have an estate of $600,000 at his death in 1987, an estate tax return will not have to be filed. Consequently, in subsequent years when a trustee or distributee requests information regarding the "deemed transferor" that is needed to prepare the Form 706-B, the I.R.S. simply will not be able to provide it. If a trustee or distributee cannot obtain needed information from the I.R.S. as mandated by Congress, Chapter 13 then becomes completely unenforceable. Absent any mechanism for the I.R.S. to enforce the tax, the only possible result will be wholesale unintentional non-compliance with the law. Clearly this threatens the integrity of our voluntary system of taxation which in this case can only be rectified by repeal of the statute.

THE GENERATION-SKIPPING TRANSFER TAX DOES NOT ACCOMPLISH ITS INTENDED PURPOSE AND UNFAIRLY DISCRIMINATES AGAINST THOSE OF MODERATE MEANS WHO CANNOT AFFORD ALTERNATIVE ESTATE PLANNING TECHNIQUES.

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 wealthier individuals with estates of $1 million or more, the generation-skipping tax does not and will not accomplish this purpose. This is due to the fact that there are a number of estate planning techniques which wealthy individuals can afford to employ to benefit various generations and still avoid generation-skipping transfer taxes. The most common of these techniques is known as "layering," where a grantor creates 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 and their families can afford the extra administrative expense of creating separate trusts.

If 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 classes that will bear the brunt of the generation-skipping tax and the costs of administering it. These are the very people who need trusts and quite properly should use trusts to protect themselves and their families from a very uncertain and probably a very inflationary future.

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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 worth less than $500,000 and more than 80% are valued at 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 and the overall 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 is the equivalent of only $370,000 in 1974. It is also important to remember that people with this relatively modest amount of wealth are the entrepreneurs who are most often motivated by our capitalistic system to work hard and save. They are also the ones who invest to protect themselves and their families from financial hardship in the future. Their savings in turn provide the capital that is needed for our economy to keep on growing. For these people, trusts are important vehicles for achieving their financial security and well-being. They ought not to be discouraged from doing so simply because of the burdensome and unfair application of the generation-skipping transfer tax.

It should also be noted that when the "deemed transferor" is living, the unified gift tax credit (currently $47,000) is not available when computing the generation-skipping transfer tax. As a result, except for the $250,000 grandchild exclusion, assuming the generation-skipping transfer is to a grandchild, 100% of the generation-skipping transfer is subject to tax. This is but one

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more example of the unfair and discriminatory nature of Chapter 13.

THE EVIL WHICH THE GENERATION-SKIPPING TRANSFER TAX WAS INTENDED TO CORRECT IS MERELY IMAGINARY AND DOES NOT, IN FACT, EXIST.

A common misconseption 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 at The Northern Trust Company, 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 continue for multiple generations. Accordingly, I submit that the evil which the generation-skipping tax was intended to correct is merely imaginary and does not exist. Moreover, it seems apparent that the unified estate and gift tax structure as enacted by Congress under the Economic Recovery Tax Act of 1981 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. That being the case, then the generation-skipping transfer tax is unnecessary from a policy point of view and ought to be repealed.

THE EXPENSE TO THE PUBLIC AND TO THE I.R.S. OF ADMINISTERING CHAPTER 13 IS EXCESSIVE AND CANNOT BE JUSTIFIED ON THE BASIS OF REVENUE.

You may be interested to know that over the past 4-1/2 years,

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I and members of my staff at The Northern Trust Company 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 $50 per hour, this represents an expense to The Northern Trust Company and ultimately to the customers over the past 4-1/2 years that exceeds $400,000. Not included in this figure are the numerous hours we have had to spend writing explanatory material and trying to educate our personal trust administrators.

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 generation-skipping tax. Expensive data on more than 900 account beneficiaries was collected in order to determine the generation-skipping tax consequences of the distributions out of these 400 accounts. 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 particular aspect of the project to a very modest 175 man hours. Again, assuming a very low rate of $50 per hour for technically trained personnel, the total expense to The Northern Trust Company for this supposedly simple and limited project exceeded $8,000.

What is the result of all this effort? So far, out of 7,000 accounts which The Northern Trust Company administers, we have found 4 trusts that will be subject to the generation-skipping transfer tax when they terminate at some undetermined time in the future. We have also found 11 trusts that might be subject to the generation-skipping tax, depending upon the order of the deaths of the current beneficiaries. However, after all this effort and expense, we have yet to identify our first "taxable distribution" or "taxable termination," or file our first generation-skipping tax return or pay our first penny of generation-skipping transfer tax.

The Harris Trust and Savings Bank, another major trust institution in Chicago and a member of the Corporate Fiduciaries Association of Illinois, has had similar experience. Their staff examined in excess of 3,500 pre-1976 trusts to determine their eligibility under the grandfathering provisions, to ascertain if any additions were made to those trusts and to identify any potential generation-skipping situations. Ten were found. This project, coupled with the costs of in-house seminars, attendance at seminars outside the bank and the formation of an internal task force to undertake an ongoing role in understanding and disseminating information is estimated to have cost in excess of $600,000. For this necessary work special fees totalling approximately $400,000 were assessed against these personal accounts to the detriment of their beneficiaries. These charges, of course, were for work which

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clearly was not anticipated when the settlor created the trust. The only benefit resulting from these efforts was the determination that in the overwhelming majority of cases, the generation-skipping provisions would never apply.

Harris' ongoing expenses associated with review of newly created accounts, review of the impact of discretionary payments, development and maintenance of control procedures, review of regulations, etc. are expected to exceed $15,000 annually. To the best of our knowledge the Harris is the only member of the Corporate Fiduciaries Association of Illinois which has actually filed a generation-skipping "return." They had one situation involving a trust of a 1978 decedent. Since no forms were then available a free-form "letter" return was filed. In this case, no tax resulted from the generation-skipping transfer. Legal fees and other special charges to the account for researching the many complex questions involved and preparing the "letter" return exceeded $4,000.

At The First National Bank of Chicago, a definite generation-skipping transfer was recently identified. At the Continental Illinois National Bank and Trust Company, they have not found one generation-skipping transfer.

As noted above, 46 of the 60 members of the Corporate Fiduciaries Association of Illinois administer personal trusts and estates totalling less than $100 million in assets. Another 10 members of the Association administer personal trust assets valued at between $100 million and $325 million. As the attached membership list shows, these are all small banks located in such rural

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Illinois communities as Carlinville, Macomb, Dixon and Belleville. It is reasonable to assume that personal trusts administered by these smaller institutions are worth considerably less on average than those which are administered by the 4 multi-billion dollar trust companies in Chicago. The fact of the matter is that these institutions do not and cannot be expected to have the capability or the financial resources to conduct the type of review or analysis required to comply with the generation-skipping transfer tax provisions. If these institutions do not conduct such a review, they no doubt will be subject to significant penalties for their failure to carry out their fiduciary responsibilities. Caught between the dilemma of inadequate resources to conduct this review and the potentially large penalties that will be assessed when the I.R.S. discovers a taxable transfer, these institutions understandably will be reluctant to continue in the personal trust business. This can only lead to diminished use of trusts as a source of financial security by those people most in need of the protection they afford. I respectfully suggest that Congress could not have intended this result. In the Request for OMB Approval of I.R.S. Form 706-B dated August 26, 1981, it was stated as follows:

> "Using information based on a taxpayer survey, it was estimated that it takes 15.912 hours to gather the required information and complete the form." (Emphasis added)

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It was further stated that:

> "The estimated annual cost (to the Federal Government) associated with developing, printing, distributing and processing Form 706-B is $193,747." (Emphasis added)

Based upon my experience with generation-skipping, I would suggest that the I.R.S.'s estimate of merely 16 hours to gather all the required information and prepare the form is conservative. However, assuming it is correct and also assuming an hourly rate of $75 for professional assistance, the cost of preparing a Form 706-B on average would be nearly $1,200. The August 26, 1981 Request for OMB Review also assumes that 5,000 Form 706-B returns will be filed each year. This amounts to a total annual cost to the public to prepare this return of nearly $6,000,000. Furthermore, as noted above, the Form 706-B must be prepared even though no tax is due. Moreover, this estimate does not take into consideration any costs associated with preparation of Forms 706B-(1) and 706B-(2) or the millions of dollars that must be spent by the I.R.S. and the public to keep necessary records or administer the tax.

To the best of my knowledge, no generation-skipping transfer taxes have been generated since Chapter 13 became effective nearly 5 years ago. In the General Explanation of the Tax Reform Act of 1976 as prepared by the Staff of the Joint Committee on Taxation, generation-skipping is only expected to generate $280 million in revenue longer term. With the recently enacted increases in the unified estate and gift tax credit, it is reasonable to assume that considerably less revenue will be generated than was originally

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anticipated. Very likely the costs to the I.R.S. and the public of administering Chapter 13 will exceed any revenue generated. This being the case, I submit that the time and effort being spent by the I.R.S. in an attempt to enforce the generation-skipping tax is a waste and that surely these funds could be used for more productive purposes.

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 describe how such a system might work. His description, which is 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 be $250,000. These costs do not include any estimates for a user's cost of converting existing trust files or beneficiary information into 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

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the enormity of the task of attempting to administer this extremely burdensome tax. I submit that such a commitment of resources cannot be justified on either a social or an economic basis. Therefore, the only alternative is repeal.

The complexity of the generation-skipping transfer tax suggests that as a practical matter only the most sophisticated trust companies and tax practitioners will be in a position to make even a good faith effort to comply. Non-professional individuals that serve as executors of estates (which under I.R.C. regulations are treated as generation-skipping trust equivalents) and trusts are likewise faced with the impossible task of trying to comply with this burdensome tax. In 1980 there were 1,884 estates over $100,000 in value that were opened in Cook County, Illinois and of these estates banks served as executor in only 339. This means individuals rather than professional corporate executors were appointed in more than 1,500, or 80% of the total number of Cook County estates. If professional fiduciaries are having problems complying with the law, consider the difficulties facing the hundreds of thousands of individuals that are appointed each year as executors and trustees. This is just one more example of the impossible task of enforcement which is facing the I.R.S. I respectfully suggest that in fact it cannot be enforced under any circumstances and therefore strongly urge that Chapter 13 be repealed.

Respectfully submitted,

Doyle S. Key

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Association Members	Personal Trusts and Estates * (Dollars in Millions)
Asset Value Over $100 Million	
American National Bank and Trust Company of Chicago	$ 322
Chicago Title and Trust Company	300
The Citizens National Bank of Decatur	153
Commercial National Bank, Peoria	200
Continental Illinois National Bank and Trust Company of Chicago	2,263
The First National Bank of Chicago	2,125
The First National Bank of Peoria	129
Harris Trust and Savings Bank	2,819
La Salle National Bank, Chicago	145
Moline National Bank	206
National Boulevard Bank of Chicago	124
The Northern Trust Company, Chicago	3,651
Springfield Marine Bank	178
State National Bank, Evanston	208

* Assets of accounts over which institution exercises investment discretion.

SOURCE: "Trust Assets of Banks and Trust Companies--1979" Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Controller of the Currency.--Washington: Federal Financial Institutions Examination Council, 1980.

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Association Members

Asset Value Under $100 Million

Amalgamated Trust and Savings Bank

American National Bank and Trust Company, Rockford

American State Bank of Bloomington

Bank of Pontiac

Beverly Bank

The Carlinville National Bank

Central National Bank, Chicago

The Champaign National Bank

Citizens National Bank of Macomb

City National Bank and Trust Company, Dixon

The Dixon National Bank

Elliott State Bank, Jacksonville

Exchange National Bank of Chicago

The Farmers State Bank and Trust Company, Jacksonville

First Galesburg National Bank and Trust Company

The First National Bank and Trust Company, Alton

First National Bank and Trust Company of Barrington

First National Bank and Trust Company, Centralia

The First National Bank of Elgin

First National Bank and Trust Company of Evanston

First National Bank and Trust Company of Rockford

First National Bank of Joliet

First National Bank of Lansing

First National Bank, Mattoon

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Association Members

Asset Value Under $100 Million (Continued)

First National Bank of Skokie

The First National Bank of Springfield

The Granite City Trust and Savings Bank

Heritage Pullman Bank and Trust Company, Chicago

Illinois National Bank of Springfield

Illinois State Bank of Quincy

Illinois State Trust Company, Belleville

Lake Shore National Bank, Chicago

Mid America Bank and Trust Company, Edgemont

The Millikin National Bank of Decatur

The Naperville National Bank and Trust Company

The National Bank, Bloomington

Northwest National Bank, Chicago

The Old National Bank of Centralia

Pioneer Bank and Trust Company, Chicago

The St. Charles National Bank

Sears Bank and Trust Company, Chicago

Suburban Trust and Savings Bank, Oak Park

Union National Bank and Trust Company of Elgin

United Bank of Illinois, N.A., Rockford

Washington National Trust Company, Evanston

White County Bank, Carmi

Senator SYMMS. Thank you very much for a very excellent statement. I want to make note for the record that all of your entire statements—Mr. Block, you had a more detailed statement in addition to the one that you made—will be made a part of our record, and the record will remain open for 30 days if any of you wish to add comments to your testimony.

Now, for the fourth time before your subcommittee this year, we will hear from Don Thurmond, group vice president of the Trust Co. Bank in Atlanta, Ga., for the American Bankers Association.

Welcome back, Don, and we are glad to have you here.

STATEMENT OF DONALD W. THURMOND, GROUP VICE PRESIDENT, TRUST CO. BANK, ATLANTA, GA., FOR THE AMERICAN BANKERS ASSOCIATION

Mr. THURMOND. Thank you, Mr. Chairman.

My name is Donald Thurmond, and I am now the past chairman of the trust taxation committee of the trust division of the American Bankers Association.

I am accompanied by Marshall Zissman of the First National Bank of Chicago, who is now the current chairman of our trust taxation committee.

The American Bankers Association is a trade association composed of more than 13,100 banks. Approximately 4,000 of these institutions are authorized to serve their customers as trustees and executors. The association has a long involvement in the Federal estate and gift area because of our members' experience in the planning and administration of customers' estates.

We appreciate the opportunity to present our views on S. 1695, the pending legislation to repeal the generation-skipping transfer tax.

We are not prepared today to comment on the legislation on section 6166, but we would like to submit our comments at a later date.

When I have finished my part, Mr. Zissman would like a minute to express some additional views.

As you stated, this is not the first time we have appeared before this committee to present our views. In our testimony of May 1 before this panel, we urge repeal of this tax, and we continue to do so.

I would like to clarify one point that was made earlier. The American Bankers Association has never supported the generation-skipping tax, and we do not do so now.

The extreme complexity of the statute is evidenced by the fact that the IRS, nearly 5 years after enactment, has failed to publish final regulations, except some transitional rules.

Moreover, the proposed definitional rules that have been proposed by the Service are simply inadequate. They fail to provide needed guidance on a number of issues, the answers to which are required to draft properly even common types of trusts.

Unlike the estate tax, the mere recognition of taxable events in the generation-skipping tax context is difficult and may frequently be missed.

The problems we have encountered with respect to the generation-skipping tax are not reserved to the inadequacy of the regulations alone. The unworkability of the tax is further illustrated by the fact that the Service has repeatedly postponed filing dates because the required tax forms were being drafted and redrafted.

Apparently, in fact, the form required for the reporting of generation-skipping tax liability, form 706-B, despite an October 15 deadline that has been previously announced, is still circulating within the Office of Management and Budget for comment.

I understand that Federal Register has just announced that the October 15 deadline has been changed to February 15, this is some 19 days after the required filing date, and leaves the taxpayers hanging on a limb.

This has been our experience time and time again. The regulations provide for a filing date, and the forms are not issued by the Service and about the time the returns are required to be filed, the IRS announces a postponement of the due dates.

We question how trustees and taxpayers can be expected to understand and comply with the requirements of generation-skipping tax if the Internal Revenue Service cannot draft a simple, relevant, and timely set of forms.

Even assuming understandable regulations and forms could be issued, the Government's cost of administering the tax will be monumental. Enormous amounts of money will have to be expended to train revenue agents to enforce the tax even in an unsophisticated manner.

In contrast to the costs that will be incurred in the administration of the tax, the revenue impact is de minimis. The costs to the Government and the expense to trustees and the taxpayers will certainly, in the early years, far exceed the revenues.

Noncompliance with the generation-skipping tax will inevitably be massive. Since most estate planning experts do not fully understand the tax and cannot be expected to have the time to educate themselves completely about this tax, noncompliance from sheer ignorance will occur in a clear majority of cases.

The generation-skipping tax is impossibly complex. It is a trap for the unwary. It is extremely costly to administer, and yet will raise little revenue. It is yet another tax on capital. The American Bankers Association urges its immediate repeal.

There was a comment earlier today about making this an integral part of the transfer tax system, and compared it with the gift tax. The gift tax works, and it is in the system. It is a unified rate structure.

There was the additional suggestion made that a flat rate would apply to such a transaction. It takes it out of the integral transfer tax system, to put a flat rate, and pulls it away from the unified rate system. To me that makes no sense.

Mr. Zissman has some comments that he would like to present.

[Statement of Mr. Thurmond follows:]

**SUMMARY OF TESTIMONY
OF
DONALD W. THURMOND
ON
BEHALF OF
AMERICAN BANKERS ASSOCIATION
ON
REPEAL OF THE GENERATION-SKIPPING TRANSFER TAX
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE**

November 4, 1981

The ABA urges the immediate repeal of the generation-skipping transfer tax.

- The tax is so inordinately complex and intricate most attorneys do not understand its provisions.

- The complexity of the statute is evidenced by the fact that the IRS, five years after enactment, has failed to publish final regulations except for some transitional rules.

- Even assuming understandable regulations and forms could be issued, the government's cost of administering the tax will be monumental.

- In contrast to the costs of administration the revenue gain is minimal.

- Non-compliance from sheer ignorance will inevitably be massive.

TESTIMONY

OF

DONALD W. THURMOND

ON BEHALF OF

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COMMITTEE ON FINANCE

UNITED STATES SENATE

November 4, 1981

Mr. Chairman and Members of the Committee: My name is Donald W. Thurmond. I am Group Vice-President of the Trust Company Bank of Atlanta, Georgia, and past Chairman of the Taxation Committee of the Trust Division of the American Bankers Association. I am today accompanied by Mr. Marshall L. Zissman, Vice-President of the First National Bank of Chicago, Illinois, and current Chairman of the Trust Taxation Committee.

The American Bankers Association (ABA) is a trade association composed of more then 13,100 banks -- over 90 percent of the nation's full service banks. Approximately 4,000 of these institutions are authorized to serve their customers as trustees and executors. The Association has a long involvement in the federal estate and gift tax area because of our members' experience in the planning and administration of customers' estates. We appreciate the opportunity to present our views on pending legislation to repeal the generation-skipping transfer tax, S. 1695.

This is not the first time the ABA has appeared before this committee to present its views on the generation-skipping tax, embodied in Chapter 13 of the Code. In our testimony of May 1, 1981 before this panel we urged repeal of this tax. Since that time, with the enactment of the Economic Recovery Tax Act of 1981, we have witnessed drastic and much needed revision of the federal estate tax providing relief to millions of American taxpayers. Unfortunately, however, that relief was not extended to those who will be subject to a generation-skipping transfer tax and the accompanying administrative burdens.

The tax on generation-skipping transfers is so inordinately complex and intricate most attorneys do not understand its provisions. Even attorneys and estate planners who consider themselves experts readily admit that they do not understand the tax in detail and they are deeply concerned about the unknown effects of the tax on their clients. This is despite the fact that the statute has been the subject of considerable study and debate since its enactment in 1976, as part of the Tax Reform Act of that year. If the experts in the field are unable to fully comprehend the intricacies of the tax it is totally unrealistic to assume that the general practitioner will be able to advise clients with any degree of accuracy of their obligations under the generation-skipping tax. And the poor taxpayer without an attorney will be completely in the dark.

The extreme complexity of the statute is evidenced by the fact that the IRS, five years after enactment, has failed to publish final regulations except for some transitional rules. Moreover, the proposed definitional rules that have been issued by the Service are simply inadequate. They fail to provide needed guidance on a number of issues, the answers to which are required to draft properly even common types of trusts. Unlike the estate tax, the mere recognition of taxable events in the generation-skipping tax context is difficult and may frequently be missed. For example, the death or resignation of a trustee or power holder may be a taxable termination even if such individual is not actively involved in the trust's administration. Likewise there are events and facts having generation-skipping consequences which may be beyond a trustee's control or knowledge. To illustrate, deemed transferors will frequently not be clients of the trustee or his attorney so that the trustee will not be knowledgeable about the deemed transferor's affairs.

The problems we have encountered with respect to the generation-skipping tax are not reserved to the inadequacies of the regulations alone. The unworkability of the tax is further illustrated by the fact that the Service has had to repeatedly postpone filing dates because the required tax forms were being drafted and redrafted. To illustrate, the form required for the payment of generation-skipping tax liability - Form 706-B - is still circulating within the Office of Management and Budget for evaluation. This is despite the existence of temporary regulations establishing an October 15, 1982 deadline for filing the Form 706-B tax return. It is our understanding that the proposed form indicates a filing deadline of February 15, 1981 rather than October 15, 1981 but the IRS has yet to issue a regulation or in any way notify the public that the filing date will be postponed because the forms are not available. This has been our experience time and again. The regulations provide for a filing date, the forms are not issued by the Service and about the time the returns are required to be filed, the IRS announces a postponement of the due dates. We question how trustees and taxpayers can be expected to understand and comply with the requirements of the generation-skipping tax if the Internal Revenue Service cannot draft a simple, relevant and timely set of forms.

Even assuming understandable regulations and forms could be issued, the government's cost of administering the tax will be monumental. Enormous amounts of money will have to be expended to train revenue agents to enforce the tax even in an unsophisticated manner. Under the statute it is anticipated that the IRS will become a national clearinghouse for transfer tax information to collect, and store, in quickly retrievable form, all estate, gift and generation-skipping transfer tax returns. Information will have to be stored for at least 75 years in order to comply with the law's requirements that the government provide a taxpayer with sufficient information to enable the taxpayer to determine his generation-skipping tax liability. The sheer mass of information involved and the problem of gathering, sorting and retrieving it will render the task not merely exceedingly expensive but actually impossible of accomplishment.

In contrast to the costs that will be incurred in the administration of the tax the revenue impact is de minimis. According to the Staff of the Joint Committee on Taxation, the generation-skipping tax was projected to have negligible revenue in its early years and to produce only $400 million of revenue in its twentieth year (1996). This figure has been reduced by the increase in the unified credit which may be used against the generation-skipping tax to the extent not used by the deemed transferor's own estate. The costs to the government and the expense to trustees and the taxpayers will certainly in the early years far exceed the revenues.

Noncompliance with the generation-skipping tax will inevitably be massive. Since most estate planning experts do not fully understand the tax and cannot be expected to have the time to educate themselves completely about this tax, non-compliance from sheer ignorance will occur in a clear majority of cases. For example, the untimely death ot a trust beneficiary can convert an ordinary nongeneration-skipping testamentary family trust into a generation-skipping trust subject to tax when the result was neither intended nor could it have been reasonably anticipated at the time the trust was created. At the same time the very wealthy who can afford to establish separate trusts for each generation level may avoid the tax.

The generation-skipping tax is impossibly complex, it is a trap for the unwary, it is extremely costly to administer and yet will raise little revenue. It is yet another tax on capital. The American Bankers Association urges its immediate repeal.

Senator SYMMS. Thank you very much.
Mr. Zissman.

STATEMENT OF MARSHALL J. ZISSMAN, VICE PRESIDENT, THE FIRST NATIONAL BANK OF CHICAGO, FOR THE AMERICAN BANKERS ASSOCIATION

Mr. ZISSMAN. Senator, I am appreciative of the opportunity to appear before you here today, and I guess I am happy to come last because that gave me an opportunity to hear what all these other folks had to say about this tax.

I am going to be going back to Chicago in a couple of hours. This afternoon and tomorrow I am going to be talking to people in the estate planning community back there, and they are going to be interested in what went on here. To us, it is a pretty big deal being able to appear before you and they are going to want to know what happened.

I guess what I am going to tell them is that there was substantial agreement that we have a law that is much too complex, and nobody understands. We have no substantive regulations that have been issued by Treasury in final form, and that is just too bad. We have no form, we have no 706-B on which the tax is supposed to be reported and paid, and that is just too bad, 5 years after the law was enacted.

Yes; there is an insignificant amount of revenue involved. Yes; the transitional rule involved with chapter 13 does interfere with sensible estate planning, but that is just too bad.

I must say that I was frankly astonished to have a representative of President Reagan's Treasury Department tell us to live with it, live with it while we take as much time as we need to explore all of the alternatives.

And, by the way, live with it without any help from the Treasury Department, which has the responsibility for gathering, storing, retrieving, and supplying taxpayers with generation-skipping transfer tax information, and get to it, I believe, because they haven't got the systems to do it.

I am not talking about the system that Treasury may come up with, if it ever drafts the proposals that it suggested here today. I am talking about the system they are asking us to live with today, the existing legislative and regulatory environment which we are cavalierly asked to continue to operate in while more thought goes on.

My conclusion, sir, and I cannot say that it is a freshly drawn conclusion, is that S. 1695 goes down the right track. I think chapter 13 ought to be repealed. Then, we can all get down to the task of seeing whether there is a workable alternative.

Thank you.

Senator SYMMS. I thank you very much, and welcome you to the committee for the first time.

I can't help but think what we should do—and I think I will do this—is to ask David Stockman at OMB to do an analysis of whether this is a cost effective tax for the Federal Government and Treasury to be even concerning themselves with.

In view of the glaring deficits that we face, we could probably send IRS agents out to work on picking apples or potatoes, or something, and they could earn more money for the Treasury by doing that, than by trying to collect this tax.

Mr. ZISSMAN. Senator, you come up with one sparkling idea after another. [General laughter.]

Senator SYMMS. I really appreciate all of the cooperation. I think it is worthy to note that we have heard from bankers, from attorneys, and from accountants, a broad section from all over the United States, with near unanimity.

I suppose it is worthy to note that Bob Woodward from Treasury is in the audience. He may not have the authority to speak on this issue now, but we would welcome, Bob, if you would like to speak for Treasury, that the Treasury is going to join on the bandwagon. We would welcome that at this point.

Mr. WOODWARD. I am not authorized to speak for the Treasury.

Senator SYMMS. I am sure that we will ask you to take the message back down to Secretary Regan.

I have to agree with our last witness. It is absolutely astounding to me as a Reagan Republican to find this kind of resistance in a Reagan Treasury Department, when we all know very well what the man stands for, why he was elected in November 1980, is to do away with exactly this type of intricacy that is so irritating to the public, and makes so much cynicism on the possibilty in this case to enforce a voluntary tax system.

It is highly incredible, from my point of view, and I am hopeful that Treasury will change their mind on this after reviewing the excellent testimony that all of you have contributed to this hearing today. I thank all of you very much for being with us. We will let you go catch your planes now.

I think I saw Tad Davis come in from the National Cattlemen's Association—come on up—Tad, and Burt Eller, vice president for government affairs, National Cattlemen's Association, from Denver, Colo.

Now we will hear from another sector of our economy. It used to be said that cattlemen had a problem with estate taxes. The way the cattle business has been in the last couple of years, I am not so sure that there are any of them left that have an estate to worry about. We hope that it is not the case.

Welcome to the committee, Mr. Davis, and Mr. Eller. Go right ahead.

STATEMENT OF THOMAS A. DAVIS, ACCOMPANIED BY BURTON ELLER, VICE PRESIDENT FOR GOVERNMENT AFFAIRS, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. DAVIS. Thank you, Mr. Chairman.

Testifying before you, Mr. Chairman, is a little bit like preaching to the choir when we talk about estate and gift taxes because no one, I think, has gone out in front more for, if not repealing, changing the inequities and complexities in the estate and gift tax law.

For the record, Mr. Chairman, I am Thomas A. Davis. I am here representing the National Cattlemen's Association, and with me is

Burton Eller, who is vice president for government affairs, National Cattlemen's Association. His offices are here in Washington.

The National Cattlemen's Association certainly commends you, Mr. Chairman, for your continuing interest in this subject.

As you know, we support repeal of the estate and gift tax laws, which you have supported and introduced legislation on in the past.

Short of repeal, however, we do think that there are a continuing number of inequities and complexities in the estate and gift tax law which need to be addressed, and you are now addressing. Those before me have commented much more articulately than I will be able to do about a lot of those problems.

Let me just point out several items that are of particular interest to the cattlemen.

First, we do support your legislation which would allow judicial review in the case of extended payment provisions, and in the case of the special valuation provisions for farms, ranches, and other land held by closely held business.

For farmers and ranchers, one serious problem with the extended payment provision is the impending change in the interest rate charged on deferred taxes. Under section 6166 of the present law, an estate can take up to 15 years to pay the estate tax liability as you have already been told. A favorable 4 percent interest rate is changed on the tax liability on the first $1 million of taxpayers' gross estate which is deferred under this entended payment provision.

However, if the adjusted gross estate exceeds $1 million, that portion of the estate tax attributable to the excess over $1 million bears interest at the same rate generally charged any other underpayment of taxes. As a result changes made to the law in the 1981 Tax Act, the interest rate is going to 20 percent next February.

Most of the efficient cattle ranchers around the country, and I am sure there are many that are efficient that are still losing money, require a substantial investment in land, equipment, and livestock. It is not uncommon for a ranch estate to exceed the $1 million. Consequently, a number of estates for family farms and ranches will find the new interest rate applicable to a significant portion of the estate tax liability which can be deferred under section 6166. Since it is virtually impossible for farmers to earn 20 percent on their capital invested, deferring taxes at a 20 percent interest rate, makes 6166 virtually impossible to use in those cases. Accordingly, we would recommend that Congress impose a cap on the interest rate charged on taxes deferred under section 6166.

For the same reason, a similar cap should also be imposed on interest charged where there is a recapture of the tax under the special valuation provision where the qualified heir elects to have the basis of the property stepped up.

I might say that we have not suggested the amount of the cap. We are not saying 4 percent, but we think that 20 percent is too high.

NCA also supports technical revisions of the extended payment provisions. In addition to the technical changes recommended by others, there is one change of particular significance to farmers and ranchers. The extended payment provisions apply to estate taxes attributable to interest in a closely held business, provided the closely held business makes up at least 35 percent of the adjusted gross estate. In administering this provision, the IRS strictly interprets the definition of a closely held interest. For example, real property which is leased by a rancher to a corporation controlled by the rancher or his family is not treated as part of the assets of the business for purposes of determining whether an estate is eligible for the extended payment provisions, nor is it included for purposes of determining the amount of the estate tax eligible for deferral. NCA believes that this interpretation regarding leased property is inconsistent with the intent of the provisions and should be changed.

Thanks in large measure to you, Mr. Chairman, the provisions relating to special valuation were vastly improved during the 1981 Tax Act. There are still some changes that need to be made, and we would commend you to our written statement for some of the suggestions that we do have.

Finally, we would support, as others have this morning, the repeal of the tax on generation-skipping transfers.

On behalf of the cattlemen, we thank you for allowing us to express our views.

[Statement of Thomas A. Davis follows:]

NATIONAL CATTLEMEN'S ASSOCIATION
P O Box 569 1001 Lincoln St
Denver Colorado 80201

STATEMENT

of the

NATIONAL CATTLEMEN'S ASSOCIATION

to the

Subcommittee on Estate and Gift Taxation

Committee on Finance
United States Senate

Relating to S.1695, S.1733, and Other Proposed

Amendments to the Estate and Gift Tax Laws

Presented by
Thomas A. Davis

accompanied by

J. Burton Eller, Jr
Vice President, Government Affairs
National Cattlemen's Association

November 4, 1981

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, prodducers, and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 18 affiliated national breed organizations.

SUMMARY OF STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION ON ESTATE TAX ISSUES

THE NATIONAL CATTLEMEN'S ASSOCIATION COMMENDS SENATOR SYMMS FOR HIS CONTINUING INTEREST IN PROBLEMS CREATED BY THE ESTATE AND GIFT TAX LAWS. FURTHERMORE, NCA SUPPORTS LEGISLATION WHICH HE HAS INTRODUCED TO REPEAL THE ESTATE AND GIFT TAXES. SHORT OF REPEAL, NCA GENERALLY SUPPORTS LEGISLATION INTENDED TO ELIMINATE THE NUMEROUS INEQUITIES AND COMPLEXITIES THAT ARE NOW A PART OF THE ESTATE AND GIFT TAX LAWS.

NCA IS PARTICULARLY CONCERNED THAT FARMERS, RANCHERS AND OTHER SMALL BUSINESSMEN SHOULD BE ABLE TO OBTAIN THE FULL BENEFITS OF THOSE PROVISIONS ALLOWING SPECIAL VALUATION OF FARM AND OTHER BUSINESS REAL PROPERTY, DEFERRED PAYMENT OF ESTATE TAXES, AND SPECIAL CORPORATE STOCK REDEMPTION RULES TO PAY ESTATE TAXES. A NUMBER OF FACTORS HAVE MADE THESE PROPOSALS UNAVAILABLE OR UNNECESSARILY COMPLEX IN CERTAIN INSTANCES. CONSEQUENTLY, NCA SUPPORTS S.1733 WHICH WAS INTRODUCED BY THE CHAIRMAN OF THIS SUBCOMMITTEE. THIS BILL WILL PROVIDE FOR JUDICIAL REVIEW OF DETERMINATIONS MADE UNDER SECTION 6166 OF THE CODE, ALLOWING ESTATES TO SPREAD OUT

PAYMENT OF ESTATE TAXES, AND SECTION 2032A OF THE CODE, ALLOWING ESTATES TO ELECT A SPECIAL VALUATION FOR FARMLAND.

FOR FARMERS AND RANCHERS, ONE SERIOUS PROBLEM WITH THE EXTENDED PAYMENT PROVISIONS IS THE IMPENDING CHANGE IN THE INTEREST RATE CHARGED ON THE DEFERRED TAXES. UNDER SECTION 6166 OF THE PRESENT LAW, AN ESTATE CAN TAKE UP TO 15 YEARS TO PAY ITS ESTATE TAX LIABILITY. A FAVORABLE 4 PERCENT INTEREST RATE IS CHARGED WITH RESPECT TO THE ESTATE TAX LIABILITY ON THE FIRST $1 MILLION OF THE TAXPAYER'S GROSS ESTATE WHICH IS DEFERRED UNDER THIS EXTENDED PAYMENT PROVISION. HOWEVER, IF THE ADJUSTED GROSS ESTATE EXCEEDS $1 MILLION, THAT PORTION OF THE ESTATE TAX ATTRIBUTABLE TO THE EXCESS OVER $1 MILLION BEARS INTEREST AT THE SAME RATE GENERALLY CHARGED FOR UNDER-PAYMENTS OF TAXES. AS A RESULT OF CHANGES IN THE LAW MADE BY THE ECONOMIC RECOVERY TAX ACT OF 1981, THIS INTEREST RATE WILL BE INCREASED FROM 90 PERCENT OF THE PRIME RATE TO 100 PERCENT OF THE PRIME RATE IN 1982. UNDER THIS FORMULA, THE NEW INTEREST RATE ON UNDERPAYMENTS OF TAX WILL BE 20 PERCENT BEGINNING NEXT FEBRURARY.

MOST EFFICIENT CATTLE-RAISING OPERATIONS ARE VERY CAPITAL INTENSIVE--REQUIRING SUBSTANTIAL INVESTMENTS IN LAND,

EQUIPMENT, AND LIVESTOCK. IT IS NOT UNCOMMON FOR THE FARM ESTATE TO EXCEED $1 MILLION. CONSEQUENTLY, A NUMBER OF ESTATES OF FAMILY FARMERS WILL FIND THIS NEW INTEREST RATE APPLICABLE TO A SIGNIFICANT PORTION OF THE ESTATE TAX LIABILITY WHICH CAN BE DEFERRED UNDER SECTION 6166. SINCE IT IS VIRTUALLY IMPOSSIBLE FOR FARMERS TO EARN 20 PERCENT ON THEIR CAPITAL INVESTMENT, DEFERRING ESTATE TAXES AT 20 PERCENT INTEREST RATES IS OUT OF THE QUESTION, AND, THEREFORE, SECTION 6166 CANNOT BE USED.

ACCORDINGLY, NCA RECOMMENDS THAT CONGRESS IMPOSE A CAP ON THE INTEREST RATE CHARGED ON TAXES DEFERRED UNDER SECTION 6166. FOR THE SAME REASONS, A SIMILAR CAP SHOULD ALSO BE IMPOSED ON THE INTEREST CHARGED ON THE ESTATE TAXES RECAPTURED UNDER SECTION 2032A IF THE QUALIFIED HEIR ELECTS TO HAVE THE BASIS OF THE PROPERTY STEPPED UP.

NCA ALSO SUPPORTS TECHNICAL REVISIONS OF THE EXTENDED PAYMENT PROVISIONS. IN ADDITION TO THE TECHNICAL CHANGES RECOMMENDED BY OTHERS, THERE IS ONE CHANGE OF PARTICULAR SIGNIFICANCE TO FARMERS AND RANCHERS. THE EXTENDED PAYMENT PROVISIONS APPLY TO ESTATE TAXES ATTRIBUTABLE TO AN INTEREST IN A CLOSELY HELD BUSINESS, PROVIDED THE CLOSELY HELD

BUSINESS MAKES UP AT LEAST 35 PERCENT OF THE ADJUSTED GROSS ESTATE. IN ADMINISTERING THIS PROVISION, THE IRS STRICTLY INTERPRETS THE DEFINITION OF A CLOSELY HELD BUSINESS INTEREST. FOR EXAMPLE, REAL PROPERTY WHICH IS LEASED BY AN INDIVIDUAL TO A CORPORATION CONTROLLED BY THE INDIVIDUAL OR HIS FAMILY IS NOT TREATED AS PART OF THE ASSETS OF THE BUSINESS FOR PURPOSES OF DETERMINING WHETHER AN ESTATE IS ELIGIBLE FOR THE EXTENDED PAYMENT PROVISIONS, NOR IS IT INCLUDED FOR PURPOSES OF DETERMINING THE AMOUNT OF THE ESTATE TAX ELIGIBLE FOR DEFERRAL. NCA BELIEVES THAT THIS INTERPRETATION REGARDING LEASED PROPERTY IS INCONSISTENT WITH THE INTENT OF THE PROVISIONS AND SHOULD BE CHANGED.

ALTHOUGH THE PROVISIONS RELATING TO SPECIAL VALUATION OF FARM AND SMALL BUSINESS REAL PROPERTY WERE VASTLY IMPROVED BY THE 1981 TAX ACT, THERE ARE STILL A FEW REMAINING PROBLEMS. THESE PROBLEMS ARE DISCUSSED IN DETAIL IN MY FULL STATEMENT. NCA PROPOSES THAT THE COMMITTEE CONSIDER ADDRESSING THESE PROBLEMS IN ANY TECHNICAL REVISION OF THE ESTATE TAX RULES.

FINALLY, NCA CONTINUES TO SUPPORT REPEAL OF THE TAX ON GENERATION-SKIPPING TRANSFERS.

ON BEHALF OF NCA, I THANK YOU VERY MUCH FOR THIS OPPORTUNITY TO EXPRESS THEIR VIEWS ON THIS SUBJECT WHICH IS SO IMPORTANT TO THE FARMERS AND RANCHERS IN THIS COUNTRY.

STATEMENT

Introduction

For a number of years, the National Cattlemen's Association (NCA) and other agricultural organizations have been concerned about the impact of the estate and gift tax laws upon the owners of family farms, ranches, and other closely held businesses. In part as a result of the efforts of these organizations, the Internal Revenue Code contains provisions which recognize the special problems of family farms and other closely held businesses. Thus, Section 6166 of the Code permits an estate to defer a portion of the estate taxes attributable to certain closely held businesses and to pay off these taxes over a period of up to 15 years. Also, Section 2032A provides that, under certain circumstances, the executor may elect to value certain farm or business real property in an estate on the basis of its current use rather than its highest and best use. This provision applies only to real property used in a closely held business or as part of a family farming operation.

From time to time, technical problems resulting from unanticipated factual situations or overly restrictive IRS interpretations have resulted in the benefits of these provisions not being available to family farms. As a result, Congress has periodically reexamined these provisions and made changes to insure that they were available for the types of taxpayers whom they were intended to benefit. Thus, improvements in the extended payment provisions were made in 1976 and again in the 1981 Tax Act. Similarly, the special use valuation provisions, which were added in 1976, were revised in 1978 and again in 1981.

Notwithstanding the significant improvements which have been made to these provisions, there are a number of additional changes which would substantially improve these provisions.

NCA commends Senator Symms for his continuing interest in improving the administration of the estate tax laws and supports the basic goal of making the extended payment provisions more administrable.

NCA supports S.1733

There are many circumstances under which it may not be clear as to whether an estate is eligible to elect to defer estate taxes under Section 6166. Also because of the language of the jurisdictional provisions, it appears that an executor cannot obtain judicial review if the IRS denies the executor's election to use Section 6166.

NCA believes that estates should be able to obtain judicial review of disputes with the Internal Revenue Service arising under Section 6166. NCA also believes that disputes arising under Section 2032A should be subject to judicial review even if the disputes do not result in a current tax deficiency

Interest rate cap for deferred payments

Under present law, a 4 percent interest rate is available with respect to the estate tax liability on the first $1 million of the taxpayer's gross estate which is deferred under the extended payment provision (Code Sec. 6166). All other interest on amounts of estate tax deferred under Section 6166 bear interest at the same rate that underpayments of taxes generally bear. This rate is, by statute, currently set at 90 percent of the prime rate with adjustments to be made no more frequently than every two years. Under these rules the current rate is 12 percent. However, by reason of changes made in the 1981 Tax Act, the rate of interest on underpayments of tax is to be 100 percent of the prime rate and is to be adjusted annually. Under the new rules, the rate of interest will be raised to 20 percent as of February 1, 1982.

Most commercially viable family cattle operations are extremely capital intensive--requiring substantial capital investment in land, livestock, building and equipment. Consequently, many farm estates will exceed $1 million even though the owners are not thought of as wealthy, and such estates will be able to defer payment of estate taxes only by paying 20 percent interest on a portion of the tax deferred. The assets used in a cattle operation normally cannot generate the type of cash return necessary to service debt bearing a 20 percent interest rate. Consequently, the allowance of a deferred payment provision with high interest rates will not provide any meaningful benefit to many estates containing cattle operations. In order to provide for a deferred payment provision with utility to cattle operations, the interest rates should have a cap of 12 percent. Thus, NCA supports H.R. 4524, sponsored by Mr. Bafalis, which provides that the maximum rate of interest shall be 12 percent on estate taxes which are deferred under Section 6166 (or Section 6166A as in effect prior to its repeal by the 1981 Tax Act). This 12 percent maximum also applies to interest on the recapture tax under Section 2032A where the qualified heir elects a stepped-up basis. NCA strongly suggests that similar provisions be included in any bill seeking to make improvements to Section 6166.

NCA supports technical improvements to Section 6166

The testimony of other witnesses will describe in detail some of the technical problems with Section 6166. In addition to the concerns expressed by others, there are certain situations in which the deferred payment provisions do not apply in the agricultural area where NCA believes that they should apply and recommends that technical revisions be adopted to take care of these problems.

Under the extended payment provisions, deferral is available only with respect to qualifying closely held business interests. A qualifying 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 a business has been carried on by a decedent as a sole proprietor, the 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 Section 6166. These guidelines set up a somewhat narrower definition of a trade or business than applies 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 by transferring some assets to a family corporation but retaining individual ownnership of the farm real property which is leased to the corporation may prevent his estate from using installment payments for estate tax purposes. In one situation, a decedent incorporated a sole proprietorship but retained personal ownership of the land and buildings used in the business. The decedent leased the real property to the corporation which used it in the corporation's business. The IRS ruled that the decedent's ownership of the real property did not qualify as a business and, therefore, could not be taken into account in determining whether the estate met the percentage requirrements for deferral of estate tax.

Similarly, giving up active participation in farming because of age and health may result in the loss of the use of the extended 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 his 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. Thus, 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 provisions do not allow deferral where property is not owned by the same entity which is engaged in the trade or business.

Thus, NCA supports provisions, such as those contained in Section 9(a)(3) of H.R. 3882, which would provide 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. We strongly suggest that provisions to this effect be included in the bill to make technical improvements in Section 6166.

Technical amendments relating to Section 2032A

In large part due to the efforts of a number of members of the Committee on Finance, the 1981 Tax Act contained a significant number of provisions which materially improved the special use valuation provisions. However, NCA believes that certain additional improvements should be made. First, the "comparable land" requirement should be removed from the valuation formula. Under present law, once property qualifies for special use valuation, the easiest and most beneficial way to value the property is to use a capitalization formula under which the value of the farmland is determined by dividing the annual cash rental or crop share rental by the average annual interest rate during the last five years for all new Federal Land Bank loans. The IRS has taken a very strict interpretation of what comparable land is and has denied the use of a capitalization formula whenever it does not believe that there is comparable land in the locality. NCA believes that the capitalization formula should be revised so that the real property—would be valued by using the average annual rental value of that property determined on the basis of the rental that would be paid in an "arm's-length" transaction with an unrelated party. This may be computed by the use of cash rentals or crop share rentals. This approach eliminates the need for finding comparable land and disputes with the IRS as to what land is comparable.

Second, the facts and circumstances valuation formula needs to be revised. Under present law, if the capitalization 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. Also, the IRS interpretation of this provision has been so strict that little, if any, benefit is obtainable in most circumstances. NCA recommends that the five-factor method be replaced by a provision that allows the executor to value the qualified real property at 50 percent of its fair market value. This provision is contained in H.R. 3882, which has more than 50 House cosponsors.

Third, an inappropriate IRS interpretation of the rules relating to mortgage debt on specially valued property needs to be overruled. 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. 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. NCA strongly supports a provision, such as contained in H.R. 3882, which makes it clear that the deduction for mortgage debt, or other indebtedness on property, is not to be reduced if the property is valued under the special use valuation provisions.

Fourth, the rules relating to consents of individuals with an interest in property to be specially valued need to be liberalized. For the executor of an estate to be eligible to elect special use valuation, each person who has an interest in the 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 a 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 guardian. The reason for this position is that the IRS is concerned that the liability for the recapture tax could be avoided if the agreement were disaffirmed by the minor or other person when his legal disability ceases. NCA supports a provision which would permit the natural parents of a minor or a person under a legal disability to sign the agreement for such person without requiring a guardianship proceeding and would provide 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. Such a proposal should also permit the trustee of a trust holding property for the benefit of the person under a legal disability to sign the agreement and bind such a person. A provision of this sort is included in H.R. 3882. Although such a provision was considered in the 1981 Tax Act, it was not included in that Act because some believed that the Judiciary Committees should have jurisdiction over this provision which preempts state laws.

Fifth, certain persons who have nonpossessory interests in real property should be able to have such interests valued under the special valuation rules. If a decedent who owns 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 positon even if the decedent himself (or member of his family) materially participated in farming activities on the real property. NCA supports a provision such as is found in H.R. 3882, which would provide that the fact that a decedent does not have a present interest in real property would not prevent the property from being treated as qualified real property.

Finally, the rules relating to partial dispositions of qualified real property should be revised. 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 saving from special valuation may be recaptured. NCA believes that only pro-rata recapture based on relative fair market value should occur upon partial dispositions or partial cessations of qualified use. A provision to this effect is included in H.R. 3882.

NCA supports S.1695

As it has in the past, NCA supports repeal of the tax on generation-skipping transfers and commends Senator Symms for introducing S.1695 which would accomplish this worthwhile goal. The complexity of the tax on generation-skipping transfers and the resulting tax traps and cost of compliance far outweigh any tax equity arguments in favor of this tax.

Senator SYMMS. Thank you very much. Your entire statement will be part of the record that is attached to your testimony that you just gave this morning. We appreciate hearing from you.

Did you want to make any comments, Mr. Eller?

Mr. ELLER. Not at this time, unless there are some questions, Mr. Chairman.

We appreciate all that you have done in this area already.

Senator SYMMS. I certainly appreciate having the support of the cattlemen on this issue, and I think that it is worthy to note that we have heard from all the people who actually handle the estates, that are in the business of estate planning, this morning, lawyers, accountants, and bankers.

I think it makes the hearing more complete to have the affected one group, but I am sure that the same thing could be applied to other small business groups across the country, they suffer from exactly the same complexities that a cattleman does. There really isn't any difference.

I appreciate the support, and I appreciate the fact that all the witnesses were here this morning.

Our hearing record will be kept open for 30 days for those who wish to comment on the Treasury testimony this morning, or other aspects of it.

Also, we will be hopeful that by the time the hearing record is closed, the Treasury will have reappraised their position and recognized the wisdom of all the testimony that we have heard this morning, and we can get on with trying to make one small simple step toward simplifying our tax code.

Thank you very much.

If there are no further witnesses, the hearing is adjourned.

[Whereupon, at 11:50 a.m., the subcommittee adjourned, to reconvene at the call of the Chair.]

ADDITIONAL ESTATE AND GIFT TAX ISSUES

TUESDAY, NOVEMBER 10, 1981

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

The subcommittee met, pursuant to call, at 9:40 a.m., in room 2221, Dirksen Senate Office Building, Hon. Steven Symms (chairman of the subcommittee) presiding.

Present: Senators Symms, Long, Boren, and Baucus.

Senator SYMMS. The subcommittee will come to order.

The Subcommittee on Estate and Gift Taxation will hold a hearing this morning, November 10, which I might say is a very historic day in America, it being the birthday of the U.S. Marine Corps. The hearing will focus on three bills concerning tax problems of artists and artists' estates. They are S. 649 introduced by Senator Baucus with Senator Heinz and others, S. 651 introduced by Senator Moynihan, and S. 852 introduced by Senator Moynihan.

[The Joint Committee on Taxation description and the text of bills S. 649, S. 851, and S. 852 follow:]

90-590 O—82——19

DESCRIPTION OF TAX BILLS
(S. 649, S. 851, and S. 852)
RELATING TO
THE TAX TREATMENT OF ARTISTS

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on November 10, 1981, regarding the tax treatment of artists.

There are three bills scheduled for the hearing: S. 649 (Senator Baucus, et al.), S. 851 (Senator Moynihan), and S. 852 (Senator Moynihan).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 649—Senators Baucus, Lugar, Kasten, Leahy, Williams, and Heinz

Special Valuation for Estate Tax Purposes, and Removal of Certain Income Tax Limitations on Charitable Contributions, of Artistic and Creative Property

Under present law, donors of appreciated property, the sale of which would give rise to long-term capital gain, generally are allowed an income tax deduction equal to the fair market value of the donated item. However, a taxpayer who makes a charitable contribution of appreciated property, the sale of which would give rise to ordinary income (or short-term capital gain), generally is required by present law to reduce the amount of the deduction (from fair market value) by the amount of any ordinary income (or short-term capital gain) which the taxpayer would have realized had the property been sold at that time (sec. 170(e)). The effect of this rule is to limit the charitable income tax deduction to the donor's basis in the property.

Under present law, the sale of a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property by its creator results in ordinary income (sec. 1221(3)). As a result, an author, artist, etc., who donates works of art, books, letters, or memorandums which he or she created or prepared generally is allowed a deduction limited to the cost of the materials used in the creation of the work.

Under present law, a decedent's gross estate generally includes the value of all property in which the decedent had an interest at the time of his death (sec. 2033). The amount included in the gross estate is generally the fair market value of the property interest on the date of the decedent's death, unless the executor elects to value all property in the gross estate on the alternate valuation date (which is six months after the date of death). Under these rules, works of art and literary and musical compositions are included in the gross estate of their creator at the fair market value of the property on the date of death or alternate valuation date, rather than at an amount equal to the decedent's income tax basis in the property.

The bill generally would provide an income tax charitable deduction equal to the full fair market value of any literary, musical or artistic composition, any letter or memorandum, or similar property contributed to a qualifying charity. However, no deduction would be permitted for a contribution of any such property prepared by any governmental officer or employee if such property arose out of, or was related to the performance of, that individual's official duties. The bill also would permit an executor to include qualified creative property in the decedent's gross estate based upon the decedent's adjusted basis rather than the property's fair market value.

Effective date.—The bill would be effective for contributions made, and estates of decedents dying, after December 31, 1980.

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2. S. 851—Senator Moynihan

Increased Income Tax Deduction for Charitable Contributions of Donor-Created Literary, Musical, or Artistic Compositions

and

S. 852—Senator Moynihan

Allowance of an Income Tax Credit for Charitable Contributions of Donor-Created Literary, Musical, or Artistic Compositions

Under present law, donors of appreciated property, the sale of which would give rise to long-term capital gain, generally are allowed an income tax deduction equal to the fair market value of the donated item. However, a taxpayer who makes a charitable contribution of appreciated property, the sale of which would give rise to ordinary income (or short-term capital gain), generally is required by present law to reduce the amount of the deduction (from fair market value) by the amount of any ordinary income (or short-term capital gain) which the taxpayer would have realized had the property been sold at that time (sec. 170(e)).

Under present law, the sale of a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property by its creator results in ordinary income (sec. 1221(3)). As a result, an author, artist, etc., who donates works of art, books, letters, or memorandums which he or she had created or prepared is allowed a deduction limited to the cost of the materials used in the creation of the work.

S. 851

S. 851 would permit a deduction equal to a statutorily prescribed percentage of fair market value for individuals who contribute self-created literary, musical, or artistic compositions to charitable organizations (under sec. 501(c)(3)) or governmental units (under sec. 170(c)(1)). The increased charitable deduction would not apply to certain charitable contributions of government officials.

Effective date.—The bill would be effective for taxable years beginning after December 31, 1981.

S. 852

S. 852 would permit a credit against income tax equal to a statutorily prescribed percentage of fair market value for individuals who contribute self-created literary, musical, or artistic compositions to charitable organizations (under sec. 501(c)(3)) or governmental units (under sec. 170(c)(1)).

The credit could not exceed the tax on the taxpayer's income from sales of literary, musical, or artistic compositions or the greater of $2,500 or one-half of the taxpayer's total income tax for the year. The income tax credit would not apply to certain charitable contributions of government officials.

Effective date.—The bill would be effective for taxable years beginning after December 31, 1981.

II. DESCRIPTION OF THE BILLS

1. S. 649—Senators Baucus, Lugar, Kasten, Leahy, Williams, and Heinz

Special Valuation for Estate Tax Purposes, and Removal of Certain Income Tax Limitations on Charitable Contributions, of Artistic and Creative Property

Present Law

Income tax valuation

Under the law since 1969, donors of appreciated property, the sale of which would give rise to long-term capital gain, generally are allowed an income tax deduction equal to the fair market value of the donated item. Thus, a collector who contributes a painting to a museum (more than a year after purchasing it, e.g., from the artist) may deduct the fair market value of the painting at the time of the contribution.

Except in two cases, however, a taxpayer who makes a charitable contribution of appreciated property, the sale of which would give rise to ordinary income or short-term capital gain, is required by present law to reduce the amount of the deduction (from fair market value) by the amount of any ordinary income or short-term capital gain which the taxpayer would have realized had the property been sold at that time (sec. 170(e)). Thus, a donor of appreciated ordinary income property (property the sale of which would not give rise to long-term capital gain) may deduct only the donor's basis in the property, rather than its full fair market value.

Under present law, the sale of a copyright, a literary, musical, or artistic composition, a letter, or memorandum, or similar property by its creator results in ordinary income (sec. 1221(3)). As a result, an author, artist, etc., who donates works of art, books, letters, or memorandums which he or she created or prepared generally is allowed a deduction limited to the cost of the materials used in the creation of the works. This is because the sale of the art works by the artist would give rise to ordinary income, in much the same manner as would the sale of inventory by a manufacturer.

These general rules of present law governing gifts of appreciated property to charity were enacted as part of the Tax Reform Act of 1969. Before the 1969 Act, except in a few limited circumstances,[1] a deduction was allowed for the full fair market value of the contributed property, and no income tax was imposed on the appreciation at the

[1] Before the 1969 Act, the amount of the charitable deduction was reduced only by the amount of gain which would have been treated as ordinary income under the recapture rules for certain mining property (sec. 617), depreciable tangible personal property (sec. 1245), and certain depreciable real property (sec. 1250), if the property contributed had been sold at is fair market value.

time of the gift. However, in 1969 Congress concluded that the combined effect of not taxing the appreciation and at the same time allowing a charitable contribution deduction for the appreciation as to produce unwarranted tax benefits that were significantly greater than the tax benefits from cash contributions.[3]

The Tax Reform Act of 1976 provided an exception to the general rule requiring a reduction in the charitable deduction for gain that would be treated as ordinary income had the appreciated property been sold for contributions by corporations of certain types of ordinary income property (e.g., medical equipment) donated for the care of the needy, the ill, or infants (sec. 170(e) (3)). In the case of such a qualifying charitable contribution of inventory, the exception generally allows a deduction equal to the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation (but not to exceed twice the basis of the property).

The Economic Recovery Tax Act of 1981 (ERTA) created a second exception to this general reduction rule for corporate contributions of newly manufactured ordinary income property to a college or university for research or experimentation, including research training (sec. 170(e)(4)). This exception permits a charitable deduction equal to the taxpayer's basis in the property plus 50 percent of appreciation (but not to exceed twice the basis of the property).

Estate tax valuation

Under present law, a decedent's gross estate generally includes the value of all property in which the decedent had an interest at the time of his death (sec. 2033). The amount included in the gross estate is generally the fair market value of the property interest on the date of the decedent's death, unless the executor elects to value all property in the gross estate on the alternate valuation date (which is six months after the date of death).

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[3] This result and the reason for the change were illustrated as follows in the Report of the Committee on Finance on the 1969 Act (S. Rep. No. 91-552, 91st Cong., 1st Sess. 80 (1969)) [Note that the Economic Recovery Tax Act of 1981 reduced the maximum individual income tax rate from 70 percent to 50 percent, effective January 1, 1982]:

> . . . [I]n some cases it actually is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds. This is true in the case of gifts of appreciated property which would result in ordinary income if sold, when the taxpayer is at the high marginal tax brackets and the cost basis for the ordinary income property is not a substantial percentage of the fair market value. For example, a taxpayer in the 70-percent tax bracket could make a gift of $100 of inventory ($50 cost basis) and save $105 in taxes (70 percent of the $50 gain if sold, or $35, plus 70 percent of the $100 fair market value of the inventory, or $70).
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> The committee does not believe that the charitable contributions deduction was intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax saving is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity. Moreover, an unwarranted tax benefit is allowed these taxpayers, who usually are in the very high income brackets. The committee, therefore, considers it appropriate to narrow the application of the tax advantages in the case of gifts of certain appreciated property.

Under these rules, works of art and literary and musical compositions, like other types of property, are included in the gross estate of their creator based upon the fair market value of the property at the date of death or alternate valuation date, rather than based upon the decedent's income tax basis in the property. Property (both appreciated and depreciated) which is included in the gross estate receives an income tax basis equal to its fair market value on the date of death (or the alternate valuation date) (sec. 1014). This, if the heir sells inherited property, all pre-death appreciation in the property's value is not subject to income tax.

Present law also permits a deduction from the gross estate for property passing to charitable organizations, the United States, and State and local governments (sec. 2055). The amount of this deduction is equal to the value of the interest in property received by the charity (in the case of an outright gift of property, the full value at which it is included in the gross estate). Thus, property can be contributed to a charitable organization free of Federal estate tax.

Issues

The first issue is whether a change should be made in the present law rule which permits a creator of appreciated literary, musical, or artistic compositions to claim an income tax charitable deduction equal to the fair market value of the property minus any amount of appreciation that would have been taxed as ordinary income or short-term capital gain had the property been sold.

The second issue is whether a change should be made in the present law rule which provides for inclusion of appreciated literary, musical, or artistic compositions in a decedent-creator's gross estate based upon the property's fair market value.

Explanation of the Bill

The bill would provide an income tax charitable deduction equal to the full fair market value of any literary, musical or artistic composition, any letter or memorandum, or similar property contributed to a qualifying charity if the taxpayer's personal efforts created such property. No charitable contribution deduction would be permitted for a contribution of any qualifying property prepared by any governmental officer or employee if such property arose out of, or was related to the performance of, that individual's official duties.

The bill would permit an executor to include qualified decedent-created property in the decedent's gross estate based upon the decedent's adjusted basis rather than the property's fair market value.[3] For these purposes, qualified decedent-created property includes any copyright, any literary, musical, or artistic composition, any letter or memorandum, or any similar property which was held by the decedent at the time of his death and which was created by the decedent.

[3] The bill does not modify the rule of present law under which the basis of property passing from a decedent is stepped up to its fair market value at the date of the decedent's death or alternate valuation date.

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Effective Dates

The provisions of the bill relating to income tax valuation would apply to charitable contributions made after December 31, 1980.

The provisions of the bill relating to estate tax valuation would apply to estates of decedents dying after December 31, 1980.

Revenue Effect

It is estimated that this provision would reduce federal budget receipts by $15 million a year.

2. S. 851—Senator Moynihan

Increased Charitable Income Tax Deduction for Charitable Contributions of Donor-Created Literary, Musical, or Artistic Compositions

and

S. 852—Senator Moynihan

Allowance of an Income Tax Credit for Charitable Contributions of Donor-Created Literary, Musical, or Artistic Compositions

Present Law

Under the law since 1969, donors of appreciated property, the sale of which would give rise to long-term capital gain, generally are allowed an income tax deduction equal to the fair market value of the donated item. Thus, a collector who contributes a painting to a museum (more than a year after purchasing it, e.g., from the artist) may deduct the fair market value of the painting at the time of the contribution.

Except in two cases, however, a taxpayer who makes a charitable contribution of appreciated property, the sale of which would give rise to ordinary income or short-term capital gain, is required by present law to reduce the amount of the deduction (from fair market value) by the amount of any ordinary income or short-term capital gain which the taxpayer would have realized had the property been sold at that time (sec. 170(e)). Thus, a donor of appreciated ordinary income property (property the sale of which would not give rise to long-term capital gain) may deduct only the donor's basis in the property, rather than its full fair market value.

Under present law, the sale of a copyright, a literary, musical, or artistic composition, a letter, or memorandum, or similar property by its creator results in ordinary income (sec. 1221(3)). As a result, an author, artist, etc., who donates works of art, books, letters, or memorandums which he or she created or prepared generally is allowed a deduction limited to the cost of the materials used in the creation of the work. This is because the sale of the art works by the artist, would give rise to ordinary income, in much the same manner as would the sale of inventory by a manufacturer.

These general rules of present law governing gifts of appreciated property to charity were enacted as part of the Tax Reform Act of 1969. Before the 1969 Act changes were effective, except in a few limited circumstances [1] a deduction was allowed for the full fair market

[1] Before the 1969 Act, the amount of the charitable deduction was reduced only by the amount of gain which would have been treated as ordinary income under the recapture rules for certain mining property (sec. 617), depreciable tangible personal property (sec. 1245), and certain depreciable real property (sec. 1250), if the property contributed had been sold at its fair market value.

value of the gifted property and no income tax was imposed on the appreciation at the time of the gift. However, in 1969 Congress concluded that the combined effect of not taxing the appreciation and at the same time allowing a charitable contribution deduction for the appreciation was to produce unwarranted tax benefits that were significantly greater than the tax benefits from cash contributions.[3]

The Tax Reform Act of 1976 provided an exception to the general rule requiring a reduction in the charitable deduction for gain that would be treated as ordinary income had the appreciated property been sold for contributions by corporations of certain types of ordinary income property (e.g., medical equipment) donated for the care of the needy, the ill, or infants (sec. 170(e)(3)). In the case of such a qualifying charitable contribution of inventory, the exception generally allows a deduction equal to the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation (but not to exceed twice the basis of the property).

The Economic Recovery Tax Act of 1981 (ERTA) created a second exception to this general reduction rule for corporate contributions of newly manufactured ordinary-income property to a college or university for research or experimentation, including research training (sec. 170(e)(4)). This exception permits a charitable deduction equal to the taxpayer's basis in the property plus 50 percent of appreciation (but not to exceed twice the basis of the property).

Issue

The issue is whether a change should be made in the present law rule which permits a creator of appreciated literary, musical, or artistic compositions to claim an income tax charitable deduction equal to the fair market value of the property minus any amount of appreciation that would have been taxed as ordinary income or short-term capital gain had the property been sold.

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[3] This result and the reason for the change were illustrated as follows in the Report of the Committee on Finance on the 1969 Act (S. Rept. 91-552, 91st Cong., 1st Sess. 80 (1969),) [Note that the Economic Recovery Tax Act of 1981 reduced the maximum individual income tax rate from 70 percent to 50 percent, effective January 1, 1982]:

> . . . [I]n some cases it actually is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property paying the tax on the gain, and keeping the proceeds. This is true in the case of gifts of appreciated property which would result in ordinary income if sold, when the taxpayer is at the high marginal tax brackets and the cost basis for the ordinary income property is not a substantial percentage of the fair market value. For example, a taxpayer in the 70-percent tax bracket could make a gift of $100 of inventory ($50 cost basis) and save $105 in taxes (70 percent of the $50 gain if sold, or $35, plus 70 percent of the $100 fair market value of the inventory, or $70).
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> The committee does not believe that the charitable contributions deduction was intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold and the proceeds were retained by the taxpayer. In cases where the tax saving is so large, it is not clear how much charitable motivation actually remains. It appears that the Government, in fact, is almost the sole contributor to the charity. Moreover, an unwarranted tax benefit is allowed these taxpayers, who usually are in the very high income brackets. The committee, therefore, considers it appropriate to narrow the application of the tax advantages in the case of gifts of certain appreciated property.

Explanation of the Bills

S. 851

S. 851 would permit a deduction equal to a statutorily prescribed percentage of fair market value for individuals who contribute self-created literary, musical, or artistic compositions to charitable organizations (under sec. 501(c)(3)) or governmental units (under sec. 170(c)(1)).

The deductible percentage of fair market value would decrease as the donor's adjusted gross income increased. The maximum deductible percentage would be 86 percent and the minimum would be 30 percent. The amounts of adjusted gross income at which each decrease from the 86 percent maximum would be effective would vary depending on the donor's income tax filing status (i.e., married filing joint returns, married filing separate returns, heads of households, and unmarried individuals).

The bill would require the charitable recipient of the property to certify to the donor that the contributed property represents material of artistic, musical, or literary significance and that the property would be used in a manner related to the donee's exempt function. Although the deduction generally would be permitted to the individual whose personal efforts created such property, no deduction would be permitted for a charitable contribution of any qualifying property prepared by any governmental officer or employee if such property arose out of, or was related to the performance of, that individual's official duties.

S. 852

S. 852 would permit a credit against tax equal to a statutorily prescribed percentage of fair market value for individuals who contribute self-created literary, musical, or artistic compositions to charitable organizations (under sec. 501(c)(3)) or governmental units (under sec. 170(c)(1)).

The creditable percentage of fair market value would decrease as the donor's adjusted gross income increased. The maximum creditable percentage would be 86 percent and the minimum would be 30 percent. The amounts of adjusted gross income at which each decrease from the 86 percent maximum would be effective would vary depending on the donor's income tax filing status (i.e., married filing joint returns, married filing separate returns, heads of households, and unmarried individuals).

Under the bill, the credit could not exceed the amount of tax on the donor's income from sales of literary, musical, or artistic compositions. Additionally, the credit could not exceed the greater of $2,500 or one-half of the taxpayer's Federal income tax liability for the taxable year. Unused credits would be eligible for a five-year carryover.

The bill would require the charitable recipient of the property to certify to the donor that the contributed property represents material of artistic, musical, or literary significance and that the property would be used in a manner related to the donee's exempt function. Although the credit generally would be permitted to the individual whose personal efforts created such property, no credit would be permitted for a charitable contribution of any qualifying property prepared by any governmental officer or employee if such property arose out of, or was related to the performance of, that individual's official duties.

Effective Dates

The provisions of the bills would apply to contributions made in taxable years beginning after December 31, 1981.

Revenue Effect

S. 851

It is estimated that S. 851 would reduce budget receipts by $10 million a year.

S. 852

It is estimated that S. 852 would reduce budget receipts by $20 million a year.

II

97TH CONGRESS
1ST SESSION

S. 649

To amend the Internal Revenue Code of 1954 to provide that the executor may elect, for estate tax purposes, to value certain items at an amount equal to the adjusted basis of the decedent in such items and to remove certain limitations on charitable contributions of certain items.

IN THE SENATE OF THE UNITED STATES

MARCH 6 (legislative day, FEBRUARY 16), 1981

Mr. BAUCUS (for himself, Mr. LUGAR, Mr. KASTEN, Mr. LEAHY, and Mr. WILLIAMS) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide that the executor may elect, for estate tax purposes, to value certain items at an amount equal to the adjusted basis of the decedent in such items and to remove certain limitations on charitable contributions of certain items.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Artist's Tax Equity and Donation Act of 1981".

SEC. 2. CHARITABLE CONTRIBUTIONS OF CERTAIN ITEMS CREATED BY THE TAXPAYER.

Subsection (e) of section 170 of the Internal Revenue Code of 1954 (relating to certain contributions of ordinary income and capital gain property) is amended by adding at the end thereof the following new paragraph:

"(4) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS OF LITERARY, MUSICAL, OR ARTISTIC COMPOSITIONS.—

"(A) IN GENERAL.—In the case of a charitable contribution of any literary, musical, or artistic composition, any letter or memorandum, or similar property if such property was created by the personal efforts of the taxpayer making such contribution, the amount of such contribution shall be the fair market value of the property contributed at the time of such contribution and no reduction in such amount shall be made under subparagraph (A) or (B) of paragraph (1).

"(B) CERTAIN CONTRIBUTIONS BY PUBLIC OFFICIALS.—Subparagraph (A) shall not apply in the case of any charitable contribution of any letter, memorandum, or similar property which was written, prepared, or produced by or for an individual while such individual was an officer or employee of the United States or of any State (or political subdivision thereof) if the writing, preparation, or production of such property was related to, or arose out of, the performance of such individual's duties as such an officer or employee.".

SEC. 3. VALUATION OF CERTAIN ITEMS CREATED BY THE DECEDENT FOR ESTATE TAX PURPOSES.

(a) IN GENERAL.—Part III of subchapter A of chapter 11 of the Internal Revenue Code of 1954 (relating to gross estate) is amended by inserting after section 2032A the following new section:

"SEC. 2032B. VALUATION OF CERTAIN ITEMS CREATED BY THE DECEDENT.

"(a) GENERAL RULE.—If—

"(1) the decedent was (at the time of his death) a citizen or resident of the United States, and

"(2) the executor elects the application of this section,

then, for purposes of this chapter, the value of qualified creative property shall be determined under subsection (b).

"(b) VALUE OF QUALIFIED CREATIVE PROPERTY.—For purposes of subsection (a), the value of qualified creative property of the decedent shall be an amount equal to the adjusted basis (within the meaning of section 1011) of the decedent in such property immediately before his death.

"(c) QUALIFIED CREATIVE PROPERTY DEFINED.—For purposes of this section, the term 'qualified creative property' means any copyright, any literary, musical, or artistic composition, any letter or memorandum, or any similar property—

"(1) which was held by the decedent at the time of his death, and

"(2) which was created by the personal efforts of the decedent.

"(d) ELECTION.—The election under this section shall be made not later than the time prescribed by section 6075(a) for filing the return of tax imposed by section 2001 (including extensions thereof), and shall be made in such manner as the Secretary shall by regulations prescribe.".

(b) CONFORMING AMENDMENT.— The table of sections for such part III is amended by inserting after the item relating to section 2032A the following new item:

"Sec. 2032B. Valuation of certain items created by the decedent.".

SEC. 4. EFFECTIVE DATES.

(a) CHARITABLE CONTRIBUTIONS.—The amendment made by section 2 shall apply to contributions made after December 31, 1980.

(b) ESTATE TAX VALUATION.—The amendments made by section 3 shall apply to estates of decedents dying after December 31, 1980.

II

97TH CONGRESS
1ST SESSION

S. 851

To amend the Internal Revenue Code to increase the amount that an artist may deduct when he contributes an artistic composition to charity.

IN THE SENATE OF THE UNITED STATES

APRIL 1 (legislative day, FEBRUARY 16), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code to increase the amount that an artist may deduct when he contributes an artistic composition to charity.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Pen and Ink Act of 1981".

90-590 O—82——20

SEC. 2. DEDUCTIONS FOR CONTRIBUTING CERTAIN LITERARY, MUSICAL, OR ARTISTIC COMPOSITIONS.

Section 170(e) of the Internal Revenue Code (relating to certain contributions of ordinary income and capital gains property) is amended by adding at the end thereof the following new paragraph—

"(4) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS OF LITERARY, MUSICAL, OR ARTISTIC COMPOSITIONS.—

"(A) QUALIFIED CONTRIBUTIONS.—For an individual who contributes a literary, musical, or artistic composition created by his own efforts to an organization described in section 501(c)(3) (that is exempt from tax under section 501(a)) or to a governmental unit described in section 170(c)(1), the amount of charitable contribution taken into account under this section shall be a percentage of the fair market value of such composition determined according to the applicable table.

"(B) APPLICABLE TABLES.—For purposes of subparagraph (A), the applicable table for—

"(i) married individuals and surviving spouses described in section 1(a) is table 1,

"(ii) heads of households described in section 1(b) is table 2, "(iii) unmarried individuals described in section 1(c) is table 3, and

"(iv) married individuals described in section 1(d) is table 4.

"Table 1

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $7,500	86
Over $7,500 but not over $9,600	84
Over $9,600 but not over $13,900	82
Over $13,900 but not over $18,000	79
Over $18,000 but not over $22,200	76
Over $22,200 but not over $26,600	72
Over $26,600 but not over $31,900	68
Over $31,900 but not over $37,200	63
Over $37,200 but not over $47,800	57
Over $47,800 but not over $62,000	51
Over $62,000 but not over $87,600	46
Over $87,600 but not over $111,400	41
Over $111,400 but not over $164,400	36
Over $164,400 but not over $217,400	32
Over $217,400	30

"Table 2

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $6,400	86
Over $6,400 but not over $8,500	84
Over $8,500 but not over $10,700	82
Over $10,700 but not over $13,800	78
Over $13,800 but not over $17,000	76
Over $17,000 but not over $20,200	74
Over $20,200 but not over $25,500	69
Over $25,500 but not over $30,800	64
Over $30,800 but not over $36,100	58
Over $36,100 but not over $46,700	54
Over $46,700 but not over $62,600	46
Over $62,600 but not over $83,800	41
Over $83,800 but not over $110,300	37
Over $110,300 but not over $163,300	32
Over $163,300	30

"Table 3

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $4,400	86
Over $4,400 but not over $5,400	84
Over $5,400 but not over $7,500	82
Over $7,500 but not over $9,500	81
Over $9,500 but not over $11,800	79
Over $11,800 but not over $13,900	76
Over $13,900 but not over $16,000	74
Over $16,000 but not over $19,200	70
Over $19,200 but not over $24,500	66
Over $24,500 but not over $29,800	61
Over $29,800 but not over $35,100	56
Over $35,100 but not over $42,500	51
Over $42,500 but not over $56,300	45
Over $56,300 but not over $82,800	37
Over $82,800 but not over $109,300	32
Over $109,300	30

"Table 4

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $3,750	86
Over $3,750 but not over $4,800	84
Over $4,800 but not over $6,950	82
Over $6,950 but not over $9,000	79
Over $9,000 but not over $11,100	76
Over $11,100 but not over $13,300	72
Over $13,300 but not over $15,950	68
Over $15,950 but not over $18,600	63
Over $18,600 but not over $23,900	57
Over $23,900 but not over $31,000	51
Over $31,000 but not over $43,800	46
Over $43,800 but not over $55,700	41
Over $55,700 but not over $82,200	36
Over $82,200 but not over $108,700	32
Over $108,700	30

"(C) CERTIFICATION REQUIRED.—This paragraph shall not apply unless the individual receives from the donee a written statement that the donated composition represents material of artistic, musical, or literary significance and that the use of such composition by the donee will be related to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in section 170(e)(2)(B)).

"(D) CERTAIN LETTERS, MEMORANDA, OR SIMILAR PROPERTY PREPARED BY GOVERNMENT OFFICIALS.—This paragraph shall not apply to a contribution by an individual of a letter, memorandum, or similar property that was written, prepared, or produced by or for the individual while he held an office under the Government of the United States or of any State or political subdivision thereof if the writing, preparation, or production of such property was related to the performance of the duties of such office.".

SEC. 3. EFFECTIVE DATE.

The amendment made by this Act shall apply to taxable years beginning after December 31, 1981.

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II

97TH CONGRESS
1ST SESSION

S. 852

To amend the Internal Revenue Code to provide a tax credit for certain contributions of literary, musical or artistic compositions.

IN THE SENATE OF THE UNITED STATES

APRIL 1 (legislative day, FEBRUARY 16), 1981

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code to provide a tax credit for certain contributions of literary, musical or artistic compositions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Pen and Ink Act of 1981".

SEC. 2. CREDIT FOR CONTRIBUTING CERTAIN LITERARY, MUSICAL OR ARTISTIC COMPOSITIONS.

Subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code (relating to credits allowable) is amended by inserting before section 45 the following new section—

"SEC. 44F. CREDIT FOR CONTRIBUTING CERTAIN LITERARY, MUSICAL OR ARTISTIC COMPOSITIONS.

"(a) GENERAL RULE.—In the case of an individual who contributes a literary, musical or artistic composition created by his own efforts to an organization described in section 501(c)(3) (that is exempt from tax under section 501(a)) or to a governmental unit described in section 170(c)(1), there shall be allowed a credit against the tax imposed by this chapter. The credit shall be a percentage of the fair market value of such composition determined according to the applicable table.

"(b) APPLICABLE TABLES.—For purposes of subsection (a), the applicable table for—

"(1) married individuals and surviving spouses described in section 1(a) is table 1,

"(2) heads of households described in section 1(b) is table 2,

"(3) unmarried individuals described in section 1(c) is table 3, and

"(4) married individuals described in section 1(d) is table 4.

"Table 1

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $7,500	86
Over $7,500 but not over $9,600	84
Over $9,600 but not over $13,900	82
Over $13,900 but not over $18,000	79
Over $18,000 but not over $22,200	76
Over $22,200 but not over $26,600	72
Over $26,600 but not over $31,900	68
Over $31,900 but not over $37,200	63
Over $37,200 but not over $47,800	57
Over $47,800 but not over $62,000	51
Over $62,000 but not over $87,600	46
Over $87,600 but not over $111,400	41
Over $111,400 but not over $164,400	36
Over $164,400 but not over $217,400	32
Over $217,400	30

"Table 2

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $6,400	86
Over $6,400 but not over $8,500	84
Over $8,500 but not over $10,700	82
Over $10,700 but not over $13,800	78
Over $13,800 but not over $17,000	76
Over $17,000 but not over $20,200	74
Over $20,200 but not over $25,500	69
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Over $36,100 but not over $46,700	54
Over $46,700 but not over $62,600	46
Over $62,600 but not over $83,800	41
Over $83,800 but not over $110,300	37
Over $110,300 but not over $163,300	32
Over $163,300	30

"Table 3

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $4,400	86
Over $4,400 but not over $5,400	84
Over $5,400 but not over $7,500	82
Over $7,500 but not over $9,500	81
Over $9,500 but not over $11,800	79
Over $11,800 but not over $13,900	76
Over $13,900 but not over $16,000	74
Over $16,000 but not over $19,200	70

"If the adjusted gross income is:	The percentage is:
Over $19,200 but not over $24,500	66
Over $24,500 but not over $29,800	61
Over $29,800 but not over $35,100	56
Over $35,100 but not over $42,500	51
Over $42,500 but not over $56,300	45
Over $56,300 but not over $82,800	37
Over $82,800 but not over $109,300	32
Over $109,300	30

"Table 4

"If the adjusted gross income is:	The percentage is:
Over $0 but not over $3,750	86
Over $3,750 but not over $4,800	84
Over $4,800 but not over $6,950	82
Over $6,950 but not over $9,000	79
Over $9,000 but not over $11,100	76
Over $11,100 but not over $13,300	72
Over $13,300 but not over $15,950	68
Over $15,950 but not over $18,600	63
Over $18,600 but not over $23,900	57
Over $23,900 but not over $31,000	51
Over $31,000 but not over $43,800	46
Over $43,800 but not over $55,700	41
Over $55,700 but not over $82,200	36
Over $82,200 but not over $108,700	32
Over $108,700	30

"(c) LIMITATIONS.—

"(1) CREDIT MAY BE USED ONLY TO REDUCE TAX ON ARTS INCOME.—The amount of credit allowed under subsection (a) for the taxable year shall not exceed the amount of tax on the taxpayer's income from sales of literary, musical or artistic compositions.

"(2) MAXIMUM CREDIT.—The amount of credit allowed under subsection (a) for the taxable year shall not exceed the greater of—

"(A) $2,500 or

"(B) half of the taxpayer's liability for tax under this chapter for the taxable year.

"(d) FIVE-YEAR CARRYOVER OF EXCESS CREDITS.—If the amount of credit allowed by subsection (a) for any taxable year exceeds the limits imposed by subsection (c), then the excess shall be added to the amount allowed as a credit in the next five succeeding taxable years to the extent that it may be used in those years.

"(e) CERTIFICATION REQUIRED.—This section shall not apply unless the individual receives from the donee a written statement that the donated composition represents material of artistic, musical or literary significance and that the use of such composition by the donee will be related to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in section 170(c)(2)(B)).

"(f) CERTAIN LETTERS, MEMORANDA OR SIMILAR PROPERTY PREPARED BY GOVERNMENT OFFICIALS.—This section shall not apply to a contribution by an individual of a letter, memorandum, or similar property that was written, prepared, or produced by or for the individual while he held office under the Government of the United States or of any State or political subdivision thereof if the writing, preparation, or production of such property was related to the performance of the duties of such office.".

SEC. 3. CONFORMING AND TECHNICAL AMENDMENTS.

(a) Section 170(e) of the Internal Revenue Code (relating to certain contributions of ordinary income and capital gains property) is amended by inserting at the end thereof the following—

"(4) DENIAL OF DEDUCTION FOR CERTAIN CONTRIBUTIONS OF LITERARY, MUSICAL OR ARTISTIC COMPOSITIONS.—No deduction shall be allowed under this section for any contribution for which a credit is claimed under section 44F.".

(b) The table of sections for subpart A of part IV of subchapter A of chapter 1 of the Code is amended by inserting immediately before the item relating to section 45 the following—

"Sec. 44F. Credit for contributing certain literary, musical or artistic compositions.".

(c) Section 42(b) of the Code (relating to the general tax credit) is amended by striking out "and" at the end of paragraph (4), by inserting "and" at the end of paragraph (5), and by inserting after paragraph (5) the following new paragraph—

"(6) section 44F (relating to credit for contributing certain literary, musical or artistic compositions),".

SEC. 4. EFFECTIVE DATE.

The amendments made by this Act shall apply to taxable years beginning after December 31, 1981.

Senator SYMMS. We are very pleased to have as our first witness, our distinguished colleague from the State of Ohio, whom I am sure has the same problem as the chairman does this morning. We have both the Budget Committee, which starts at 10 o'clock, and the Environment and Public Works Committee which starts at 10 o'clock, which require our presence.

I will now relinquish the time and ask Senator Metzenbaum to present his testimony.

I might just say to all witnesses this morning that unless I can get some support from other members of the subcommittee, we may have to have a delay. So if there are any witnesses who have airplanes to catch at a certain time, they should notify the staff, because we do want to hear from you but we have a tremendous conflict on our time this morning.

I am hoping that Senators Moynihan and Baucus will be able to be here later on in the morning to help chair the panel.

Senator, go right ahead. We are pleased to have you.

STATEMENT OF HON. HOWARD METZENBAUM, U.S. SENATOR, STATE OF OHIO

Senator METZENBAUM. I appreciate the conflicts you have and the pressures of other committee responsibilities.

I want to express my appreciation to you for giving me the opportunity to testify today on the tax treatment of charitable contributions of artistic works. This is not a new subject for the Congress, but it is a subject with respect to which we have long overdelayed in focusing our attention and taking responsible action.

I strongly support the thrust of the legislation which the committee is today considering. Whether it is the Baucus bill, or the Moynihan bill, or some other draft of legislation which deals with this problem, in my opinion legislation is a necessity. Both from the standpoint of the concern of the artist and the institutions in this country which would be the recipients of the art, the current law is unfair.

These bills include art and the artists in the longstanding practice of encouraging through the Federal tax code contributions to nonprofit, religious, charitable, and educational organizations.

Under current law, unfortunately, Mr. Chairman, you or I can contribute a work of art to a museum, a university, or a place of worship, and deduct from our taxes the purchase price of the gift. But, unfortunately, if the artist wants to contribute his or her work, the situation is quite different.

The artist may deduct the cost of materials, paint and canvas, for example, but as far as the IRS is concerned, the artist's time, training, and talent are without value. That is obviously absurd. It does not make good sense. In addition to everything else, it is unfair and actively discourages charitable giving.

The bills before you would correct this situation in different manners, but I think that it is important that the committee in its deliberations figure out exactly what the language should be so that the Treasury not be that severely negatively impacted, while at the same time the artist and the recipient of the art be given fair and equitable treatment.

Congress has already enacted special provisions designed to enhance charitable giving. The Tax Reform Act of 1976, for example, gave special incentives to corporations that contribute items like medical equipment to programs serving the needy. In the Economic Recovery Tax Act of 1981, Congress provided special incentives for companies to donate research or experimental equipment to colleges and universities.

The Presidential Task Force on the Arts and Humanities, which I know is well represented here today, has endorsed similar treatment for works of art. I strongly concur in the recommendation, and I urge the committee to eliminate the discriminatory treatment of some of the Nation's most talented and creative people.

Although I am not here as a spokesperson for Senators Concerned for the Arts, a group of us in the Senate who have indicated concern for the arts, I do feel that a majority, or perhaps all of those in that group, would feel very strongly that we need to do something on this subject.

We have moved now into a situation in our economy where we have changed the laws concerning charitable giving. We now have a 50-percent maximum taxable rate as compared to a 70-percent maximum, that in and of itself provides some disincentive as far as contributions to foundations and to various nonprofit organizations are concerned.

That is not to suggest that I think there ought to be a 70-percent rate as compared to the 50-percent rate, but rather to indicate the reality of the situation, that the new tax laws make it that much more difficult for charitable institutions to obtain works of art and other contributions.

I am hopeful that this committee will act with dispatch. I would hope that it would not have to wait for the enactment of a new tax bill, that perhaps the matter could be handled separate. I think that it would reflect the view of the majority of the Members of the Senate, and hopefully of the House as well, to remedy that which I consider to be a great inequity in our tax laws and an unfair discrimination against artists as well as recipients of the art.

I am grateful to you, Mr. Chairman. I wish to commend Senator Baucus for his sponsorship of legislation in this area.

[The prepared statement of Senator Howard M. Metzenbaum follows:]

Statement of Senator Howard M. Metzenbaum

Mr. Chairman, I want to express my appreciation to you for giving me the opportunity to testify today on dealing with the tax treatment of charitable contributions of artistic works.

I strongly support the thrust of the legislation which the committee is today considering. These bills include art and artist in the long-standing practice of encouraging through the federal tax code contributions to nonprofit religious, charitable, and educational organizations.

Under current law, Mr. Chairman, you or I can contribute a work of art to a museum, a university or a place of worship and deduct from our taxes the purchase price of the gift.

But, if an artist wants to contribute his or her own work, the situation is quite different. The artist may deduct the cost of materials—paint and canvas, for example—but as far as the IRS is concerned, the artist's time, training and talent are without value.

That, Mr. Chairman, is unfair—and it actively discourages charitable giving.

S. 751 would correct this inequity by allowing a deduction equal to a percentage of fair market value for individuals who contribute self-created artistic compositions. S. 648 would permit a deduction equal to the full fair market value of the work. And S. 752 would permit a credit against income tax equal to a prescribed percentage of the item's worth. These bills differ in detail, but their thrust is the same—to encourage, rather than to discourage artists to contribute their work.

Congress has already enacted special provisions designed to enhance charitable giving. The Tax-Reform Act of 1976, for example, gave special incentives to corporations that contribute items like medical equipment to programs serving the needy. In the Economic Recovery Tax Act of 1981, Congress provided a special incentive for companies to donate research or experimental equipment to colleges and universities.

The Presidential Task Force on the Arts and Humanities has endorsed similar treatment for works of art. I strongly concur in that recommendation and I urge the Committee to eliminate the discriminatory treatment of some of the nation's most talented and creative people.

Senator SYMMS. Senator Baucus.

Senator BAUCUS. Thank you very much, Mr. Chairman.

Senator, I wish to thank you for your statement.

I simply want to thank you for lending your support to this effort, because we recognize that it is needed. I am a bit embarrassed that we have not passed this legislation more quickly because it is so important.

I wish to thank you very much for your efforts, it means a lot to us in trying to remedy a very difficult situation.

Senator METZENBAUM. Thank you very much.

Senator SYMMS. Thank you very much, Senator.

I would at this time ask unanimous consent that the testimony of Congressman Richmond be made part of the record. If he shows up later, we will make sure that he has an opportunity to testify but it will be part of our record.

We will now hear from Daniel Boorstin.

I might ask, Senator Baucus, do you have an opening statement that you wish to make?

Senator BAUCUS. I do, but I will put it in the record, Mr. Chairman, thank you.

[Opening statement of Senator Baucus follows:]

OPENING STATEMENT OF SENATOR MAX BAUCUS

The legislation being considered today represents efforts to reverse the decline in gifts by artists to non-profit institutions and to correct some of the special tax problems artists face.

In 1969, the tax laws were changed to provide that an artist may deduct only the cost of materials when donating his work to a museum, university or other non-profit institution. Librarians and curators across the country have confirmed that this change in the law has had a devastating impact on the donation of art and manuscripts by artist, authors and composers.

Collectors may deduct the full fair market value of donated artwork and manuscripts, even when that value far exceeds their cost basis. Artists should receive similar tax benefits, not only for reasons of equity, but also because they represent a potentially rich source of donations for our educational and cultural institutions.

The estate tax also presents special problems for artists and their families. For most artists, the vast bulk of their estate consists of unsold art. The death of an artist and the imposition of the estate tax can force an umtimely selloff of a significant portion of an artist's lifetime work.

The estate tax changes contained in the Economic Recovery Tax Act of 1981, such as the adoption of the unlimited marital deduction, will certainly be helpful in alleviating this situation. However, further reforms—such as the optional cost-of-materials valuation provision contained in S. 649—may be necessary to assure fair treatment of artists and their heirs.

I look forward to hearing the views of the witnesses today on these subjects.

STATEMENT OF DANIEL J. BOORSTIN, LIBRARIAN OF CONGRESS

Mr. BOORSTIN. Mr. Chairman, I want to thank you for this opportunity to appear to support the bills to amend the Internal Revenue Code of 1954, to remove the limitations on charitable contributions of literary, musical, or artistic compositions. I cannot overemphasize the importance of these bills for libraries, museums, and all institutions of learning.

I would like to read an abridged statement, and put the full statement in the record, if I may, Mr. Chairman.

For many years, the Library of Congress, like other research institutions in the United States, has actively solicited gifts of personal papers, music, rare books, prints and photographs, and other historically valuable material. The preeminence of the Library of Congress collections in these areas is largely due to our ability to solicit and receive such gifts. The donors have been able to deduct, as a charitable contribution, the fair market value of their gifts.

Since the enactment of the Tax Reform Act of 1969, one category of donors has been unable to claim such a deduction, and we have suffered sorely at the Library of Congress. These are the people who are themselves the creators of literary, scientific, and artistic works. Living authors, poets, musicians, scientists and artists who wish to donate the results of their creative efforts to a library or a museum are ineligible for a deduction. Yet, at the same time, the owner of a work of art or a manuscript created by someone other than himself can take advantage of the charitable contributions deduction.

Moreover, Mr. Chairman, this inequity has had a devastating effort on the ability of the libraries and museums to receive and preserve important collections for future generations.

Before 1969, the Library of Congress' Music Division was annually receiving the original manuscripts of works from 35 living composers. Between 1963 and 1970, the manuscripts added to the collections came to 1,200, but in all the years since we have received a scant 30.

The Library of Congress' Manuscript Division was receiving manuscript collections totaling nearly 200,000 manuscripts a year before 1969. Although bequests and donations of other materials have occurred, the Library of Congress has received only one major gift of self-created material of a living author since 1969.

The number of gifts of original works of art to the Prints and Photographs Division of the Library of Congress of living artists, photographers, and cartoonists has dwindled since the 1969 Tax Reform Act. Three *New Yorker* artists have stopped donating their drawings and cartoons as a direct result of the 1969 act.

The consequences of this reduced level of acquisitions will be disastrous for scholarship and for the study and appreciation, and record of American civilization. Creators disperse their collections by selling them in the open market. I have appended here, Mr. Chairman, a list of the price at which these have been sold recently.

They disperse these collections by selling them mostly to individual collectors, thus the material ceases to be available for research in public institutions. Even more alarming, these materials are usually stored where they suffer rapid deterioration or are subject to risks of fire, flood, or theft. They are lost forever.

These hearings are most especially timely, Mr. Chairman, since the Presidential Task Force on the Arts and Humanities recently presented a report to the President in answer to his charge to the task force to develop new ideas to stimulate private support to the arts and humanities.

The task force addressed the tax system and private initiatives, and recommended that the 1969 amendment to the Tax Code governing charitable gifts of creative works by artists, writers, and composers, should be amended as follows:

1. That creators of these works shall receive the same tax treatment, as a result of charitable contribution of such work, available to a collector or other donor giving a purchased work or manuscript.

2. That the value of the contributions shall be governed by the most recent arms-length sale, by the creator, of a comparable work, or by another appropriate appraisal mechanism.

The task force outlined immediate benefits from this proposal. First, museums and libraries will be able to acquire works of art without cost. Second, artists and authors will be able to choose the institutions where their best work will be displayed. Third, the public will benefit from the presence in public institutions of the works of living artists and writers.

Inflation and shrinking tax dollars have had a catastrophic effect on libraries and museums in recent years. Funds are not available for purchasing much of what should be acquired. Enactment of legislation to give a tax incentive for the donation of materials to these institutions would be, I believe, in the public interest, and would enhance our Nation's cultural resources.

We thrive on our heritage. Positive action by Congress to restore the tax incentive for gifts of self-generated artistic and literary works will remind us that we all have a share in that heritage, and we are all nourished by it.

Thank you, Mr. Chairman.

[Statement of Mr. Boorstin follows:]

STATEMENT OF THE LIBRARIAN OF CONGRESS
DANIEL J. BOORSTIN
BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE
November 10, 1981

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear here today to support bills to amend the Internal Revenue Code of 1954 to remove certain limitations on charitable contributions of literary, musical, or artistic compositions.

For many years, the Library of Congress, like other research institutions in the United States, has actively solicited gifts of personal papers, music, rare books, prints and photographs, and other historically valuable material. The preeminence of the Library of Congress' collections in these areas is largely due to our ability to solicit and receive such gifts. The donors have been able to deduct as a charitable contribution the fair market value of their gifts.

Since the enactment of the Tax Reform Act of 1969, one category of donors has been unable to claim such a deduction. These are the people who are themselves the creators of literary, scientific, and artistic works. Living authors, poets, musicians, scientists, and artists who wish to donate the results of their creative efforts to a library or a museum are ineligible for a deduction. Yet, at the same time, an owner of a work of art or manuscript created by someone other than himself can take advantage of the charitable contributions deduction.

Moreover, this inequity has had a devastating effect on the ability of libraries and museums to receive and preserve important collections for future generations. Before 1969, the Library of Congress' Music Division was annually receiving the original manuscripts of their work from 35 living composers. Between 1963 and 1970 the manuscripts added to the collections came to 1,200. But in all the years since, we have received a scant 30. The recent report of negotiations for the purchase of the Stravinsky archives by the University of California at Los Angeles is a case in point. The price is reported to be more than a million and a half dollars. Until 1969, Igor Stravinsky had given a substantial number of his manuscripts to the Library of Congress, where they became part of a national resource of research materials on musical composition. In addition, in the year just past, two major collections on deposit were withdrawn from the Music Division; one sold, since a tax deduction was not forthcoming. The Library is now being put on notice by other depositors that they may withdraw their potential gifts if the law remains unchanged.

The Library of Congress' Manuscript Division was receiving manuscript collections totaling nearly 200,000 manuscripts each year before 1969. Although bequests and donations of other materials have occurred, the Library of Congress has received only one major gift or self-created material of a living author since 1969.

The number of gifts or original works of art to the Prints and Photographs Division of the Library of living artists, photographers, and cartoonists has dwindled since the 1969 Tax Reform Act. Three *New Yorker* artists have stopped donating their drawings and cartoons as a direct result of the 1969 act.

The consequences of this reduced level of acquisitions will be disastrous for scholarship, and for the study and appreciation of American civilization. Creators disperse their collections by selling them on the open market—mostly to individual collectors. Thus the material ceases to be available for research in public institutions. Even more alarming, these materials are usually stored where they suffer rapid deterioration and are subject to risks of fire, flood, and theft. They are lost forever.

These hearings are most especially timely since the Presidential Task Force on the Arts and Humanities recently presented a report to the President in answer to his charge to the Task Force to develop new ideas to stimulate private support to the arts and humanities.

The Task Force addressed the tax system and private initiatives and recommended that the 1969 amendment to the Tax Code governing charitable gifts of creative works by artists, writers, and composers should be amended as follows:

"1. that creators of these works shall receive the same tax treatment, as a result of a charitable contribution of such work, available to a collector or other donor giving a purchased work or manuscript.

2. that the value of the contributions shall be governed by the most recent arms-length sale, by the creator, of a comparable work, or by another appropriate appraisal mechanism."

The Task Force outlined immediate benefits from this proposal. First, museums and libraries will be able to acquire works of art without cost. Second, artists and authors will be able to choose the institutions where their best work will be displayed. Third, the public will benefit from the presence in public institutions of the works of living artists and writers.

Inflation and shrinking tax dollars have had a catastrophic effect on libraries and museums in recent years. Funds are not available for purchasing much of what should be acquired. Enactment of legislation to give a tax incentive for the donation of materials to these institutions would be, I believe, in the public interest, and would enhance our nation's cultural resources. We thrive on our heritage. Positive action by Congress to restore the tax incentive for gifts of self-generated artistic and literary works will remind us that we all have a share in the heritage and we are all nourished by it. To garner the works of artists, musicians, and authors by enacting legislation will help preserve a precious part of us.

Appended to my statement is a list of manuscripts that have been sold on the open market in recent years and the prices paid. I would appreciate it if this could be made part of the record.

Manuscript Sales as Listed in <u>American Book Prices Current</u>, 1978-80 and reported in the <u>Antiquarian Bookman</u>, 1980-81

Conrad Aiken	
8 ALS, 38 LS, total 55 pp	$2,100
Graham Green	
27 pp mss of play, "For Whom the Bell Chimes"	$3,200
Ernest Hemingway	
2 ALS's, 3 pp	$1,300
2 ALS's, 3 pp	$2,400
1 LS 2 pp	$1,400
Washington Irving	
1 page unpublished mss	$1,300
Jerome Kern	
7 bars of music	$ 350
5 pages music notes	$ 750
3 bars of music	$ 600
3 double bars of music	$ 500
Jack Kerouac	
14 ALS's, postal cards drawings, haikus, etc.	$16,000
Rudyard Kipling	
58 ALS's, 14 autographed cards and 2 notes	$5,200
Lillie Langtry	
65 ALS's totaling 330 pp	$16,000
Henry Miller	
6 pages ALS	$ 950
Marianne Moore	
3 ALS's, 1 ANS	$ 225
Eugene O'Neill	
Autographed note signed--4 lines	$ 375
Cole Porter	
2 bars from "Night and Day" with photo	$ 675
LS, 1 page with portrait type picture	$ 100

Sigmund Romberg	
23 bars of music	$ 700
4 bars of music	$ 650
Arnold Schoenberg	
ALS 1 page	$ 600
LS 1 page (repaired)	$ 250
John Steinbeck	
ALS 1 page	$1,800
ALS 2 pages	$1,200
Igor Stravinsky	
3 bars of music	$ 700
4 bars of music	$ 650
4 bars of music	$ 800
3 bars of music	$ 520
Algernon Charles Swinburne	
1 page (folio) Ballad	$ 900
6 pages (folio) mss	$1,100
Henry David Thoreau	
1 page (folio) mss	$1,300
2 pages ALS	$2,300

Senator SYMMS. Thank you very much.

Senator Baucus.

Senator BAUCUS. Thank you very much, Mr. Boorstin, for your statement.

Do you have any preference among the bills that are before this committee?

Mr. BOORSTIN. My preference, Senator, is for the Baucus bill. [General laughter.]

Senator BAUCUS. You are very wise. [General laughter.]

Do you feel that it is sufficient, because one of Senator Moynihan's bills would give a percentage tax credit deduction, which may give the taxpayer even additional incentive. I am curious as to whether you think that is a significant difference or not?

Mr. BOORSTIN. Senator, I see no reason for discriminating against creators. If anything, they should be discriminated in favor of. So I would not want to see a mere percentage.

Senator BAUCUS. You think a full 100-percent deduction is the way to go?

Mr. BOORSTIN. Yes, sir.

Senator BAUCUS. Thank you very much for your help, I appreciate it.

Mr. BOORSTIN. Thank you.

Senator BAUCUS. Next we will hear from a panel consisting of Elie Siegmeister, Jane Livingston, Irwin Karp, and Norman Tanis.

We appreciate your testimony here today. You can proceed in any order that you wish.

STATEMENT OF NORMAN E. TANIS, DIRECTOR OF UNIVERSITY LIBRARIES, CALIFORNIA STATE UNIVERSITY, NORTHRIDGE, ON BEHALF OF THE AMERICAN LIBRARY ASSOCIATION

Mr. TANIS. My name is Norman Tanis, and I am the director of University Libraries at California State University at Northridge, and also past president of the Association of College and Research Libraries, which is the academic division of the American Library Association.

I am going to submit all of my testimony to you, so I am just going to try to hit some of the spots that some of the previous speakers have not hit in their testimony before you, to save time.

I would like to say that we in university and college libraries have found that the Tax Reform Act of 1969 has certainly turned off the spigot of donations of self-created works to colleges and universities.

This has greatly affected, in our opinion, scholarship on our campuses, and has greatly increased the cost to scholars of traveling about the country trying to use these dispersed collections which have either been sold on the open market to collectors, or have been dispersed to the richest university that could afford the tariff for a manuscript.

Since these artists have turned to the open market, their works, which are so vital to the preservation of our cultural heritage and future research, are scattered and we don't know what valuable manuscript has been lost in the interim.

My observations are based on three different surveys which I took in 1974, then again in 1979 with Gayle Goldberg, and then in 1980 with Gayle Goldberg and Terry Tiernan. As a result of this, we have found some very disturbing facts, and I would like to quote, if I may, from some of the people who wrote back to us as a result of this survey.

The provisions regarding the donations of self-created documents in the Tax Reform Act of 1969 have had a crippling effect on the development of our collection of contemporary American literature. We have not had the resources to purchase all the collections that previously we had received as gifts. And there are several instances in which we held the personal and literary papers and correspondence of significant American figures up until 1970. This is from a major university in Missouri.

Another university wrote in:

> The Tax Reform Act of 1969 has had a discouraging effect upon the donations to the library, particularly in the area of industry, where we get along with Xerox copies of manuscript materials which some scholars object to because there may be certain problems which are not answered by Xerox.

That was a university in Kansas.

Another one has said:

> In fact, I can recall a number of specific instances in which authors gave the Tax Reform Act as a reason for not donating their papers to our libraries.

This is a major library in Iowa.

Another one says:

> With minor exceptions, the program of our conservatory library collections of manuscripts of living composers and musicians for its archives for the Institute of the Study of American Music has been directly affected.

This is a Midwestern university.

Finally:

I know of one collection that has come to us on loan, and which subsequently was sold to another institution. We would have received this collection as a gift had the tax deduction been available.

This is a major university in Virginia.

The point they are making is, while they were getting collections from Virginians, notable Virginians, this heritage was lost. In one instance, even, the collection was put on semipermanent loan, and then withdrawn and sold to an institution in a far distant geographical location, to the loss of Virginia scholars.

These are some of the problems I have encountered in my studies. I would like to summarize the results of the survey very briefly, and I guess it is going to be very briefly.

Senator BAUCUS. You may take an extra minute.

Mr. TANIS. Collection development in manuscripts has declined significantly in universities, and the Tax Reform Act has increased the practice of accepting gifts on deposit, which is very costly for libraries because a depositor can withdraw it whenever he feels like it. Meanwhile the university has put a lot of man-hours in preparing these documents.

The Tax Reform Act has definitely limited bibliographical and physical access to manuscript collections because they are scattered throughout this country via the open market, and even to such countries as Japan. We have nothing against Japan, but it represents a cost to scholars who use these materials.

The purchase of manuscript collections place a great burden upon book budgets, and colleges and universities are now placed in the position of competing with each other for a limited number of manuscripts which they once received through careful friendships and agreements with authors. They are now in the open market competing with each other.

The loss of valuable manuscripts through fire, theft, and water are indeterminate, but authors are keeping them and holding them often in situations which are less than ideal.

We, in the American Library Association, strongly endorse the recommendations of the Presidential task force when it touches on this subject, and we are also in strong support of S. 649. The American Library Association also supports S. 851, and is less enthusiastic about Senate bill 852. I think I was told not to put it that way, but I did.

All of these bills, I would like to remind you, are excluding the papers of public officials, which as we know were part of the reasons for the 1969 revisions.

I would also like to call the Senator's attention to some attached materials and my discussions about a Resolution of the American Library Association on this subject, and remind you that the great heritage of America is being lost because the 1969 Tax Reform Act is not being revised.

I wish to thank you, especially for the addition of time, Senator Baucus.

[Statement of Mr. Tanis follows:]

Statement of Norman E. Tanis
Director of University Libraries
California State University, Northridge
before the
Subcommittee on Estate and Gift Taxation
of the
Senate Committee on Finance
on S. 649, S. 851, and S. 852
November 10, 1981

My name is Norman E. Tanis. I am Director of University Libraries at California State University, Northridge. I am also a Past President of the Association of College and Research Libraries, a division of the American Library Association representing research and special libraries and libraries in institutions of post-secondary education.

I appreciate this opportunity to speak with you about my concerns, and the concerns of the American Library Association, as to the impact of the Tax Reform Act of 1969 upon the collections of libraries and archives throughout the country. As you are aware, the implementation of the Tax Reform Act signaled the termination of tax deductions to donators of original works of art, literary materials, and music manuscripts created by the donors themselves. What you may not be aware of is that the implementation of the Tax Reform Act also signaled a sharp decline in donations to libraries and archives by originators of artistic and literary works in this country. With priceless creations reduced to the mere valuation assigned to the cost of materials used in production, a major incentive for artists to donate their original works was removed.

Instead, artists, musicians, and writers now turn to the open market. As a result, these works, so vital to the preservation of our cultural heritage and to future research, are scattered, and who knows which valuable manuscripts are lost in the interim? I do not make this remark casually. My observation is based upon the results of three surveys undertaken in 1974, 1979 with Gayle Goldberg, and 1980 with Gayle Goldberg and Terry Tiernan to determine the effects of the 1969 legislation upon collection development in libraries and archival depositories. I feel that you will find the results of my surveys disturbing.

The first two surveys were conducted five and ten years after implementation of the Tax Reform Act (1974 and 1979) and concentrated upon the impact of the legislation in academic and research libraries. Two hundred and fifty libraries were queried in the summer of 1974 and 228 libraries were queried in 1979. Both surveys covered a broad spectrum, ranging from libraries with newly developed archival collections through several prestigious university research libraries with long-established archival collections. Both surveys provided the same results: libraries have experienced a decline in the collection of self-created materials since 1969. This decline is documented in the testimony contained in survey responses with institutions enumerating specific losses of substantive collections to their libraries due to the change in tax structure. I will report a few responses that are representative of the rest.

1. ... The provisions regarding donations of self-created documents in the Tax Reform Act of 1969 have had a crippling effect on the development of our collection of contemporary American literature. Not only have we been unable to broaden our collecting scope to keep pace with literary developments and the needs of scholars but we have not had the resources to purchase all those collections that we had previously been receiving as gifts.... There are several instances in which we hold the personal and literary papers, correspondence, etc., of significant American literary figures only up to 1970. (A major university in Missouri) (Emphasis added.)
2. ... the Tax Reform Act of 1969 has had a discouraging effect upon donations to the...Library, particularly in the area of industry.

While the Library has been given the opportunity in several instances <u>to photocopy collections which earlier would have been donated</u>, this practice makes the collection more expensive in that copying costs must be borne by the Library. Further, the integrity of copies of documents is questioned by some scholars who wish to examine the original. (A university in Kansas) (Emphasis added.)

3. ... the Tax Reform Act of 1969 has had some effect upon donations to the University Library by literary personages. In fact I can recall <u>a number of specific instances in which authors gave the Tax Reform Act as a reason for not donating their papers to the Libraries</u>. (A major university in Iowa) (Emphasis added.)

4. The Tax Reform Act of 1969 has eliminated completely, with minor exceptions, the program of our Conservatory Library collections of manuscripts of living composers and musicians for its Archives for the Institute of the Study of American Music. (A midwestern university)

5. I know of one collection that had come to us <u>on loan</u> and which <u>subsequently was sold to another institution</u>. We should have received this collection as a gift had tax deduction been available. (A major university in Virginia) (Emphasis added.)

And the list goes on and on. These specific instances are easily recounted, but the words of a librarian in a major research library in Washington, D.C. haunt me: "What I cannot be sure of is how much the new law has discouraged potential donors from <u>seeking us out</u> for gifts." The number of valuable collections lost to libraries because tax relief was unavailable to the originators will never be fully known.

There have been some who contend that libraries have not been harmed by the Tax Reform Act, that libraries continue, as in the past, to receive collections from prominent authors and artists. Certainly, there are donors who, undaunted by the lack of incentives, have deposited their treasures for posterity. But, unfortunately for posterity, these gifts have quite often not been donated at all, but rather placed "on deposit." To place materials in a library "on deposit" is to loan the collection under conditions set by contract with the donor. Although libraries do accept such agreements in anticipation of future outright gifts, the possibility does exist, and has been exercised, that a donor may withdraw the collection, leaving the library or archives with an empty shelf, angry scholars, and a considerable expenditure of professional time involved in the cataloging, maintaining, and promoting of the collection as well as costs for specialized storage boxes. In times of fiscal restraint, libraries can ill-afford to spend limited resources on these transitory collections. More importantly, contracts for such collections may contain highly restrictive provisions governing usage of the collection, seriously hampering collection use by research scholars.

In 1980, a third survey was conducted. This survey shifted focus from academic and research libraries to archival collections within the United States. One hundred archives were queried at random, and, as with the two previous surveys, information was requested as to the effect of the Tax Reform Act upon donations to archival collections. These archives included local museums, historical societies, local libraries, a social club, and in one instance, a state archive. The results of that survey overwhelmingly indicate that archives have not been substantially affected by the Tax Reform Act because the majority of these institutions collected materials produced by persons already deceased or because local citizens who donated papers were aware that the papers had minimal market value at this time.

To summarize, the results of our three surveys indicate the following:

1. Academic and research libraries have been most affected by the Tax Reform Act, particularly those institutions which specialize in original works of contemporary literature, art, and music. Collection development has experienced a definite decline traceable to the present tax structure.

2. The Tax Reform Act has also increased the practice of accepting gifts "on deposit," a costly practice for libraries often with a limited benefit to scholars and researchers.

3. This tax reform has definitely limited bibliographic and physical accessibility of manuscript collections through (a) reduced donations, and (b) restricted use policies mandated by donors in cases where donations have been accepted "on deposit." In addition, illogical locations, divided collections, separation of collections from closely related materials, as well as the likelihood of the complete loss of valuable documents, have posed considerable problems for researchers.

4. The purchase of manuscript collections places a greater burden upon library book budgets. If these collections were available through donations, more money would be available for general acquisitions.

5. The loss of valuable archival materials is indeterminable. Specific instances of manuscript collection losses directly attributable to lack of tax incentives have been cited. However, the number of authors, artists, and composers who may have come forward with donations had the Tax Reform Act not been in effect will never be fully known.

What has become of these collections that are not donated to nonprofit institutions or even placed on deposit? Some have, perhaps, been sold abroad to be housed in foreign libraries or in private, foreign collections. Other collections may have been sold piecemeal to dealers or private collectors within the United States, a practice which renders scholarly research difficult, if not virtually impossible. Or, such collections may be sold to the very nonprofit institutions which previously would have benefitted from their donation. This latter practice has two detrimental side effects. First, the acquisition of such collections place an ever-increasing burden upon already-dwindling budgets. And, secondly, wealthier private universities often have the advantage over public, state-supported institutions, with location of a collection decided upon by the highest bidder rather than the collection's relevance to scholars and academic programs of the region.

In summary, the cultural contributions of our most prominent authors, composers and artists and the records of our most precious heritage are being scattered. And, a traceable archive of their involvement which has been instrumental in the growth of our society in the past and, which will lay the foundation for growth in the future, is imperiled. We strongly endorse the recent recommendation of the Presidential Task Force on the Arts and Humanities that authors, artists and composers should receive the same tax treatment as a result of charitable contributions of their works as collectors or other donors giving a purchased work or manuscript. The Presidential Task Force, concerned that the recently enacted Economic Recovery Tax Act (PL 97-34) may have the unintended effect of reducing private giving to the arts and humanities and responding to the President's request to suggest ways to increase private sector support, made several tax recommendations. The first of these is to restore the pre-1969 fair market value tax deduction; the text of this recommendation is attached to my statement.

We are pleased to note that there are three bills (S. 649, S. 851, and S. 852) under consideration by the Subcommittee in response to the current inequitable tax treatment of authors and artists and the decline in charitable contributions of creative works. S. 649 would accomplish the Presidential Task Force recommendation by restoring the pre-1969 fair market value tax deduction. S. 851 would also restore a tax incentive by providing a partial tax deduction keyed to the artist's or author's tax bracket. S. 852 provides a partial tax credit which may not exceed "the amount of tax on the taxpayer's income from sales of literary, musical or artistic compositions." Because of this limitation we do not believe S. 852 would reverse the decline in contemporary manuscript donations to libraries. Many authors do not make their living from the sale of their works, and many authors would have no income from their writing at the point of making a decision on the disposition of their manuscripts and papers.

All three bills would exempt the papers of public officials prepared in the course of their official duties. All three would involve a very modest loss of federal revenue, but we concur with the Presidential Task Force that such tax measures would "foster the shared responsibility of support for the arts and the humanities between the public and private sectors." Measures such as S. 649 and S. 851 would remove an existing barrier to charitable activity which would help maintain our heritage for future generations.

I would like to call the Subcommittee's attention to the attached resolution in favor of restoring a tax incentive for charitable donations of artistic and literary works by their creators approved by the White House Conference on Library and Information Services in November 1979. Two-thirds of the over 1,000 White House Conference delegates were lay persons with no direct connection to libraries, indicating widespread citizen support for such legislation.

The American Library Association, a nonprofit educational organization of over 37,000 members dedicated to the improvement of library service for all Americans, has long been on record in support of legislation such as S. 649 and S. 851. Also attached to my statement is a resolution adopted by the Council of the American Library Association at its Dallas Conference in June 1979. I appreciate the opportunity to appear before the Subcommittee to present the views of the American Library Association.

PRESIDENTIAL TASK FORCE ON THE ARTS AND HUMANITIES

First Tax Recommendation: Donations of Works by Creators

The 1969 amendment to the tax code governing charitable gifts of creative works by artists, writers and composers should be amended as follows:

1. that the creators of these works shall receive the same tax treatment, as a result of the charitable contribution of such work, available to a collector or other donor giving a purchased work or manuscript;

2. that the value of the contribution shall be governed by the most recent arms-length sale, by the creator, or a comparable work, or by another appropriate appraisal mechanism.

Current tax law allows the creator of a work who donates the work to a charitable institution to deduct only the value of the materials that were used in creating the literary, musical, or artistic work. A donor who is not the creator may deduct the fair market value of the work. Donations of works to institutions such as museums and libraries by living artists and authors have been substantially reduced since this provision was instituted. The dispersion of collections of creators' works has had a deleterious effect on the availability of research materials for scholarly activity.

There are three immediate benefits from this proposal. First, museums and libraries will be able to acquire works of art without cost. Second, artists and authors will be able to choose the institutions where their best work will be displayed. Third, the public will benefit from the presence in public institutions of the works of living artists and writers.

Furthermore, since the Internal Revenue Service now has a panel which monitors the value of artistic works for tax purposes, and as the revenue loss for similar legislative proposals has been estimated at no more than $5 million annually, such a modest change in the tax code appears reasonable.*

* Report to the President, Presidential Task Force on the Arts and Humanities, October 1981, p. 20.

THE WHITE HOUSE CONFERENCE ON LIBRARY AND INFORMATION SERVICES

Resolution B-5: Tax Incentives for Donations of Authors and Artists

WHEREAS, prior to the Tax Reform Act of 1969 (PL 91-172), an author or artist who donated his or her literary, musical or artistic compositions or papers to a library or museum could take a tax deduction equal to the fair market value of the items at the time of the contribution, and

WHEREAS, since 1969 such deductions have been limited to the cost of the materials used to produce the compositions, and donations to libraries have been severely reduced, and

WHEREAS, an entire generation of literary papers may be lost to future scholars through lack of an incentive to donate them to libraries, and

WHEREAS, restoration of a tax incentive would contribute to the equitable tax treatment of authors and artists and would increase public access to and preservation of the Nation's literary and artistic legacy,

THEREFORE BE IT RESOLVED, that the United States Congress enact legislation restoring a tax incentive for authors and artists to donate their creative works to libraries and museums.*

Approved in General Session, November 19, 1979

*Information for the 1980's: Final Report of the White House Conference on Library and Information Services, 1979, p. 57.

RESOLUTION ON LITERARY, MUSICAL, AND ARTISTIC DONATIONS TO LIBRARIES

WHEREAS prior to the Tax Reform Act of 1969 (PL 91-172), an author or artist who donated his or her literary, musical or artistic compositions or papers to a library or museum could take a tax deduction equal to the fair market value of the items at the time of the contribution, and

WHEREAS since 1969 such deductions have been limited to the cost of the materials used to produce the composition, and

WHEREAS since 1969 donations of manuscripts and papers from authors and other figures to libraries have been severely reduced, and

WHEREAS libraries, in their present precarious financial condition, are rarely able to compete successfully for manuscripts on the open market, and

WHEREAS an entire generation of literary papers may be lost to future scholars through lack of an incentive to donate them to libraries, and

WHEREAS restoration of the tax deduction would contribute to the equitable tax treatment of authors and artists and would increase public access to and preservation of the nation's literary and artistic legacy;

THEREFORE BE IT RESOLVED, that the American Library Association go on record in support of legislative measures which would help restore a tax incentive for authors and artists to donate their creative works to libraries and museums, and

BE IT FURTHER RESOLVED, that the American Library Association supports the restoration of the pre-1969 tax deduction equal to the fair market value of literary, musical or artistic compositions or papers at the time donated by the creator to a library or museum.

Adopted by the Council of the
American Library Association
Dallas, Texas, June 28, 1979

Senator BAUCUS. Thank you.

Senator SYMMS. Senator Baucus, I have been out of the room, who is up next?

Do you have any questions?

Senator BAUCUS. Why don't we first hear from the panel, and then ask questions.

Senator SYMMS. All right, go right ahead, Ms. Livingston.

STATEMENT OF JANE LIVINGSTON, ASSOCIATE DIRECTOR, CORCORAN GALLERY OF ART, ON BEHALF OF THE AMERICAN ASSOCIATION OF MUSEUMS AND THE AMERICAN ARTS ALLIANCE

Ms. LIVINGSTON. I am Jane Livingston, the associate director and chief curator of the Corcoran Gallery in Washington.

My perspective on this issue is as a person who was curator of 20th century art at the Los Angeles County Museum when this transition took place in the tax law, and it was at that time a dramatic change. Suddenly we were not getting gifts of paintings and sculptures.

The Corcoran Gallery is rather typical of American art museum in that it was founded as an American museum. There is a tradition at the Corcoran called the biennial. Every 2 years there is a major show of paintings, and it has been a key sort of resource for the acquisition of works for the collection.

Since I have been at the Corcoran, I have mounted three biennials, two of which included recent works, really masterpieces by major figures, most of whom are somewhat older, Jasper Johns, Roy Lichtenstein, Robert Rauschenberg, Ellsworth Kelly, DeKooning, Richard Serra, Frank Stella, Agnes Martin, Joan Mitchell, and Richard Diebenkorn.

All of the works by these artists shown at the Corcoran, most of them were available for sale, many of them were of this kind of stature that the appropriateness for the Corcoran collection was just sort of stunning. Not one of these works were we able to afford, in terms of purchase.

The really sad thing here is that we had a certain amount of money which we would have been willing to put toward the purchase, and in every case the artist would have been willing to make the rest of the value as a donation were it tax deductible.

In fact, we have not acquired one work from either of these major shows, and doubly sad is the fact that the works which were prime in these shows went wholesale to Europe and Japan. So there is a sort of incredible drain of this great heritage of recent American painting and sculpture to places which seem to appreciate it more and are willing to pay huge prices.

The Peter Ludwig Collection in Germany is one of the great collections of American art. Those works simply will not return to this country. The great works, for example, of Jasper Johns are simply not available to be been in American museums.

It is sort of a tragedy that this law came into effect just at the moment in American art history when there is a certain kind of special quality. We are nationally ascendant at this time, and have been since the late 1940's. This is shifting a little bit, but we have really missed the boat. We have missed an incredible part of our heritage in terms of fine art.

It is not so true that the American museums are bereft of abstract expressionist work, the earlier period, because at that time artists could give to museums and receive the benefits of tax deductions.

There is one more point that I want to hit on. At this moment, the National Endowment for the Arts has just issued its new guidelines. The only thing that has enabled us to acquire work at all at the Corcoran since 1970 has been the existence of money coming from the NEA under a program called the museum purchase plan. That is matching money, and we scramble and raise funds, and we somehow do acquire at least one major contemporary work each year.

In the new guidelines, this category of funding by NEA is being eliminated. So even this means of acquiring paintings and sculptures by living American artists is being taken away. I think if this year the tax deduction could be reinstated, it would certainly help enormously to take up that slack which is going to, I think, affect all of us dramatically.

I think that is all I have to say, thank you.

Senator SYMMS. Thank you very much.

Mr. Karp.

STATEMENT OF IRWIN KARP, COUNSEL, AUTHORS LEAGUE OF AMERICA

Mr. KARP. I am the counsel for the Authors League of America, which is the national society of professional writers and dramatists. I would like to submit my statement, and just summarize it briefly, and add some comments within my time period.

Mr. Boorstin and Mr. Tanis have described, as have other witnesses in the past, the devastating effects of the elimination in 1969 of the provision in the code which permitted authors to take a deduction for charitable contributions of their manuscripts.

I might say that authors were damaged by this change in the law in two respects. Obviously, losing the opportunity to take the deduction does not make possible the contribution of manuscripts; This is no longer possible because of the significant financial loss authors would suffer. But authors also used these collections of manuscripts to create some of the most important literature of our time—biography, history, social commentary, and the like. As the contributions have dried up, American literature, American history, and American biography have suffered from it.

We have pointed out in our statement certain provisions of these bills that we think require some revision. We would prefer, of course, the full 100 percent deduction provided in Senator Baucus' S. 649.

Although our statement does not address itself to the other provisions of the bill, we certainly support the provision permitting an executor to elect the alternative basis for valuing literary property.

First of all, in Senator Moynihan's bills, both bills, "qualified literary property" is defined as consisting of copyrights in literary, artistic, and musical compositions. We should point out that as a technical matter that would not encompass the very type of materials that these bills were intended to encourage donations of. As a matter of definition, both in the Copyright Act and the Internal Revenue Code, a literary composition and a manuscript are two very different types of property.

If the committee were to recommend either Senator Moynihan's deduction bill or contribution bill, the definition should be adjusted to parallel the definition in Senator Baucus' bill, which includes letters, memoranda, and similar property, and which would encompass manuscripts.

Second, Senator Moynihan's bills would limit the amount of deductions to the income from sales by the donor of literary works. As our statement points out, many authors don't sell works, they license them. The Internal Revenue Code and the rulings make a sharp distinction between a sale and a license. Therefore, the bills as written place an unrealistic ceiling on contributions.

Third, some of the most distinguished authors, whose manuscripts are most desired by libraries, don't make much money from their literary works at all. It is almost an inverse proportion. So if you maintain that limitation, you will not accomplish the purpose of stimulating contributions of manuscripts by poets, biographers, historians, and serious classical composers.

As far as the percentage limitations in the Moynihan bills are concerned, they go beyond the point necessary to make certain that an author or composer doesn't achieve more by contribution than by sale. Actually, authors and composers are subject to the 50 percent maximum rate and could not, even if they deducted the full amount of the fair market value of their contributions, come out earning more money after taxes by contributing than by selling. If the percentage limitations are to be maintained, they should be adjusted.

Last, we support Senator Moynihan's proposal that libraries be required to certify that the contributions of manuscripts serve a serious purpose. I think that would help satisfy the Treasury's opposition. There are also other methods that could be incorporated to do so.

Thank you very much, Mr. Chairman.

[Statement of Mr. Karp follows:]

November 10, 1981

Subcommittee on Estate and Gift Taxation
Committee on Finance, United States Senate

Statement of The Authors League of America
on S. 649, S.850 and S. 851.

The Authors League of America, the national society of professional authors and dramatists, respectfully urges that Congress eliminate inequities in the tax treatment of authors' charitable contributions of their manuscripts and similar property, and thus permit them to resume contributing these valuable papers to libraries and archives.

S. 649, introduced by Senator Baucus, would accomplish that objective by allowing authors to deduct, as they could before 1970, the fair market value of contributed papers. S. 850 and S. 851, introduced by Senator Moynihan, would partially achieve the objective, but provide less of a stimulus for contributions. They respectively permit a deduction and a tax credit for a percentage of the fair market value which varies in accordance with the taxpayer's adjusted gross income. However, certain of the conditions in S. 850 and S. 851 are inadvertantly phrased in a manner that could totally or substantially defeat their purpose.

The Effect of Sec. 170(e)

Prior to 1970, the right of authors and artists to deduct the fair market value of contributed manuscripts and paintings enabled libraries and museums to develop comprehensive collections of the papers and artistic works of these distinguished novelists, poets, playwrights, historians, biographers and artists. Since the deduction was eliminated in 1970, by enactment of Sec. 170(e) (IRC), libraries and museums have not been able to obtain contributions of manuscripts, paintings, and similar works from their creators, because authors and artists cannot afford to donate their property without a tax deduction or credit to offset its value. The damaging effects of the choking-off of authors' contributions on libraries, on scholarship and research have been described by other witnesses.

Are Contributions Of Manuscripts To Be Eligible for Deduction or Credit?

It is plain that all three bills are intended to provide a deduction or credit for contributions of manuscripts. But S.850 and S. 851 only allow a deduction or credit for the contribution of a "literary, musical or artistic composition" -- i.e. the novel or play or song created by the author, not the manuscript on which it was written, or the papers on which earlier drafts were inscribed, or the journal in which notes and comments were recorded while the author or composer prepared the work. The literary composition is property separate and distinct from the manuscript or other object on which the composition is written or typed. (17 U.S.C. 202) When authors and composers contribute their manuscripts and other papers to libraries, they rarely assign the rights in the works ("compositions") which the papers embody or relate to.

The Authors League urges that S. 850 and 851 be amended to provide a deduction or credit for the contribution of manuscripts, letters, memoranda or similar property -- as well as literary, musical or artistic compositions; thus conforming to the language of

Sec. 1221 (IRC). S. 649 uses such language.

Limitation of Income-From-"Sale" in S.851

S. 851 provides that its credit for charitable contributions cannot exceed the amount of tax on the author's income from sales of literary, musical and artistic compositions. However, many authors, dramatists and composers derive much of their income from licenses of their works, rather than sales -- and Internal Revenue Service Rulings make a sharp distinction between sales and licenses (e.g., Rev. Rul. 60-226; Rev. Rul 75-202). If such a limitation is retained, it should include the tax on authors' income from licenses and other dispositions of their compositions, as well as from sales. We do recommend that the limitation be deleted entirely, for it would prevent libraries from acquiring some of the most valuable papers they seek -- those from distinguished poets, historians , biographers and classical composers whose work has great literary and artistic value, but produces meagre or modest income. Moreover, the limitation would prevent authors from contributing in years when their income, which fluctuates greatly, was low.

The Percentage Limitation on Deductions

S. 850 and S. 851 allow a deduction or credit for a percentage of the fair market value of the materials contributed. This is intended to meet the Treasury's objection that contributions otherwise permit the donor to escape income tax on the "appreciated" income - the difference between the author's nominal cost basis and market value at the time of the contribution. The Authors League recognizes that a partial deduction is better than no deduction. But it would find the proposal more equitable if it applied to all donors of appreciated property: the collector who buys manuscripts at a low price and deducts a much higher ("appreciated") market value when he donates them to a library years later; or the individual who is permitted to escape tax on the appreciated value of stock which he contributes to a library or university, at a deduction based on current fair market value.

The Authors League is grateful to the Subcommittee for this opportunity to express its views.

Irwin Karp
Counsel

Senator SYMMS. I want to thank all of you, and all of the written statements from the previous witnesses and the ones following, will be made a part of our written record.

Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

I want to thank all of you very much for the time you have taken in preparing for this hearing, and also for appearing today. I regrettably have to leave, but I want you to know that I personally will undertake every effort to help get this bill passed at the first opportunity. It is needed, and it is not a matter, if I have anything to do with it, that is going to slide through the year. I hope that we will get something passed this year, or at the very least at the very first opportunity to make the appropriate change.

Thank you all very much.

Senator SYMMS. Thank you very much, Senator Baucus. I can assure you that I share your point of view that this should be done at the first possible opportunity.

I want to thank all the witnesses.

I understand that we have not yet heard from Mr. Siegmeister. I thought you had testified, and I apologize. Please go right ahead.

STATEMENT OF ELIE SIEGMEISTER, COUNCIL OF CREATIVE ARTISTS, LIBRARIES & MUSEUMS

Mr. SIEGMEISTER. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, I appreciate the opportunity to testify as a composer, and as chairman of the Council of Creative Artists, Libraries and Museums.

The council is a federation of 17 national organizations, including museums, libraries, authors, painters, sculptors, composers, cartoonists, and other artists, and members of the art-loving public, totaling more than 1½ million Americans.

I will submit my testimony, and in the interest of time I will simply summarize the major points. Since my colleagues have already spoken very eloquently and, I think, accurately about the impact on libraries and museums, I will simply talk about the impact on composers.

Mr. Karp has talked about the authors. Even though our organization does embrace all the arts, I have personal contact and many of the distinguished composers of our country are my colleagues and friends, and I know how they have acted and how they have felt over the years with regard to the present situation.

Perhaps a word of background on one institution, the Library of Congress across the street, where as a student and as a practicing composer I have often gone to look at manuscripts of the great composers of the past and of our times.

One of the interesting things to the artist in seeing the manuscript as distinguished from the published work, is the amendments, corrections, and comments, sometimes made by the composer on the manuscript which do not appear in the publication.

For example, the Library of Congress has the original manuscript of the great American opera "Porgy and Bess" written by George Gershwin, and I was tremendously interested to examine that when it was on display some years ago because there are things in the manuscript that do not appear on the published score which I own.

Gershwin, for example, made a comment in one place, "Use the motif of 'Sporting Life' at this place." This does not appear in the score, but that he actually identified that as a motif for "Sporting Life" is tremendously interesting to me as a composer, and certainly to scholars and students of the work, indicating the mind of the composer, the artistic and creative attitude that he poured into the work.

I have also examined such great masterpieces as the Bartok "Concerto for Orchestra," Aaron Copeland's "Appalachian Spring," and others, which were to my own personal benefit, and I am sure the same goes for any other artist. Musician, conductors, I am sure, are very interested in looking at the original score, the draft of the composer, rather than what was eventually gone over by an editor and smoothed out and changed.

So original manuscripts are a great resource. Unfortunately, the impact of the 1969 Tax Reform Act was, as you have heard, to stop the contributions.

One of the works, it was rumored some years ago, might have been given to the Library of Congress, was one of the great masterpieces of the 20th century, the "Rite of Spring" by Igor Stravinsky. There was some talk that he was about to give it, and then they learned that there was no tax deduction, and the manuscript never appeared at the Library of Congress. We believe that it has been sold for an enormous sum to a foreign buyer.

We just saw in the New York Times the other day a note that the Stravinsky manuscripts, the remaining manuscripts, and personal papers were being negotiated over by UCLA for a sum of over $1 million. I am happy that UCLA has that money, but I am sure that many other institutions do not, and here is this great treasure of our contemporary music that could have been ours, as well as many other original manuscripts, but for the impact of the law.

I am going to make my summary very brief. I would like to say that we all much prefer S. 649, the Baucus bill. However, if the committee and Congress wish to consider the Moynihan bills, we would support those as well, but I would like to point out one small consideration.

As presently drawn the Moynihan bill, S. 852, would allow a tax credit not to exceed the amount of taxpayer's income from sales of art works. I would like to second Mr. Karp's testimony and say that only graphic artists derive their major income from sales. We, composers, derive it from licenses. Therefore, if the bill is considered, it should be amended to include a reference to income from licenses as well as sales.

Thank you, Mr. Chairman.

[Statement of Mr. Siegmeister follows:]

November 10, 1981

Statement of

ELIE SIEGMEISTER, CHAIRMAN
COUNCIL OF CREATIVE ARTISTS, LIBRARIES & MUSEUMS

Before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
Committee on Finance
United States Senate

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to testify today as a composer, and as Chairman of the Council of Creative Artists, Libraries and Museums. The Council is a federation of seventeen national organizations including museums, libraries, authors, painters, sculptors, composers, cartoonists, other artists, and members of the art-loving public, totalling more than one and one-half million Americans. We express our appreciation to Senator Baucus and his colleagues, Senators Lugar, Kasten, Leahy and Williams for the introduction of S.649, the Artist's Tax Equity and Donation Act, and to Senator Moynihan for his sponsorship of alternative bills, S.851 and S.852, the Pen and Ink Act. These measures reflect a growing awareness that the present law relating to charitable deductions discriminates unfairly against artists who donate their own works to tax-exempt organizations. These bills will be of great benefit to libraries, museums and universities throughout the country by enabling them once again to obtain collections of valuable creative works directly from the creators themselves.

We are particularly grateful to the Chairman of this Subcommittee for holding hearings on this subject and hope that they will lead to enactment of legislation in this area.

I should like to begin my discussion with the year 1913 when the Income Tax law was enacted by Congress, and a few years later, the law on Charitable Contributions. For fifty years, from about 1919 to 1969, as a direct result of these two laws, American museums and libraries throughout the country were able to acquire, by the gifts of the artists themselves and other taxpayers, a magnificent treasury of paintings, sculptures, prints, cartoons, and the original manuscripts of poems, plays, novels, operas, musical comedies, and symphonies that form a great heritage of the American people. Each year millions of Americans visit the National Gallery, the Metropolitan Museum, the Chicago Art Institute, the Library of Congress, the New York, Boston, Chicago, and other public libraries, as well as the libraries and museums of Yale, Harvard, Stamford, UCLA and many others, to look at the great collections of painting and sculpture, and study the original munuscripts of Eugene O'Neill, William Faulkner, George Gershwin, Aaron Copland, Richard Rodgers, Oscar Hammerstein, and other great American artists. Many, if not most of these art works came to the public institutions as a direct result of the law on Charitable Contributions which granted the artist the same rights as other citizens, to make contributions and receive the deduction based on the fair market value of the works.

For fifty years American institutions were vastly enriched by the equitable working of this law. Nor, I may add, was the U.S. Treasury bankrupt as a result. Quite the contrary: because many of the artworks were donated during the artists' lifetime, they cost the government a small fraction of what they would cost today after the artists have passed away and their works have soared in value. Across the street, in the Library of Congress, there is the original manuscript of a great American opera: "Porgy and Bess". I have no idea what tax deduction George Gershwin received for the gift of this priceless document. But whatever it was, I am sure it was a tiny fraction of what it would cost that Library -- which of course is supported by the U.S. Treasury -- to purchase that manuscript today. The law on Charitable Contributions as it worked for fifty years was a wise, human, and <u>thrifty</u> law.

Why, then, am I here today? Because, as you gentlemen know, that law was changed by the Tax Reform Act of 1969 in such a way as to destroy the giving of artworks by the living artist. Prior to the 1969 Tax Reform Act, authors and artists like all other citizens could deduct the <u>fair market value</u> of their manuscripts, papers and paintings that they donated to tax-exempt libraries and museums. The 1969 Act was designed to deal with donations of public papers by political figures but was worded to include <u>all</u> creators of original works. As a consequence, artists and other creative individuals no longer may deduct the market values of their own works contributed to tax-exempt organizations but only the cost of materials, which is a nominal amount. On the other hand, collectors are permitted under the law to deduct appreciated market values in connection with the contribution of works they own. Authors, artists and composers consider this current tax treatment of their contributions of artworks as unfair and discriminatory.

As a result the past ten years, as any museum director or librarian can tell you, have been a disaster for American culture. I don't want to bore you with statistics, but the fact is that contributions of original works by artists, writers, composers, and other creators have practically ceased. The artist feels the law has made him a second-class citizen, who is deprived of rights that the wealthy businessman or collector can still exercise. Our country is perhaps alone among the civilized nations of the world in using tax policy to penalize the artist. Other countries, among them Ireland, France and Holland, encourage the arts by granting special tax advantages to the artist who enriches his country's culture; we do the opposite.

Most working artists cannot afford to give away valuable property without the same realistic charitable deduction available to any American citizen. As a consequence, not only the artist, but the student, the scholar and the American people as a whole have lost and are losing their priceless heritage. To take one instance, Stravinsky's greatest composition, the "Rite of Spring" could have been given to the Library of Congress a few years ago. Because the great composer learned that he would be treated worse than an average citizen, he did not make the gift, and the work went into private hands. Many paintings by our leading artists have been sold privately, some out of the country, when the artist would have been happy to donate them to an American museum where our own people could see and enjoy them.

Before concluding these remarks, I wish to say that our organization supports Senator Baucus' bill S.649 which, if enacted, would remedy the inequitable situation that exists today. S.649 would restore the deduction at 100 percent of market value, putting artists on an equal footing with collectors and other donors. We do not believe that the deduction should be restricted; however, if the Committee believes that some form of restriction is needed and chooses an approach embodied in one of the Moynihan bills, the tables set forth therein should be re-examined and modified in light of recent Tax Code revisions.

Mr. Chairman, existing law accords a full fair market value charitable deduction for donations of art work by collectors -- indeed by <u>any</u> donor other than the creator of the work. The Senate Committee Report (S.Rept. No. 91-552) justified its special treatment of collectors' donations on the ground that to do otherwise would have a "substantial adverse impact on charitable giving to public charities and schools ..." An identical justification exists for restoring the artists' fair market value charitable deduction today.

The Council of Creative Artists, Libraries and Museums thanks the Committee for the opportunity to present this statement.

Senator BOREN. Thank you very much for your testimony, and we will certainly bear in mind that point about licensing. I think that it is an important one, and an important one to include in the record.

I would only tell you that if it looks like musical chairs up here this morning, unfortunately in scheduling hearings, we never know what else is going to come up. There is a markup on the Clean Air Act that Senator Symms had to go to attend. There is a piece of legislation on the floor that both Senator Baucus and I have been involved in that we are expecting a vote on shortly. So we have been sort of taking turns meeting our other responsibilities this morning.

We have been joined by Senator Long, the ranking minority member of the committee, and the former chairman of the full committee. We are glad to have you with us.

Again, I want to say how much we appreciate the testimony of all of you. Have you all had a chance to testify?

Ms. LIVINGSTON. Excuse me, Senator Boren. I have one other statement I would like to make.

I would like to submit for the record, as part of my testimony, two statements, one by the American Association of Museums and the American Arts Alliance. Those are written statements which should be sumitted.

Senator BOREN. Very good. We will receive those for the record, and they will be printed in full in the record.

[Statements from American Arts Alliance and American Association of Museums follow:]

STATEMENT OF AMERICAN ARTS ALLIANCE

Mr. Chairman and members of the Sub-committee. On behalf of the over 400 nonprofit professional arts institutions that are members of the American Arts Alliance, we want to thank you for giving us the opportunity to testify today.

We would also like to thank Senators Baucus and Moynihan, who, with the introduction of their Artist's Tax Equity Bills, have again demonstrated their concern with and commitment to the preservation of our nation's cultural heritage. It is in support of these bills that I appear before you today.

Today's hearing could not be more timely for the consideration of this legislation. Just two weeks ago the report of the White House Task Force on the Arts & Humanities was presented to the President. After three months of careful examination, the Task Force recommended the passage of Artist's Tax Equity legislation as part of its plan to increase private giving to our nation's cultural institutions.

Those who favor the Artist's Tax Equity bills are not asking for a tax bonus for our nation's artists, writers and composers. Passage of this legislation will rectify an inequity in the current tax code which was an unintended effect of changes made in the code in 1969.

Prior to 1969, artists, writers and composers, like the patrons who collected their works, could donate their creations to museums, libraries and other nonprofit institutions and receive a tax deduction equivalent to the fair market value of the donated item. Public officials could also take advantage of this provision in the tax code when donating their public papers to libraries and archives.

However in 1969, the code was changed specifically to prevent elected officials from taking advantage of this privilege. Unfortunately, swept up with this change was the ability for artists, musicians and writers to use this tax deduction. Since then, these men and women have been able to deduct only the cost of materials which went into the creation of the donated work, while a patron may purchase a work of art, donate it to a museum and deduct its full market value at tax time.

It would appear that such unequal treatment could be viewed as a violation of the fundamental concept of equal treatment under the law. There would seem to be no mitigating factors that differentiate between the two groups of donors and which would justify different methods of tax evaluation.

In addition, the treatment of artists and scholars under the tax code is fraught with irony and has placed a devastating financial burden on them and their heirs. If an artist donates one of his paintings to a museum today, he may only deduct the cost of the paint, canvas, frame, etc. But if that artist should die tomorrow, his estate will be taxed at the fair market value of each of the paintings left in his estate. Overnight his works have miraculously increased in value - if only for tax purposes.

Taxing the compositions, manuscripts and works of art in an artist's estate at market value can create staggering tax debts for the estate. We have all been sickened by the horrific stories of artists who have destroyed their work rather than pass this staggering burden on to their heirs.

The heirs find themselves in a catch-22 situation. To pay off the estate tax they are forced to sell off art work in the estate. This produces a glut in the market, reducing the price each work can fetch. Thus taxes have been assessed on the fair market value of works that cannot command their fair market value in the marketplace. This situation is unconscionable and must be rectified.

Since 1969 donations of artistic, literary and musical works to museums and libraries by their creators, have virtually ceased. Daniel Boorstin, the Librarian of Congress, in testimony before the Senate Finance Committee stated that before 1969, writers donated 200,000 original manuscripts to the Library each year. Since 1969, the Library has received only one major original manuscript from an author. The Museum of Modern Art in New York has reported that between 1967 and 1969 they received donations of 52 paintings and sculptures from the artists who created them. However, between 1972 and 1975, only one such work was donated by an artist to the museum.

The experience of the Library of Congress and the Museum of Modern Art is not unique to these institutions. Similar patterns have been reported by museums and libraries throughout the country.

As a result of the 1969 tax law, artists have been forced to hold onto their works or to sell them to private collectors. This has not only limited their accessibility to the public, but has scattered works of closely related material throughout the country and abroad. The dispersal of these works will seriously hamper all future scholarship concerning this generation of American artists and writers, an unconscionable situation that must not be allowed to continue.

Objections to this legislation raised in a previous session of Congress questioned the accurate determination of the fair market value of donated works of art and the revenue loss to the Treasury which would result from passage of this bill. The first concern was removed by the creation of the Art Advisory Panel of the Commissioner of the Internal Revenue Service. As for the revenue loss, the Treasury estimates that passage of this legislation would cost approximately $5 million per year - a small price to pay for the preservation of our nation's cultural heritage.

In summary, passage of Artist's Tax Equity legislation will allow the Congress to affect a reform in the tax code which will have a significant impact on the future of our nation's cultural history. It will eliminate an inequity in the code which discriminates against artists and scholars. By removing this barrier, it will stimulate the flow of contemporary American art and scholarship to cultural institutions, ensuring the preservation of our cultural heritage. Finally it will keep art and scholarship in the public domain providing the American public with accessibility to these works.

On behalf of our nation's artists and scholars, its cultural institutions, and the future generations of Americans who will learn from and enjoy the works of contemporary American art and scholarship, we urge passage of an Artist's Tax Equity Bill.

STATEMENT OF AMERICAN ASSOCIATION OF MUSEUMS

Mr. Chairman and members of the subcommittee:

The American Association of Museums is grateful for the opportunity to submit testimony in support of the arts-related legislation being considered today. The AAM has a membership of more than 7,000 museums, museum professionals and trustees, and represents at the national level the interests and concerns of approximately 5,400 museums of art, history and science.

The bills introduced by Senators Baucus and Moynihan would create by various means a greater incentive for both artists and their heirs to donate works to museums, libraries and archives. The bills serve two equally worthy purposes: they rectify an inequity in the current tax law that treats artists unfairly and they encourage the giving of objects to museums and similar organizations for preservation, study and public enjoyment.

Since passsage of the Tax Reform Act of 1969, an artist has been able to deduct only the cost of materials when making a gift of his work to a museum. A collector, on the other hand, making a similar gift may take the full market value as a charitable deduction. The intent of the proposed legislation is to restore to artists a reasonable tax deduction for gifts of their works to nonprofit organizations.

The current situation is extremely unfair to the artist. He is deprived of an incentive, available to others, to make worthwhile gifts of his work. As well, he must see his work dispersed, item by item, through sale to collectors with no assurances that it will be properly cared for or studied by scholars. If he is an artist of some importance, he experiences in addition the irony of knowing that the works that in his lifetime he could not give away will be properly valued at his death and present a tax burden to his heirs.

The current situation is also unfair to the general public, which is deprived access to the best of American art because of its increasing acquisition by private collectors in this country and abroad.

Museums and museum professionals are committed to the task of collecting, preserving and interpreting the nation's cultural heritage for the benefit of its citizens. For the past 12 years, this has been as increasingly difficult task for museums with an interest in and commitment to contemporary art and artists. Since 1969, artists' gifts to museums have almost completely dried up. Museums must now purchase work that in many cases would be given them if artists had any incentive to do so. Museums must now compete with collectors for those objects at a time when prices for American art are high and acquisition funds are tight.

The bills under consideration today would help to restore the balance that once existed among artists, museums and private collectors. Each bill safeguards against potential abuses of the deduction by public officials, which was the sole intent of the changes in 1969, although unfortunately not the sole effect. In addition, the IRS has in place the Arts Advisory Panel which is capable of reviewing the use of a restored fair-market deduction for artists, thereby further reducing the likelihood of abuse.

The timing of today's hearing is particularly apt in light of the just published report of the Presidential Task Force on the Arts and Humanities. One of the principal areas of study for the Task Force was the use of tax incentives to increase private support for arts and humanities activities and institutions. The members of the Task Force considered quite carefully what the estimated impact of the Economic Recovery Tax Act of 1981 would be on cultural institutions. They concluded that private support for cultural institutions would probably decline and made a series of recommendations to the President on ways in which to compensate for the reduction. Primary among them was the recommendation that artists, writers and composers should receive "the same tax treatment, as a result of the charitable contribution of [their] work, available to a collector or other donor giving a purchased work or manuscript."

The American Association of Museums strongly supports passage of an artist's tax equity bill and appreciates the efforts of Senators Baucus and Moynihan to see that such legislation is advanced through Congress.

Senator BOREN. Does any other member of the panel have any other point that they would like to add before we move on?

Mr. SIEGMEISTER. Could I make one other small point?

Senator BOREN. Certainly.

Mr. SIEGMEISTER. You are all, of course, aware of the great contributions of Charles Ives as a composer. The absence of a possibility to contribute may not have operated in Ives' case, but he had a magnificent work called "15 Studies for Piano," which were left in his bond in those days because he was not aware of the value of the manuscripts. Eight of them now appear in the Yale University Music Library, and the other seven are lost.

This is a great tragedy for American culture, which a change in the law would tend to avert in the future.

Mr. TANIS. If I may mention a personal anecdote, Senator.

Senator BOREN. Yes.

Mr. TANIS. William Saroyan had written me a total of 17 letters while he was alive, and I can now turn around and give those to a college, and take a tax deduction for them.

William Saroyan couldn't get more than 10 cents a page for those letters, and I know that probably I will get more. It is very unfortunate because Mr. Saroyan was not rich.

Senator BOREN. The point is very, very well made. It certainly dramatizes the inequity in the present law. We thank all of you for appearing before the committee.

Let me ask, Senator Long, do you have any comment or question at this time?

Senator LONG. Not at this time.

Senator BOREN. Again, we thank all of you very much.

We will ask the two members of the last panel at this time, Mr. Gordon Hanes of Winston-Salem, N.C., and Dr. Roscoe Rouse, the dean of library services and sciences at Oklahoma State University.

Mr. Hanes, if you will allow me a little in-State pride this morning to make a comment here about my good friend Dr. Rouse. I am certainly glad to have him before the committee, he has been host on the Oklahoma State University on a number of occasions, I think one occasion being research day, when I was there.

He has been the head librarian at the university level for 30 years. Not only does he have great skills as an administrator, and an expert in the field of library sciences, but as an author, a researcher, an archivist himself. Speaking personally, I am very, very glad to have you with us this morning.

We are ~~very~~ glad to have both of you. Having taken the liberty of doing some in-State bragging this morning, I think it would be only fair if I called Mr. Hanes first to proceed with his testimony.

STATEMENT OF GORDON HANES, CHAIRMAN, NORTH CAROLINA MUSEUM OF ART, WINSTON-SALEM, N.C.

Mr. HANES. Thank you very much. I appreciate the opportunity of being here, and I am going to beat the yellow light.

This is coming to the end of a long road for me. Some 10 years ago, my family and I spent a long weekend with Andrew Wyeth and his family, and I first became aware of the inquity of the law as changed in 1969. The reason for the change was logical, but the result has been disastrous.

I only want to make two quick points. One, since that time, 10 years ago, I have become chairman of the board of a North Carolina museum of art, and I am also on boards and committees of the Folger Shakespeare Library, the Smithsonian Institution, which has a lot of museums, and the Whitney in New York, none of these institutions has budgeted funds for the acquisition of works of art of current artists.

As has been pointed out, the funds available for matching from the National Endowment for the Arts have been withdrawn. The same thing was true in North Carolina, the acquisition funds due to pressure on budgets have been withdrawn. Therefore, it is terribly important to these museums to have this ability to acquire works of living American artists.

The second point that I would like to make is, someone on the President's task force said: "Let's don't do this because there are artists who will just give works that they can't sell otherwise."

I have talked with Roy Lichenstein, and Frank Stella, as you know, two of the leading contemporary artists, both of them said: "Nothing could be further from the truth. Our only hope of immortality is to have our work shown and belong to the great museums of America. If this law is changed, we will give our very best work to these museums."

Thank you for this opportunity to appear.

Senator BOREN. We appreciate your appearance very much.

Again, if I could impose on Dr. Rouse, we have with us Congressman Fred Richmond, he has just received a phone call calling him back to the House very, very quickly, and there is a vote on our floor. We will try to get this all done here.

I wonder if you would mind for Congressman Richmond to make a brief statement to us, since he has to return back over to the House.

STATEMENT OF HON. FRED RICHMOND, U.S. REPRESENTATIVE FROM THE STATE OF NEW YORK

Mr. RICHMOND. Thank you, Senator.

Senator BOREN. We are very glad to have you this morning.

Mr. RICHMOND. I have some testimony and I would be very grateful if you would include it in the record.

Senator BOREN. We will include the full statement in the record.

Mr. RICHMOND. I certainly want to thank you for the opportunity to testify this morning on several tax proposals which are of vital interest to the arts.

The first one concerns donation of works by creators. As you know, we changed the tax code in 1969, but it had nothing to do with artists at all. It had to do with various politicians' papers.

I think we all realize by now that an artist should have the same right that you and I have in donating a work of art to a museum, if the museum, or library, or duly constituted entity of that type, is willing to accept the manuscript, the sculpture, or painting.

It seems to me that anybody—the artist or the private citizen, ought to be able to get a legitimate tax deduction. Now, the law only allows private citizens to take the full deduction—not the artist. I certainly applaud your committee for having this hearing, and actually being interested in correcting this very, very unfortunate situation.

I know that major artists—Andrew Wyeth, Jamie Wyeth, Rob Rauschenberg, Roy Lichenstein, so many of them—would like to donate their works of art to museums. They all happen to be very generous, prolific people, but they really feel they ought to get the same treatment that you and I would get.

So I do hope that your committee can find it in its wisdom to approve that portion of the legislation which allows charitable deductions of an artist's work to be computed at fair-market value or at a percentage of the fair-market value, as in Senator Moynihan's bill.

In reference to the valuation of an artists estate, I have had any number of complaints from the families of artists who died leaving their works of art. For example, take the case of Thomas Hart Benton, and another chap from out West—Ted DeMillo, I believe his name was—left an estate the valuation of which was based on the retail price of his last picture. He left an estate of roughly $1 million based on that valuation. His widow finally got $60,000 out of the deal.

We had a long meeting with Al Ullman on that question last year, and he was about to recommend that the Ways and Means Committee correct that inequity in the tax law.

Certainly, an artist's estate should be valued at nothing more than the cost of materials, and when the beneficiaries sell the piece of art, certainly they ought to be made to pay a proper income tax on it. But it seems to me that the reasonable thing would be that the original valuation should not be so high that the estate is nearly wiped out.

We have had cases, for example, where a number of artists have actually destroyed their works before they died because they didn't want their families to be burdened with this unfair estate tax.

So, I do hope that you will look favorably on the Baucus bill and the Moynihan bill because I have a feeling that over at the House, the Ways and Means Committee will also feel that these inequities ought to be straightened out.

[Statement of Mr. Richmond follows:]

TESTIMONY OF
CONGRESSMAN FRED RICHMOND
BEFORE THE
SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
HEARINGS ON S. 649, S. 851, S. 852
WASHINGTON, D.C.
NOVEMBER 10, 1981

MR. CHAIRMAN, DISTINGUISHED COLLEAGUES OF THE SUBCOMMITTEE, I WOULD LIKE TO THANK YOU FOR THE OPPORTUNITY TO TESTIFY THIS MORNING ON SEVERAL TAX PROPOSALS OF VITAL IMPORTANCE TO THE ARTS. THESE PROPOSALS WOULD RECTIFY THE INEQUITIES IMPOSED BY THE TAX CODE ON ARTISTS AND THEIR HEIRS AND ENABLE MUSEUMS AND LIBRARIES TO INCREASE THEIR ACQUISITION OF WORKS BY LIVING ARTISTS AND WRITERS.

DONATION OF WORKS BY CREATORS

IN 1969, CONGRESS CHANGED THE TAX CODE TO PREVENT ELECTED OFFICIALS FROM DONATING THEIR PERSONAL PAPERS TO LIBRARIES OR ARCHIVES IN ORDER TO RECEIVE LARGE TAX DEDUCTIONS. ALTHOUGH CONGRESS ACTED PROPERLY BY CLOSING THAT TAX LOOPHOLE, THE CHANGE HAD AN UNINTENTIONAL, YET DETRIMENTAL, EFFECT ON CONTRIBUTIONS BY ARTISTS AND WRITERS. THESE PERSONS WERE ALSO PREVENTED FROM RECEIVING TAX DEDUCTIONS EQUAL TO THE FAIR MARKET VALUE OF THE WORKS THEY CONTRIBUTED.

CONGRESS NEVER INTENDED TO PENALIZE ARTISTS, WRITERS, AND MUSICIANS. BUT FOR ALMOST THIRTEEN YEARS NUMEROUS ARTWORKS, MANUSCRIPTS, AND COMPOSITIONS HAVE NOT BEEN CONTRIBUTED BECAUSE ARTISTS CAN RECEIVE A TAX BENEFIT OF NO MORE THAN THE COST OF MATERIALS WHEN DONATING THEIR WORKS TO NONPROFIT, TAX-EXEMPT ORGANIZATIONS.

THIS INEQUITY OF THE TAX CODE TOWARD ARTISTS IS MOST EVIDENT IN THE CASE OF AN ART COLLECTOR WHO BUYS A WORK FROM AN ARTIST, KEEPS IT FOR A YEAR, THEN DONATES IT TO A MUSEUM AND RECEIVES A TAX DEDUCTION FOR THE FAIR MARKET VALUE OF THE WORK. IF THE ARTIST HAD WISHED TO DONATE THE SAME WORK, HE OR SHE WOULD HAVE BEEN PROHIBITED FROM RECEIVING A DEDUCTION EQUAL TO THAT GIVEN TO THE ART COLLECTOR.

AMERICAN ARTISTS CONTINUALLY SUBSIDIZE OUR MUSEUMS AND ART CENTERS BY CONTRIBUTING THEIR TIME AND TALENTS, BY WORKING FOR MINIMUM WAGES, AND BY CONTRIBUTING THEIR ARTWORK. THEY SHOULD AT LEAST BE GIVEN EQUITABLE TREATMENT BY THE TAX CODE.

THE LEGISLATION YOU ARE CONSIDERING TODAY, AS WELL AS SIMILAR LEGISLATION I HAVE INTRODUCED IN THE HOUSE, WOULD RECTIFY THIS SITUATION BY INCREASING THE DEDUCTION GIVEN TO ARTISTS OR BY PROVIDING A TAX CREDIT FOR AN ARTIST WHO DONATES HIS/HER WORK.

MR. CHAIRMAN, THIS TAX CHANGE WAS ONE OF THE MAJOR RECOMMENDATIONS OF THE PRESIDENTIAL TASK FORCE ON THE ARTS AND HUMANITIES. IN ITS REPORT TO THE PRESIDENT, RELEASED LAST MONTH, THE TASK FORCE STATES THAT THE CURRENT LAWS GOVERNING CHARITABLE GIFTS OF CREATIVE WORKS BY ARTISTS, WRITERS, AND COMPOSERS HAS "SUBSTANTIALLY REDUCED" DONATION OF WORKS BY LIVING ARTISTS AND AUTHORS TO MUSEUMS AND LIBRARIES. THIS REDUCED NUMBER OF CONTRIBUTIONS HAS SHARPLY CURTAILED THE AMOUNT OF RESEARCH MATERIALS AVAILABLE FOR SCHOLARLY ACTIVITY.

THIS UNFORTUNATE SITUATION, HOWEVER, WOULD BE CHANGED BY THE LEGISLATION INTRODUCED BY SENATOR BAUCUS AND SENATOR MOYNIHAN, AS WELL AS SIMILAR BILLS ON THE HOUSE SIDE. WITH THESE CHANGES SEVERAL BENEFITS WOULD RESULT:

--ARTISTS AND AUTHORS WOULD RECEIVE EQUITABLE TAX TREATMENT AND BE ABLE TO CHOOSE THE INSTITUTIONS WHERE THEIR WORK WOULD BE DISPLAYED BEST

--MUSEUMS AND LIBRARIES WOULD ACQUIRE MORE WORKS OF ART WITHOUT COST

--THE PUBLIC WOULD BENEFIT BY THE PRESENCE IN PUBLIC INSTITUTIONS OF THE WORKS OF LIVING ARTISTS AND WRITERS

FURTHERMORE, ACCORDING TO THE TASK FORCE REPORT, THE INTERNAL REVENUE SERVICE, WHICH NOW HAS A PANEL TO MONITOR THE VALUE OF ARTISTIC WORK, ESTIMATES THAT NO MORE THAN $5 MILLION IN REVENUES WOULD BE LOST ANNUALLY. THE BENEFITS DERIVED FAR OUTWEIGH THIS SMALL LOSS TO THE TREASURY.

VALUATION OF ARTISTS' ESTATES

AN ISSUE CLOSELY RELATED TO THE SIZE OF THE DEDUCTION GIVEN TO AN ARTIST FOR CONTRIBUTING HIS/HER ARTWORK IS THE VALUATION OF THAT ARTIST'S ESTATE. ALTHOUGH THE LIVING ARTIST RECEIVES A DEDUCTION EQUAL TO THE COST OF MATERIALS, WHEN HE/SHE DIES THE VERY SAME WORK IS TAXED AT ITS FULL FAIR MARKET VALUE.

MUCH ARTWORK HAS BEEN DESTROYED BY LIVING ARTISTS RATHER THAN HAVE THEIR HEIRS BURDENED WITH LARGE AMOUNTS OF ESTATE TAXES. THOMAS HART BENTON, WHOSE MURALS ADORN THE TRUMAN LIBRARY, BURNED MANY OF HIS WORKS TO SPARE HIS FAMILY AN ENORMOUS TAX BURDEN.

LEGISLATION BEFORE YOU TODAY, AS WELL AS SIMILAR LEGISLATION I HAVE INTRODUCED IN THE HOUSE, WOULD RECTIFY THIS INEQUITY. FOR ESTATE TAX PURPOSES ONLY, THE VALUATION OF ARTWORK LEFT IN AN ARTISTS ESTATE WOULD BE EQUAL TO THE COST OF MATERIALS. IN THIS CASE THE FAMILY WOULD NOT BE FORCED TO LIQUIDATE THE ESTATE TO PAY THE TAXES.

I HAVE RECEIVED MANY FAVORABLE COMMENTS FROM PROMINENT ARTISTS ABOUT BOTH OF THE TAX CHANGES WE ARE DISCUSSING TODAY. ROBERT RAUSCHENBERG, JAMES ROSENQUIST, ROY LICHTENSTEIN, AND GEORGE SEGAL HAVE ALL ENDORSED THESE CHANGES. THE FOLLOWING COMMENTS WERE WRITTEN BY THE NOTABLE ARTIST JAMIE WYETH:

> THE PRESENT ESTATE TAX SITUATION IS A GLARING INEQUITY. IT SEEMS TO ME AN APPALLING CONTRADICTION THAT AN ARTIST GIVING A GIFT OF HIS OR HER OWN WORK TO A PUBLIC INSTITUTION MAY DEDUCT ONLY THE COST OF PRODUCING THAT WORK (USUALLY ABOUT $75). AT THE ARTIST'S DEATH THAT SAME WORK IS THEN ASSESSED AT FAIR MARKET VALUE AND THIS FIGURE OFTEN REACHES INTO THE HUNDREDS OF THOUSANDS OF DOLLARS. THE REAL LOSERS IN THIS SITUATION ARE OUR PUBLIC INSTITUTIONS, LIBRARIES, AND MUSEUMS AND THUS THE AMERICAN PEOPLE. IF WE ARE TO BELIEVE THAT THE ARTS ARE A NATIONAL RESOURCE, LET US ENCOURAGE THEM WITH THIS MEASURE.

I URGE THE SUBCOMMITTEE TO CONSIDER THIS PROPOSED LEGISLATION AND TO RECOMMEND FAVORABLY CHANGES WHICH WILL HELP PRESERVE AMERICA'S MOST VALUABLE NATURAL RESOURCE.

Senator BOREN. Thank you very much.

We can assure you, speaking personally, that we get action on this very, very soon. I appreciate your comments coming from the House, and knowing that there will be some support for action if we are able to move forward over the House side.

We very much appreciate your taking the time to come over on a busy morning to let us know of your personal support.

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

Senator BOREN. Senator Long.

Senator LONG. Can you tell me what the Treasury's position is with regard to these bills? I would think the Treasury would oppose the provision.

Mr. RICHMOND. Senator, I get the feeling that the Treasury is willing to discuss this. They are not adamantly against it. These are two unfortunate loopholes in the tax law. I would put these in the same category as the unfair marriage penalty. Why should somebody pay a different tax on their income if they are married or single and it is the same way here. Why should somebody pay an estate tax on something that has not been sold. Why shouldn't an artist be allowed to give a contribution to a museum, the same way you and I can?

These are inequities the Treasury would not cause too much fuss about. I have discussed it briefly with a couple of members of the Treasury.

Senator LONG. I am not focusing at this point on a specific situation. I am just thinking of the problems generally, which can probably be placed under control. But at the time you give the painting, you could start a very beneficial loophole.

People giving and receiving the painting would not argue too much about what the fair value of the painting was. Someone could give a painting and place a very high value on it, and the people on the receiving end would agree with whatever price was put on it.

So the people in the highest brackets, at the time they give the painting, it could be really quite a tax gimmick for them, a tax shelter, if you will. The people at the Treasury have to think about the revenue loss on things like this.

You are talking about a situation where the artist has not paid a tax on the value of what he has produced. He gives it away, so the Government has received no tax on the income on the production of the thing. When he makes the donation, of course, he is entitled to a deduction. So the question is, how much deduction is he entitled to.

I have heard the Treasury argument about the matter before, and I hope that we can work something out. But I understand Treasury's point of view, as many times as I differed with them, when I had something that I wanted to do that was good for either my State, my constituents, or the country in general. Many times, I heard the Treasury disagree with my suggestions.

Senator BOREN. There is a vote on the floor, and we have about 5 minutes. I cannot return afterwards because I have to go and meet with the Higher Education Alumni Council. I wonder if we could let Dr. Rouse give his testimony now because we are going to be called over to a vote just almost immediately. We have 5 or 6 minutes remaining on the rollcall.

STATEMENT OF ROSCOE ROUSE, PH. D., DEAN OF LIBRARY SERVICES, OKLAHOMA STATE UNIVERSITY, ON BEHALF OF RESEARCH LIBRARIES

Mr. ROUSE. Thank you, Mr. Chairman.

Senator BOREN. I apologize for the way the schedule is this morning.

Mr. ROUSE. It is understandable.

Senator BOREN. We are very happy to have you with us this morning.

Mr. ROUSE. Thank you.

I represent the Association of Research Libraries, which is an organization of the 113 largest research libraries in North America. Most of these 113 institutions have collections of manuscripts and papers, and important documents, which primarily have been given to them. I appreciate the opportunity to testify on behalf of that organization.

We, Mr. Chairman, as Americans, stand on the belief that the preservation of our rich heritage is important to us to pass on to our descendants. We wonder now why, then, we created a law back in 1969 which almost prohibits the preservation of this heritage.

In my preparation for this testimony, I talked with a number of my colleagues, as well as with artists and writers. My inquiries lead me to the conclusion, from the responses I got, that virtually no one is really benefiting from the present law on estate and gift taxation, and the sum that the law brings into the national coffers is really inconsequential as compared with the figures for the National Government today.

There is an author in Oklahoma, with whom I talked, who has written about two dozen books. I said to him: "Aren't you interested in passing those manuscripts on to a library for preservation?" He has them in his home in the country. He said, quoting him: "I have no incentive to donate my manuscripts under the present laws to a library."

The point needs to be made, I think, that not all manuscript material comes out in print form. Handwritten notes along the margin of a manuscript, as you heard earlier this morning, tell worlds about people and events, which we don't see in finished volumes.

Sometimes, large sections, even chapters, in manuscripts are omitted, and I think you know this from your own experience with bills and resolutions. These are important documents that we should keep.

In Oklahoma there is an effort on the part of some people to write a bill that will encourage literary and artistic donations from writers and artists, an Oklahoma incentive.

I have talked to a number of people who say that the donation of manuscripts had dropped away considerably, as you have heard other people say this morning.

I will pass over those instances, but I have heard this from the University of Texas, from USC, from the University of Tulsa, where they say that scholarship is inhibited by this new law.

Senator BOREN. They have suffered a significant decline in gifts and donations since the 1969 act was passed.

Mr. ROUSE. Yes, since 1969, 75 to 80 percent, one person said that the donations had been reduced by that amount.

So why is it important that we maintain these manuscripts and papers in archives, libraries, and museums? Why don't we let the families keep them in the attics, in the trunks and the shoeboxes?

Simply because paper deteriorates, and vermin and varmints destroy it, and the heat and the humidity oxidize it.

Furthermore, relatives don't give a darn. We don't know how many important papers we have lost because relatives don't really know what they have.

I will simply say that we endorse S. 649 as the preferred bill, as noted by some of the other individuals. We want to see these papers preserved, and we think that you, the members of this subcommittee, will want to work along with us to preserve the heritage of our nation.

Thank you very much for the opportunity to testify.

[Statement of Mr. Rouse follows:]

Statement of Roscoe Rouse,
Dean of Library Services, Oklahoma State University
Before the Subcommittee on
Estate and Gift Taxation of the
Committee on Finance, U.S. Senate
November 10, 1981

Thank you for the opportunity to testify in support of S. 649, S. 851, and S. 852, measures that would provide tax relief for individuals who donate their creative works to libraries, museums, and other non-profit institutions. I am testifying on behalf of the Association of Research Libraries, an association of 113 of the largest research libraries in North America. Most of these 113 institutions house collections of manuscripts, papers, drawings, and other unique creative works used by students, scholars, and researchers from all parts of this country and from around the world. The donations of artists and writers have formed the lifeblood of great manuscript collections, such as those of the Library of Congress or the New York Public Library, and of smaller collections that preserve the history and culture of regions throughout the United States. These collections could not have been developed without the donations by creative individuals who wished to see their works stored, preserved, and made accessible to the public. Unfortunately, since the enactment of the Tax Reform Act of 1969, most artists and writers find they can no longer afford to make such donations.

The United States has long used the Federal tax system to encourage private philanthropy. The charitable deduction, which has been a component of the permanent Federal income tax almost since the inception of the tax, influences the largest source of private giving to non-profit organizations — giving by individuals. Under the current tax law as enacted in 1969, an individual collector who donates a work of art or manuscript to a library can take advantage of the charitable deduction at fair market value, but an individual who wishes to donate his <u>own</u> creation is ineligible for such a tax deduction. The result of this inequity has been either to force the sale of such creative material in the market place, or to cause potential donors to deposit rather than give their works to a library or museum. Both results have had a devastating effect on the ability of libraries to preserve and provide access to the manuscripts of living authors.

Few libraries can collect manuscripts, letters, and drawings by purchasing them, for such expensive items would quickly deplete book budgets hard hit by inflation and the decreased budgets of libraries' parent institutions. Instead they must rely on private contributions. For example, at the University of Iowa only 5% of the several million items in the manuscript collection were acquired by purchase; 2% of the ten million items in the University of Virginia's fine collections were purchased. Iowa State University, like many other state universities, has no funds at all for purchasing manuscripts. Its library's collection of papers from important Midwesterners was built entirely through the generosity of donors. While donors who have purchased the manuscripts which they give still continue to contribute to the development of such collections, the creators of manuscripts are, since 1969, much less likely to do so.

My inquiries show that since 1969 there has been a sharp reduction in donations of manuscripts to many research libraries. Several of my Association's libraries estimate that donations by living authors have fallen off by 80 to 90%. The University of Kansas Library reports that donations of manuscripts have dwindled to almost none since 1969. Several authors, among them the well-known science fiction writer James E. Gunn, who had made regular contributions before 1969 informed the University of Kansas Library that they were ceasing to do so because of the financial strain placed on them by the 1969 tax code. At least six individuals, including two well-known authors, stopped making outright gifts of their papers to the University of Virginia in 1969. The stories can be repeated for many other libraries. Instead of being donated to a library, an author's papers are frequently sold to private collectors piecemeal, bringing high prices for individual items. Thus, not only are collections lost to public access through libraries, they are broken-up and dispersed so that many items are, in effect, lost to scholars entirely. While a few of these items will eventually make their way into libraries, since collectors can realize market-value tax benefits by donating works they have purchased, the usefulness of these works to scholars is often greatly diminished as they cannot be studied along with related papers.

Many authors are conscious of the importance of maintaining the condition and integrity of their papers within a library and, instead of selling them, place their works in a library on deposit. Some do so in hope that the 1969 law will be changed; others deposit collections with the expectation that their heirs will later donate the materials and receive a tax deduction. Unfortunately, this approach does not adequately solve the problems of preserving and providing access to the materials. Often the contract specifying the terms of deposit limits access to the collection. But more important, when libraries invest considerable staff time in preserving and organizing deposit collections, they are taking a gamble, since depositors may withdraw their materials at a later date. The University of Virginia Library lost an important archive when the potential donor withdrew it from the Library's stacks and put it up for sale at a price the library could not afford. The University of Iowa Library has found that it cannot take the risk of investing funds to provide access to deposit collections and does not do so until a collection is actually turned over permanently.

Three bills under consideration by the Subcommittee — S. 649, S. 851, S. 852 — represent commendable efforts to rectify a situation which forces artists, writers and composers into the market place, either during their life times or in the persons of their executors after their deaths, in order to realize reasonable tax benefits from their intellectual work. S. 649 addresses itself in part to the estates of artists, writers, and composers, attempting to correct situations in which the families or executors sell materials, often at bargain rates, in order to pay estate taxes. Passage of S. 649 by the Senate would allow executors who are concerned about the preservation of an artist's work and the availability of that work for future scholarship to ensure access to the material while at the same time fulfilling the executor's own fiscal responsibility to the heirs. S. 649 would also permit a living artist or author to deduct from his taxable income the fair market value of a work contributed to a library or other institution . We heartily endorse both parts of S. 649 as reasonable, fair, and effective ways to encourage the contribution of creative works to institutions which make these works accessible to the public.

S. 851 and S. 852 address themselves in major part to the works of living artists, composers, and writers, and also provide a mechanism by which these creators may realize a tax benefit by donating their works to a non-profit educational institution such as an archive or library. S. 851 is a more satisfactory solution to the problem. S. 852 limits the credit allowed to "income received from sales of literary, musical, or artistic compositions". Many, if not a majority, of the serious writers, composers, and artists in the United States do not, in effect, earn their livings directly from their artistic efforts during their life time, but ~~in~~ other ways. Some teach in their own field; many others work completely outside their field of artistic interest, at least for a portion of their lives. Herman Melville worked in a customs office; William Carlos Williams was a physician, and

Wallace Stevens an insurance broker. S. 852 would not have allowed these three American artists to benefit in any way from a decision to donate their manuscripts to libraries or archives. S. 851 on the other hand, does not carry the limitations found under Section 44(F)(c) and (d) of S. 852, and therefore would be more broadly applicable.

Measures such as S. 649 and S. 851 are badly needed, and they are needed now more than ever. A recent study by the Urban Institute has found that the Economic Recovery Tax Act of 1981 reduces the tax incentives for those who now make large charitable contributions to institutions of higher education — including universities with important manuscript collections. Taking note of this situation, the Presidential Task Force on the Arts and Humanities is recommending several tax law changes to stimulate private giving. The first of the Task Force's recommendations is to amend the 1969 tax code so that those who produce creative works shall receive the same tax treatment, as a result of the charitable contribution of their work, available to a collector or other donor giving a purchased work or manuscript. We urge the Subcommittee on Estate and Gift Taxation to take a leadership role in responding to the Presidential Task Force by endorsing measures such as S. 649 and S. 851.

In responding to the President's call for reassessment of Federal priorities we hope the Subcommittee will not lose sight of the importance of preserving and studying the creations of America's artists, writers, composers, and philosophers. Enactment of the bills before you is an important step toward sharing the artistic documents of this generation with the American people, now and in the future.

Thank you.

Senator BOREN. I really appreciate your testimony, and we will have your full statement also inserted in the record. I appreciate your taking the time to come.

Mr. ROUSE. I did submit a written statement, but I was speaking supplementary to the written statement.

Senator BOREN. We will have both in the record. We will have the full statement as well as the abbreviated remarks.

I have only 3½ minutes left to make the rollcall on the floor, which I have to get to the Capitol.

Mr. HANES. May I put something in the record?

Senator BOREN. Certainly.

Mr. HANES. I would like to answer Senator Long's two questions, just for the record. So I will go ahead~~, and~~ you will go ahead.

Senator BOREN. That will be all right for you to just go ahead. If you give it to the reporter, it can be placed in the record.

Let me also say that staff has informed me that the record will remain open for 30 days, and if there are others here who have relationships with organizations and institutions that might like to make a comment, or if some of you who have testified may know of others who might want to submit a statement for the record, we will be very, very happy to receive that, if they would make contact with us during the next 30-day period.

Let me again apologize to you. Unfortunately, with 100 Senators, one of us never gets to control the schedule of the others. So I am going to have to literally dash to the Capitol to get there before the rollcall ends.

On behalf of all the members of the committee, I want to thank those who have taken the time to come and testify before us. I think there is tremendous support for making a change in the 1969 law on the committee. We are concerned about the loss of manuscripts and works of art to our institutions. I think that some action will be forthcoming, and your interest in it is very helpful to those of us who support that cause. We appreciate you being here.

Mr. ROUSE. Thank you.

Mr. HANES. I wanted to respond to Senator Long's two questions. He suggested the possibility that a museum could get a friendly appraiser and greatly overestimate the value of a work of art to be given to the museum.

The Treasury Department has the most outstanding and prestigious organization in America for the appraisal of works of art. So far as I know, their judgments have never been questioned by anybody, donor, donee, nor the Bureau of Internal Revenue. So that danger does not exist.

The other question he raised was this whole matter of the artist getting a benefit that nobody gets. He gets no benefit at all now. We feel very strongly that this is necessary.

Senator Long, I appreciate his being here, but he need not fear about an over appraisal of the works of any living artist.

Thank you very much.

[Whereupon, at 10:30 a.m., the subcommittee adjourned, to reconvene at the call of the Chair.]

ADDITIONAL ESTATE AND GIFT TAX ISSUES

WEDNESDAY, NOVEMBER 18, 1981

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

The hearing was convened, pursuant to notice, at 2:10 p.m., in room 2221, Dirksen Senate Office Building, Hon. Steven D. Symms (chairman) presiding.

Present: Senators Symms and Boren.

[The committee press release announcing this hearing; the bills S. 1430 and S. 1487; the description of these bills by the Joint Committee on Taxation and Senator Symms opening statement follow:]

[Press Release No. 81-176]

FINANCE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION SETS HEARING ON ESTATE TAX BILLS

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 estate tax bills on November 18, 1981.

The hearing will begin at 2:00 p.m., in Room 2221 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Symms indicated that the following bills would be discussed:

S. 1430—introduced by Senator Baker, with Senator Sasser. The bill would provide that the election to use the alternate valuation date for the estate tax may be made on a return that is filed late.

S. 1487—Introduced by Senator Boren, with Senators Baucus, Bentsen, Symms, and others. The bill would allow independent local newspapers to contribute corporate earnings into a trust to provide for prepayment of estate taxes.

DESCRIPTION OF TAX BILLS

RELATING TO

ELECTION OF ALTERNATE VALUATION DATE ON LATE RETURN (S. 1430) AND THE INDEPENDENT LOCAL NEWSPAPER ACT OF 1981 (S. 1487)

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Finance Committee's Subcommittee on Estate and Gift Taxation has scheduled a hearing on November 18, 1981, regarding estate taxes.

There are two bills scheduled for the hearing: S. 1430 (Senators Baker and Sasser), relating to the election of the alternate valuation date on a late estate tax return, and S. 1487 (Senator Boren, et al.), relating to the Independent Local Newspaper Act of 1981.

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of the provisions of the bills, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 1430—Senators Baker and Sasser

Election of Alternate Valuation Date on Late Estate Tax Return

Under present law, an executor may elect to value assets for estate tax purposes as of the date of the decedent's death or the alternate valuation date, which is generally six months after the date of the decedent's death. Alternate valuation must be elected on an estate tax return that is timely filed.

The bill would permit an executor to elect alternate valuation on a timely filed estate tax return or, if no estate tax return is timely filed, on the first estate tax return filed.

Generally, the bill would apply with respect to estates of decedents dying after the date of the bill's enactment. For estates of decedents dying on or before that date, the bill would permit an effective election of alternate valuation date to be made within one year after enactment of the bill by filing a written notice with the Internal Revenue Service.

2. S. 1487—Senators Boren, Cohen, Kasten, Pressler, Stevens, Helms, Baucus, Lugar, Pell, Cochran, Williams, Goldwater, Schmitt, Dixon, Riegle, Symms, Bentsen, and Inouye

The Independent Local Newspaper Act of 1981

The bill would allow an independent local newspaper to establish a tax-exempt trust fund in order to pay the estate taxes of the owners of the newspaper. Contributions to the trusts by the newspaper would generally be deductible by the newspaper for income tax purposes and would not be includible in the income of its owners. Interests in the trust would be exempt from the estate tax. In addition, the bill would provide an extended payment period for estate taxes attributable to an interest in an independent local newspaper.

II. DESCRIPTION OF THE BILLS

1. S. 1430—Senators Baker and Sasser

Election of Alternate Valuation Date on Late Estate Tax Return

Present Law

Under present law, the executor of a decedent's estate may value the property in the gross estate as of the date of the decedent's death or the "alternate valuation date," which is generally six months after the date of the decedent's death (sec. 2032). Alternate valuation provides estate tax relief when property in a decedent's estate declines in value shortly after the decedent's death. Alternate valuation must be elected by the executor on an estate tax return filed within nine months of the date of death or any period of extension granted by the Internal Revenue Service (sec. 2032(c)).[1]

Under section 6081, the Internal Revenue Service may grant an extension of time to file an estate tax return. Except in the case of taxpayers who are abroad, the Internal Revenue Service has no discretionary authority to grant an extension exceeding six months.

Issue

The issue is whether an executor should be permitted to elect alternate valuation on an estate tax return that is not timely filed.

Explanation of the Bill

The bill would permit the election of alternate valuation on a timely filed estate tax return or the first late return filed. In the case of a timely filed return, an executor would not be permitted to change the election after the due date for the return had passed. In the case of a late return, the election could not be changed after the first return had been filed.

Effective Date

The provisions of the bill would apply to estates of decedents dying after the date of the bill's enactment.

The bill includes a transitional rule applicable to estates of decedents dying on or before the date of the bill's enactment. The transitional rule would permit an effective election of alternate valuation to be

[1] An executor may elect alternate valuation by checking a box on Form 706, United States Estate Tax Return. An executor's failure to check the appropriate box on a timely filed Form 706 may not prevent the use of alternative valuation where the entries on the form are otherwise consistent with an election of alternate valuation (Rev. Rul. 61–128, 1961–2 C. B. 150).

made within one year after enactment of the bill by filing a written notice with the Internal Revenue Service. If an election were made under the transitional rule, an assessment of a deficiency in tax could be made within two years of the election although such assessment would otherwise be barred.

Revenue Effect

The bill would reduce budget receipts by an insignificant amount each year.

Prior Congressional Action

During the 96th Congress, the House passed, on February 19, 1980, a similar provision in a bill (H.R. 2492), except that it contained no transitional rule for estates of decedents dying before 1981.

That bill, with the House version of the similar provision, was favorably reported by the Senate Finance Committee on May 6, 1980 (S. Rept. No. 96-664). However, a similar provision was removed from the bill by a Senate floor amendment. The bill, with the similar provision deleted, was then enacted (P.L. 96-605).

2. S. 1487—Senators Boren, Cohen, Kasten, Pressler, Stevens, Helms, Baucus, Lugar, Pell, Cochran, Williams, Goldwater, Schmitt, Dixon, Riegle, Symms, Bentsen, and Inouye

The Independent Local Newspaper Act of 1981

Present Law

With respect to a trust established for the purpose of paying estate taxes attributable to an interest in a business (including an independent local newspaper), no provision is presently made under the Code for (1) according tax-exempt status to such a trust, (2) allowing income tax deductions for payments by the newspaper to the trust, (3) excluding payments to the trust from the gross income of the individual for whose benefit the trust is established, or (4) excluding the corpus (and accumulated income) of the trust from taxation in the gross estate of the decedent for whose benefit the trust was established.

Present law contains provisions for installment payment of estate tax attributable to an interest in a closely held business. In the case of decedents dying after December 31, 1981, section 6166 provides a 14-year period for the payment of the estate tax attributable to the decedent's interest in a closely held business. Under this provision, the executor can elect to defer principal payments for up to 5 years from the due date of the estate tax return. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 annual installments. In order to qualify for this installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must exceed 35 percent of the value of the gross estate reduced by allowance expenses, indebtedness, and losses.[1]

Under section 6166, an interest in a closely held business is defined as:

(1) an interest as a proprietor in a trade or business carried on as a proprietorship,

(2) an interest as a partner in a partnership carrying on a trade or business if the partnership has 15 or fewer partners or at least 20 percent of the partnership's capital interest is included in the decedent's gross estate, or

[1] In the case of estates of decedents dying before January 1, 1982, present law provides two overlapping installment payment provisions—sections 6166 and 6166A. Section 6166 provides for a 14-year payment period of estate tax attributable to a closely held business interest where the value of the closely held business interest exceeds 65 percent of the value of the gross estate reduced by the allowable expenses, indebtedness, and losses. Section 6166A provides a 10-year payment period of estate tax attributable to a closely held business interest where the value of the business interest is in excess of either 35 percent of the value of the gross estate or 50 percent of the taxable estate.

The Economic Recovery Tax Act of 1981 combined the two sections by broadening the application of section 6166 and repealing section 6166A, effective for estates of decedents dying after December 31, 1981.

(3) an interest in a corporation carrying on a trade or business if the corporation has 15 or fewer shareholders or at least 20 percent of the corporation's voting stock is included in the decedent's gross estate.[2]

In addition, present law provides that certain redemptions of stock in closely held corporations are to be treated as sales or exchanges (subject to capital gain treatment) instead of dividend income to the extent of any Federal estate taxes, State death taxes, funeral expenses, and administration expenses borne by the redeemed shareholders (sec. 303). To qualify for this treatment, the value of the stock of the redeeming corporation includable in the decedent's gross estate must be more than 35 percent of the "adjusted gross estate."[3]

Issues

The first issue is whether the provisions of present law that provide special relief for estates comprised largely of interests in closely held businesses from estate tax liquidity problems are inadequate to meet the needs of owners of independent local newspapers.

If the first issue is answered in the affirmative, the other issues are (1) whether an independent local newspaper should be permitted to establish a tax-exempt trust to pay estate taxes of any owner in the newspaper attributable to the value of his interest in the newspaper, (2) whether the funds contributed to the trust (within prescribed limits) should be deductible by the newspaper and excludable from income by the owner for income tax purposes, (3) whether the value of the trust assets should be excludable from the owner's gross estate in computing estate taxes, and (4) whether a special 14-year period should be provided for the payment of any estate tax attributable to the value of an interest in the newspaper to the extent the tax is not paid by the trust.

Explanation of the Bill

Under the bill, an independent local newspaper could establish a tax-exempt trust to receive payments to pay the estate tax liability of any owner of the newspaper. The newspaper would be allowed an income tax deduction in an amount not to exceed 50 percent of its taxable income for amounts paid to the trust. The trust assets would be required to be invested solely in obligations of the United States. The assets of the trust could be used only to pay the Federal estate taxes of any owner of the newspaper.

The trust would be limited to holding amounts necessary to pay the potential Federal estate tax liability of the newspaper owner. In determining this limitation, the potential estate tax liability of a living individual would be considered to be 70 percent (i.e., the maximum estate tax rate for estates of decendents dying before January 1, 1982) of

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[2] This definition applies under section 6166 regardless of whether the decedent dies before or after December 31, 1981. Section 6166A defines an interest in a closely-held business in the same way except there can be no more than 10 partners or shareholders.

[3] The required percentage is 50 percent in the case of estates of decedents dying before January 1, 1982.

the value of his interest in the business.[4] Under the bill, any interest of a decedent in the trust would generally not be included in the decedent's gross estate.

If an owner of a newspaper which has established a trust for his benefit dispose of his interest in the newspaper, the amounts in the trust must be distributed and included in the owner's income and the deductions previously allowed the newspaper would be recaptured. In addition, if the newspaper is disposed of by an heir within 15 years after the death of the owner, an additional estate tax would be imposed. This tax is phased out between the tenth and fifteenth years following the owner's death.

An "independent local newspaper" is defined as a newspaper publication which is not a member of a chain of newspapers if it has all of its publishing offices in a single city, community, or metropolitan area, or, as of January 1, 1981, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on January 1, 1981, and which are not published in a single city, community, or metropolitan area.

Under the bill, any estate tax attributable to the value of an independent local newspaper not paid by a trust established under the provisions of this bill could be paid in installments over a period of up to 14 years. This special provision for independent local newspapers would apply where the estate did not qualify under existing extended payment provisions of present law. Under this extended payment provision, the executor could elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first four years, payable at the rate of 4 percent, would be payable annually. Thereafter, the principal amount of the estate tax liability plus accrued interest could be paid in from 2 to 10 annual installments. If the business ceased to qualify as an independent local newspaper, the extension would terminate.

Effective Date

The income tax provisions of the bill would apply to taxable years ending after December 31, 1980. The estate tax provisions of the bill would apply to the estates of decedents dying after December 31, 1980.

Revenue Effect

The bill would reduce budget receipts by less than $25 million annually.

Prior Congressional Action

96th Congress

In the 96th Congress, a bill (S. 555), containing substantially identical provisions, was the subject of hearings by the Subcommittee on Taxation and Debt Management Generally of the Committee on Finance on October 31, 1979. No further action was taken with respect to this bill.

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[4] The Economic Recovery Tax Act of 1981 reduced the maximum estate tax rate from 70 percent to 50 percent in 5-percent reductions over a 4-year period beginning with decedents dying in 1982.

II

97TH CONGRESS
1ST SESSION

S. 1430

To amend the Internal Revenue Code of 1954 relating to estate taxes to provide that the election to use the alternate valuation date may be made on a return that is filed late.

IN THE SENATE OF THE UNITED STATES

JUNE 25 (legislative day, JUNE 1), 1981

Mr. BAKER (for himself and Mr. SASSER) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 relating to estate taxes to provide that the election to use the alternate valuation date may be made on a return that is filed late.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 2032(c) of the Internal Revenue Code of 1954 (relating to election of alternate valuation) is amended to read as follows:

"(c) TIME OF ELECTION.—The election provided for in this section shall be exercised by the executor on his return not later than the time such return is filed.".

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(b) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendment made by subsection (a) of this Act shall apply to estates of decedents dying after the date of enactment.

(2) TRANSITIONAL RULE.—

(A) In the case of an estate of a decedent dying on or before the date of enactment of this Act, an election under section 2032 of the Internal Revenue Code will be considered as made on a return filed within the time prescribed by law if the executor files a written statement of election within 1 year after the date of enactment of this Act in such manner as the Secretary of the Treasury or his delegate prescribes by regulations. If the executor files a written statement pursuant to the preceding sentence, the election under section 2032 made by such executor shall be irrevocable.

(B) If—

(i) credit or refund of the amount of any overpayment of estate tax or overpayment of income tax for any taxable year attributable to an election under this paragraph is not prevented on the date of the enactment of this Act, by the operation of any law or rule of law, and

(ii) credit or refund of the amount of such overpayment is prevented, by the operation of any law or rule of law (other than chapter 74 of the Internal Revenue Code of 1954, relating to closing agreements and compromises), at any time on or before the expiration of the 2-year period beginning on the date of the enactment of this Act, credit or refund of such overpayment may, nevertheless, be allowed or made, to the extent such overpayment is attributable to such election, if claim therefor is filed before the expiration of such 2-year period.

(C) The statutory period for the assessment of any deficiency in estate tax or in income tax against any person for any taxable year, to the extent such deficiency is attributable to an election under this paragraph, shall not expire before the last day of the 2-year period beginning on the date of the enactment of this Act; and such deficiency may be assessed at any time before the expiration of such 2-year period, notwithstanding any law or rule of law which would otherwise prevent such assessment.

II

97TH CONGRESS
1ST SESSION

S. 1487

To amend the tax laws of the United States to encourage the preservation of independent local newspapers.

IN THE SENATE OF THE UNITED STATES

JULY 15 (legislative day, JULY 8), 1981

Mr. BOREN (for himself, Mr. COHEN, Mr. KASTEN, Mr. PRESSLER, Mr. STEVENS, Mr. HELMS, Mr. BAUCUS, Mr. LUGAR, Mr. PELL, Mr. COCHRAN, Mr. WILLIAMS, Mr. GOLDWATER, Mr. SCHMITT, Mr. DIXON, Mr. RIEGLE, Mr. SYMMS, and Mr. BENTSEN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the tax laws of the United States to encourage the preservation of independent local newspapers.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Independent Local Newspaper Act of 1981".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

(c) TABLE OF CONTENTS.—

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SEC. 2. CERTAIN ADVANCE ESTATE TAX PAYMENT TRUSTS.

(a) IN GENERAL.—Subchapter F of chapter 1 (relating to exempt organizations) is amended by adding at the end thereof the following new part:

"PART VIII—CERTAIN ADVANCE ESTATE TAX PAYMENT TRUSTS

"SEC. 529. INDEPENDENT LOCAL NEWSPAPER ADVANCE ESTATE TAX PAYMENT TRUST.

"(a) REQUIREMENTS FOR QUALIFICATION.—A trust created or organized in the United States for an individual who has an interest in an independent local newspaper business shall constitute a trust qualified under this section if—

"(1) the trust is created pursuant to a plan adopted by such independent local newspaper business;

"(2) the plan adopted—

"(A) requires the creation of trusts conforming to the requirements of paragraph (3) for one or more individuals having an interest in such independent local newspaper business,

"(B) requires contributions to be made to such trusts by such independent local newspaper business during the period described in paragraph (3)(D) exclusively for the purpose described in paragraph (3)(E), and

"(C) limits the aggregate contributions to such trusts for any taxable year to 50 percent of the taxable income derived from the independent local newspaper business (determined as provided in subsection (e)); and

"(3) the written governing instrument creating each such trust meets the following requirements:

"(A) the contributions to and income of the trust will be invested solely in obligations of the United States except for cash on hand or in bank accounts pending such investment;

"(B) the trustee is a bank (as defined in section 401(d)(1)) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section;

"(C) the assets of the trust will not be commingled with other property except in a common trust fund;

"(D) the contributions to the trust will be made exclusively by such independent local newspaper business during the lifetime of the individual for whom such trust is created, and after his death during the period (including any extension period) prior to payment of the tax imposed by section 2001;

"(E) the assets of the trust will be devoted exclusively to the prompt payment of the tax imposed by section 2001 which is attributable to the interest in such independent local newspaper business includable in the gross estate of such individual, except to the extent of any excess funding of the trust; and

"(F) any excess funding of the trust will be distributed to such individual if living or if deceased to his estate within 65 days of the determination of such excess funding.

"(b) LIMITATION.—In the case of an individual who has an interest in more than 1 independent local newspaper business, a trust qualified under this section may be created or organized only with respect to the interest in 1 (and not more than 1) such independent local newspaper business includable in the gross estate of such individual.

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) DEFINITIONS.—For purposes of this section—

"(A) INDEPENDENT LOCAL NEWSPAPER BUSINESS.—The term 'independent local newspaper business' means—

"(i) a proprietorship which publishes an independent local newspaper;

"(ii) a partnership which publishes an independent local newspaper and which has none of its outstanding partnership interests traded in an established securities market; or

"(iii) a corporation which publishes an independent local newspaper and which has none of its outstanding capital stock traded in an established securities market.

"(B) INTEREST IN AN INDEPENDENT LOCAL NEWSPAPER BUSINESS.—The term 'interest in an independent local newspaper business' means—

"(i) the interest of the proprietor in a proprietorship described in subparagraph (A)(i) to the extent the value of such interest is attributable to the independent local newspaper published by such proprietorship;

"(ii) the interest of a partner in a partnership described in subparagraph (A)(ii) to the extent the value of such interest is attributable to the independent local newspaper published by such partnership; or

"(iii) the stock of a corporation described in subparagraph (A)(iii) to the extent the value of such stock is attributable to the independent local newspaper published by such corporation.

"(C) INDEPENDENT LOCAL NEWSPAPER.—The term 'independent local newspaper' means a newspaper publication which is not one of a chain of newspaper publications and which has all of its publishing offices (containing its principal editorial, reportorial, circulation, and business staff) in a single city, community, or metropolitan area, or, on January 1, 1981, within one State.

"(D) CHAIN OF NEWSPAPER PUBLICATIONS.—The term 'chain of newspaper publications' means 2 or more newspaper publications which are not published in a single city, community, or metropolitan area or, on January 1, 1981, within one State and are controlled, directly or indirectly, by the same person or persons.

"(E) EXCESS FUNDING.—The term 'excess funding' means the excess of the face value of the assets of a trust qualified under this section over—

"(i) 70 percent of the value of the interest in an independent local newspaper business which would be includable in the gross estate of the individual for whom such trust was created; or

"(ii) in the case of a decedent, the tax imposed by section 2001 which is attributable to the interest in an independent local newspaper business included in the gross estate of such decedent.

"(F) ATTRIBUTABLE ESTATE TAX.—The term 'the tax imposed by section 2001 which is attributable to the interest in an independent local newspaper business' means the excess of the tax imposed by section 2001 over the tax which would have been imposed if the interest in an independent local newspaper business had not been included in the gross estate of the decedent.

"(2) SPECIAL RULES.—For purposes of this subsection—

"(A) TIME FOR DETERMINATIONS.—Except as otherwise provided by subsection (d) or (g)—

"(i) in the case of an individual, all determinations shall be made as of December 31 of each calendar year, and

"(ii) in the case of a decedent, all determinations shall be made as of the time the tax imposed by section 2001 is finally determined.

"(B) CONTROLLED GROUP OF CORPORATIONS.—In applying paragraphs (1)(A)(iii), (1)(C), and (1)(D) of subsection (c), if a corporation is a member of a controlled group of corporations (as defined by section 1563 but substituting the phrase '50 percent' for the phrase '80 percent' each place appearing therein), the determination whether such corporation is publishing an independent local newspaper shall be made by treating all members of such controlled group as a single corporation.

"(C) VALUE ATTRIBUTABLE TO INDEPENDENT LOCAL NEWSPAPER.—In applying paragraph (1)(B) (ii) or (iii) of subsection (c), the determination of the value of an interest in a partnership or the stock of a corporation which is attributable to an independent local newspaper shall, except in the case of a decedent, be made by apportioning the net fair market value of such independent local newspaper (determined as a separate going business concern) proportionately among all the outstanding interests in such partnership or proportionately among all the outstanding shares of the capital stock of such corporation, as the case may be, except that the apportionment made to a partnership interest or corporate preferred stock possessing limited equity participation rights shall not exceed such limited equity participation rights.

"(D) CERTAIN INDIRECT INTERESTS.—In applying paragraph (1)(B) of subsection (c), if an individual is the grantor of a trust which holds an interest in an independent local newspaper business and is treated as the owner of such interest by section 671, or is the beneficiary of a trust which holds an interest in an independent local newspaper business and a deduction was allowed with respect to such interest by section 2056(a), such individual shall be treated as owning the interest held by such trust to the extent such interest is includable in the gross estate of such individual.

"(d) TAX TREATMENT OF QUALIFIED TRUST AND THE INDIVIDUAL FOR WHOM ESTABLISHED.—

"(1) EXEMPTION FROM TAX UNDER THIS TITLE.—

"(A) QUALIFIED TRUST.—Any trust qualified under this section is exempt from taxation under this title except to the extent otherwise provided by paragraph (2).

"(B) INDIVIDUAL FOR WHOM ESTABLISHED.—Except to the extent otherwise provided by paragraph (2), any individual for whom there is created a trust qualified under this section, and the estate of any such individual, is exempt from taxation under this title with respect to—

"(i) such trust and the contributions made to, the gross income earned by, and the payments of the tax imposed by section 2001 made by, such trust in accordance with its governing instrument, and "(ii) the distributions, if any, made by the independent local newspaper business to any other person who has an interest in such independent local newspaper business on account of the contributions made to such trust.

Any other person who has an interest in such independent local newspaper business shall also be exempt from taxation under this title with respect to such trust (including the contributions to, gross income of, and payments made by such trust).

"(2) TERMINATION OF TAX EXEMPT STATUS.—

"(A) EVENTS CAUSING LOSS OF QUALIFICATION.—If a trust qualified under this section is not administered in conformity with any of the requirements specified in subsection (a) and the regulations prescribed by the Secretary to carry out the purposes of this section, then the trust shall cease to be exempt from taxation under this title and the assets of the trust shall be distributed to the individual by or for whom such trust was created if he is then living or if he is then deceased shall be distributed to his estate.

"(B) DISPOSITIONS AND OTHER EVENTS CAUSING EXCESS FUNDING.—If at any time—

"(i) any part of the interest in an independent local newspaper business is sold, exchanged, or otherwise disposed of (other than under the individual's will or applicable law of descent and distribution) or becomes traded in an established securities market, and such event results in the excess funding of a trust qualified under this section;

"(ii) the local independent newspaper ceases to be published or is sold or otherwise disposed of or ceases to qualify as a newspaper publication which is not one of a chain of newspaper publications; or

"(iii) there is for any other reason an excess funding of a trust qualified under this section;

then the amount of such excess funding shall be distributed to the individual for whom such trust was created if he is then living or if he is then deceased shall be distributed to his estate.

"(C) TAXATION OF DISTRIBUTED AMOUNTS.—

"(i) INDIVIDUAL.—Any amount distributed to the individual for whom such trust was created shall be included in the gross income of such individual for the taxable year of distribution.

"(ii) ESTATE.—Any amount distributed to the estate of a decedent shall be included in the gross income of the estate for the taxable year of distribution as an item of income in respect of a decedent subject to section 691, and shall be included in the decedent's gross estate in determining the tax imposed by section 2001.

"(e) TAX TREATMENT OF INDEPENDENT LOCAL NEWSPAPER BUSINESS.—

"(1) DEDUCTION FOR CONTRIBUTIONS.—Any contribution made by an independent local newspaper business to a trust qualified under this section in accordance with the terms of the governing instrument of such trust shall be deductible under section 162 provided such contribution is paid to the trust during the taxable year and at a time when the trust is exempt from taxation this title. For purposes of this paragraph, an independent local newspaper business shall be deemed to have made a payment on the last day of the taxable year if the payment is on account of such taxable year and is not made later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

"(2) LIMITATIONS ON DEDUCTION FOR CONTRIBUTIONS.—

"(A) EXCESS FUNDING.—No deduction under section 162 shall be allowed for any contribution to the extent such contribution results in the excess funding of a trust qualified under this section.

"(B) 50 PERCENT OF TAXABLE INCOME.—No deduction under section 162 shall be allowed for any contribution to the extent the aggregate contributions made during the taxable year exceeds 50 percent of the taxable income derived from such independent local newspaper (determined on a separated basis and without regard to such contributions) for the taxable year.

"(3) RECAPTURE OF DEDUCTIONS FOR PRIOR CONTRIBUTIONS.—If at any time a trust qualified under this section is required to make a distribution described in subsection (d)(2) and if an independent local newspaper business realized a tax benefit as a result of prior contributions to such trust, then such independent local newspaper business (and in the case of a deceased proprietor his estate) shall include in its gross income for the taxable year ending with or during the taxable year of such distribution or if none, for the taxable year immediately preceding the taxable year of such distribution an amount equal to the lesser of—

"(A) the amount required to be distributed under paragraph (2), or

"(B) the prior contributions made to such trust as to which a tax benefit was realized.

"(f) INADVERTENT EXCESS FUNDING.—If there is excess funding of a trust qualified under this section for any calendar year and such excess funding is due solely to a decrease in, or to a good faith dispute concerning, the value of the interest in an independent local newspaper business held by or includable in the gross estate of the individual for whom such trust was created, then the determination of the amount of such excess funding shall be postponed to, and shall be made as of, the last day of the fifth calendar year immediately following such calendar year (or in the event of such individual's earlier death, the date of the determination of the tax imposed by section 2001) and the amount of any excess funding existing on the last day of such fifth calendar year (or the date of such determination) shall be distributed to such individual (or if he is then deceased shall be distributed to his estate).

"(g) TAX TREATMENT OF DISPOSITIONS BY HEIR OR LEGATEE.—

"(1) RECAPTURE OF ESTATE TAX BENEFITS.— If, at any time within 15 years after the death of the individual for whom a trust qualified under this section was created—

"(A) a trust described in paragraph (2)(D) of subsection (c), or any person receiving under such individual's will or applicable law of descent and distribution, sells, exchanges, or otherwise disposes of any part of the interest in the independent local newspaper business with respect to which the qualified trust was created, or

"(B) the local independent newspaper is sold or otherwise disposed of or ceases to qualify as a newspaper publication which is not one of a chain of newspaper publications,

then the estate tax of such individual shall be redetermined, as of the date of such disposition or other event, by including as part of the gross estate of such individual an amount equal to the payment made by such trust of the tax imposed by section 2001 which is attributable, in the case of such a disposition, to the interest disposed of, or in the case of any such other event, to the interest in the independent local newspaper business included in the gross estate of such individual.

"(2) SELLS, EXCHANGES, OR OTHERWISE DISPOSES OF.—For purposes of paragraph (1), the term 'sells, exchanges, or otherwise disposes of' does not include—

"(A) an exchange of stock pursuant to a plan of reorganization described in subparagraph (E) or (F) of section 368(a)(1),

"(B) a distribution or exchange of stock pursuant to a plan of reorganization described in subparagraph (D) of section 368(a)(1) or a distribution to which section 355 (or so much of section 356 as relates to section 355) applies by reason of subsection (h), or

"(C) a transfer or distribution to an executor or trustee, or by an executor or trustee, or a person entitled to receive such interest, under a will, applicable laws of descent and distribution or governing trust instrument,

but the person receiving the interest in the independent local newspaper business with respect to which such qualified trust was created shall be subject to this section.

"(3) EXTENSION OF PERIOD FOR ASSESSMENT AND COLLECTIONS.—Any additional estate tax owing as a result of such redetermination shall be immediately due and payable by the person making such disposition, or the persons holding the interest in the independent local newspaper business as of the date of such other event, as the case may be, and the periods of limitations provided in sections 6501 and 6502 on the making of assessments and the collection by levy or a proceeding shall with respect to any deficiency (including interest and additions to the tax resulting from such redetermination) include 1 year immediately following the date on which the Secretary is notified of such disposition or other event in accordance with regulations prescribed by the Secretary; and such assessment and collection may be made notwithstanding any provision of law or rule of law to the contrary.

"(4) PHASEOUT OF ANY ADDITIONAL ESTATE TAX.—If the date of disposition or such other event occurs more than 120 months and less than 180 months after the death of such individual, the amount of any additional estate tax shall be reduced (but not below zero) by an amount determined by multiplying the amount of such tax (determined without regard to this paragraph) by a fraction—

"(A) the numerator of which is the number of full months after such individual's death in excess of 120, and

"(B) the denominator of which is 60.

"(h) SPINOFF OF UNRELATED BUSINESS.—

"(1) GENERAL REQUIREMENTS.—If an independent local newspaper business described in paragraph (1)(A)(iii) of subsection (c) adopts a plan described in subsection (a) and is engaged in the active conduct of a trade or business in addition to the publication of an independent local newspaper, each of which satisfies the requirements of section 355(b)(2), then the distribution to its shareholders of stock of a controlled corporation (as defined in section 355(a)(1)(A)) engaged in the active conduct of such other trade or business or of such newspaper, so that the determination of the value of its stock attributable to its independent local newspaper is facilitated, shall be treated as satisfying the requirements of section 355(a)(1)(B) (including the required corporate business purpose) provided that the following conditions are satisfied:

"(A) The distributee shareholders do not, prior to the fifth anniversary of the date of distribution, sell, exchange or otherwise dispose of the stock of either the distributing corporation (as defined in section 355(a)(1)(A)) or the controlled corporation except—

"(i) pursuant to a redemption described in section 303 or a plan of reorganization described in section 368(a)(1) (D), (E), or (F),

"(ii) by will or by the laws of descent or distribution, or

"(iii) in the case of a distributee corporation or trust, by distribution to its shareholders or beneficiaries;

"(B) The distributee shareholders (including the successors-in-interest to a deceased distributee shareholder and the shareholders or beneficiaries of a distributee corporation or trust) retain control (as defined in section 368(c)) of the distributing corporation and controlled corporation throughout the 5-year period ending on the fifth anniversary of the date of distribution; and

"(C) The distributing corporation and the controlled corporation each continue to be engaged in the active conduct of the trade or business conducted on the date of distribution throughout the 5-year period ending on the fifth anniversary of the date of distribution.

"(2) EXTENSION OF PERIOD FOR ASSESSMENT AND COLLECTION.—If the distributing corporation or controlled corporation fails to meet the conditions contained in paragraph (1)(C) or if the distributee shareholders (including the successor-in-interest to a deceased distributee shareholder and the shareholders or beneficiaries of a distributee corporation or trust) fail to meet the conditions contained in subparagraphs (A) or (B) of paragraph (1) during any taxable year within 5 years from the date of distribution, then the periods of limitations provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding shall not expire, with respect to any deficiency (including interest and additions to the tax) resulting from such failure, until 1 year after the date on which the distributing corporation, the controlled corporation, or a distributee shareholder (including the successors-in-interest to a deceased distributee shareholder and the shareholders or beneficiaries of a distributee corporation or trust) notifies the Secretary of such failure in accordance with regulations prescribed by the Secretary, and such assessment and collection may be made notwithstanding any provision of law or rule of law to the contrary.

"(3) INVOLUNTARY CHANGE OF TRADE OR BUSINESS.—The distributing corporation and the controlled corporation shall be treated as meeting the conditions of paragraph (1)(C) if—

"(A) one of such corporations ceases to be engaged in the trade or business such corporation conducted on the date of distribution as a result of—

"(i) an involuntary conversion,

"(ii) an order of a governmental regulatory agency, or

"(iii) a contested or consent order of any Federal court, and

"(B) the other such corporation continues throughout the 5-year period described in paragraph (1)(C) to actively conduct the trade or business which such other corporation conducted on the date of distribution.

"(i) APPLICABILITY.—This section shall be applicable to trusts created after December 31, 1980.

"(j) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to the application of this section..

"(k) CROSS REFERENCES.—

"(1) ESTATE TAX.—For the exclusion from the gross estate of a decedent of a trust qualified under this section, see section 2046.

"(2) INCOME IN RESPECT OF DECEDENT.—For the taxation of income in respect of a decedent, see section 691.".

(b) CLERICAL AMENDMENT.—The table of parts for subchapter F of chapter 1 is amended by adding at the end thereof the following new item:

"Part VIII. Certain advance estate tax payment trusts.".

(c) CONFORMING AMENDMENTS.—

(1) Section 2002 (relating to liability for payment of estate taxes) is amended by striking out "executor." and inserting in lieu thereof "executor except to the extent paid by an independent local newspaper advance estate tax payment trust as provided by section 529.".

(2) Section 2013 is amended by adding at the end thereof the following new subsection:

"(h) TAX IMPOSED UNDER SECTION 2046 ON CERTAIN INDEPENDENT LOCAL NEWSPAPER ADVANCE TAX PAYMENT TRUSTS.—For purposes of this section, if section 2046 applies to exclude any property from the gross estate of the transferor and an additional tax is imposed with respect to such property under section 259(g)—

"(1) the additional tax imposed by section 529(g) shall be treated as a Federal estate tax payable with respect to the estate of the transferor; and

"(2) the value of such property and the amount of the taxable estate of the transferor shall be determined as if section 2046 did not apply with respect to such property.".

(3) Part III of subchapter A of chapter 11 (relating to gross estate) is amended by adding at the end thereof the following new section:

"SEC. 2046. EXCLUSION OF NEWSPAPER TRUST.

"Notwithstanding any other provision of law, the value of the gross estate shall not include the value of any interest of the decedent at the time of his death in, or any tax payments made by, an independent local newspaper advance estate tax payment trust to the extent provided by section 529.".

(4) The table of sections for part III of subchapter A of chapter 11 of subtitle B is amended by adding at the end thereof the following new item:

"Sec. 2046. Exclusion of newspaper trust.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years ending after December 31, 1980.

SEC. 3. EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE INCLUDES INTEREST IN INDEPENDENT LOCAL NEWSPAPER.

(a) IN GENERAL.—Subchapter B of chapter 62 (relating to extension of time for payment of estate tax) is amended by adding after section 6166A the following new section:

"SEC. 6166B. EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE INCLUDES INTEREST IN INDEPENDENT LOCAL NEWSPAPER.

"(a) EXTENSION PERMITTED.—If an interest in an independent local newspaper business is included in the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States, the executor may elect to pay, in 2 or more (but not exceeding 10) equal installments, part or all of the tax imposed by section 2001 attributable to the interest in 1 (but not more than 1) such independent local newspaper business. Any such election shall be made not later than the time prescribed by section 6075(a) for filing the return of such tax (including extensions thereof), and shall be made in such manner as the Secretary shall by regulations prescribe. If an election under this section is made, the provisions of this subtitle shall apply as though the Secretary were extending the time for payment of the tax.

"(b) LIMITATION.—The maximum amount of tax which may be paid in installments as provided in this section shall be—

"(1) the excess of—

"(A) the amount of tax imposed by section 2001 on the estate of the decedent, over

"(B) the tax which would have been imposed under section 2001 if the interest in an independent local newspaper business had not been included in the gross estate of the decedent, reduced by

"(2) all payments of the tax imposed by section 2001 which are made by an independent local newspaper advance estate tax payment trust described in section 529 at or before the time prescribed by section 6075(a) for filing the return of such tax (including extensions thereof).

"(c) DEFINITIONS AND SPECIAL RULES.—

"(1) DEFINITIONS.—For purposes of this section, the terms 'independent local newspaper business', 'interest in an independent local newspaper business', 'independent local newspaper', and 'a chain of newspaper publications' have the meaning given such terms in section 529(c).

"(2) SPECIAL RULES.—For purposes of this subsection—

"(A) TIME FOR DETERMINATIONS.—Except as otherwise provided by paragraph (3) of subsection (g), all determinations shall be made as of the time immediately before the decedent's death.

"(B) CONTROLLED GROUP OF CORPORATIONS.—In applying paragraphs (1)(A)(iii), (1)(C), and (1)(D) of subsection (c), if a corporation is a member of a controlled group of corporations (as defined by section 1563 but substituting the phrase '50 percent' for the phrase '80 percent' each place appearing therein), the determination whether such corporation is publishing an independent local newspaper shall be made by treating all members of such controlled group of corporations as a single corporation.

"(C) CERTAIN INDIRECT INTERESTS.—In applying paragraph (1)(B) of subsection (c), if an individual is the grantor of a trust which holds an interest in an independent local newspaper business and is treated as the owner of such interest by section 671, or is the beneficiary of a trust which holds an interest in an independent local newspaper business and a deduction was allowed with respect to such interest by section 2056(a), such individual shall be treated as owning the interest held by such trust to the extent such interest is includable in the gross estate of such individual.

"(d) DATE FOR PAYMENT OF INSTALLMENTS.—If an election is made under subsection (a), the first installment shall be paid on or before the date selected by the executor which is not more than 5 years after the date prescribed by section 6151(a) for payment of the tax, and each succeeding installment shall be paid on or before the date which is 1 year after the date prescribed by this subsection for payment of the preceding installment.

"(e) PRORATION OF DEFICIENCY TO INSTALLMENTS.—If an election is made under subsection (a) to pay any part of the tax imposed by section 2001 in installments and a deficiency has been assessed, the deficiency shall (subject to the limitation provided by subsection (b)) be prorated to such installments. The part of the deficiency so prorated to any installment the date for payment of which has not arrived shall be collected at the same time as, and as a part of, such installment. The part of the deficiency so prorated to any installment the date for payment of which has arrived shall be paid upon notice and demand from the Secretary. This subsection shall not apply if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with intent to evade tax.

"(f) INTEREST.—If the time for payment of any amount of tax has been extended under this section, interest payable under section 6601 on any unpaid portion of such amount shall be paid annually on each anniversary of the date prescribed by section 6151(a) for payment of the tax. Interest, on that part of a deficiency prorated under this section to any installment the date for payment of which has not arrived, for the period before the date fixed for the last installment preceding the assessment of the deficiency, shall be paid upon notice and demand from the Secretary.

"(g) ACCELERATION OF PAYMENT.—

"(1) DISPOSITION OF INTEREST.—If any part of the interest in an independent local newspaper business is sold or exchanged or otherwise disposed of (including by means of a distribution), then the extension of time for payment of tax provided in this section shall cease to apply with respect to the tax attributable to the interest sold, exchanged or otherwise disposed of and any unpaid portion of such tax shall be due and payable upon notice and demand by the Secretary. The tax attributable to such interest shall bear the same proportion to the total tax as to which an extension has been granted as the value of the interest so disposed of bears to the total value of the interest as to which such extension has been granted.

"(2) TERMINATION OF STATUS OF INDEPENDENT LOCAL NEWSPAPER.—If any part of the interest in the independent local newspaper business becomes traded in an established securities market, or if the independent local newspaper ceases to be published or is sold or otherwise disposed of or ceases to qualify as a newspaper publication which is not one of a chain of newspaper publications, the unpaid portion of the tax payable in installments shall be due and payable upon notice and demand from the Secretary.

"(3) FAILURE TO PAY INSTALLMENT.—If any installment under this section is not paid on or before the date fixed for its payment by this section (including any extension of time for the payment of such installment), the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.

"(4) EXCEPTIONS.—

"(A) Paragraph (1) does not apply to an exchange of stock pursuant to a plan of reorganization described in subparagraph (E) or (F) of section 368(a)(1), but any stock received in such an exchange shall be treated for purposes of such paragraph as an interest qualifying under subsection (a).

"(B) Paragraph (1) does not apply to a distribution of stock pursuant to a plan of reorganization described in subparagraph (D) of section 368(a)(1) or a distribution to which section 355 (or so much of section 356 as relates to section 355) applies by reason of section 529(g).

"(C) Paragraph (1) does not apply to a transfer of property of the decedent by the executor to a person entitled to receive such property under the decedent's will or under the applicable law of descent and distribution.

"(h) APPLICABILITY.—This section shall apply to the estate of decedents dying after December 31, 1980.

"(i) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to the application of this section.

"(j) CROSS REFERENCES.—

"(1) SECURITY.—For authority of the Secretary to require security in the case of an extension under this section, see section 6165.

"(2) LIEN.—For special lien (in lieu of bond) in the case of an extension under this section, see section 6324A.

"(3) PERIOD OF LIMITATION.—For extension of the period of limitation in the case of an extension under this section, see section 6503(d).

"(4) INTEREST.—For provisions relating to interest on tax payable in installments under this section, see subsection (j) of section 6601.".

(b) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 62 is amended by adding after section 6166A the following new item:

"Sec. 6166B. Extension of time for payment of estate tax where estate includes interest in independent local newspaper.".

(c) CONFORMING AMENDMENTS.—

(1) Section 6166A(b) is amended by striking out "The maximum" and inserting in lieu thereof "No election may be made under this section if an election under section 6166 or 6166B applies with respect to the estate of such decedent, and the maximum".

(2) The following provisions are each amended by striking out "or 6166A" each place it appears therein and inserting in lieu thereof ", 6166A, or 6166B":

(A) section 2204(a),

(B) section 2204(b),

(C) section 2204(c),

(D) section 6324A(a),

(E) section 6324A(c)(2),

(F) section 6324A(e)(1),

(G) section 6324A(e)(3), and

(H) section 6324A(e)(4).

(3) Paragraph (4) of section 6166(a) is amended by striking out "section 6166A" and inserting in lieu thereof "section 6166A or 6166B".

(4) Section 6324A is amended—

(A) by striking out "or 6166A(h)" in paragraphs (3) and (5) and inserting in lieu thereof ", 6166A(h), or 6166B(g)", and

(B) by striking out "OR 6166A" in the heading and inserting in lieu thereof ", 6166A, OR 6166B".

(5) Subsection (d) of section 6503 is amended by striking out "or 6166A" and inserting in lieu thereof "6166A, or 6166B".

(6) Subsection (j) of section 6601 is amended by striking out "6166" each place it appears in the text and caption thereof and inserting in lieu thereof "6166 or 6166B".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the estates of decedents dying after December 31, 1980.

STATEMENT BY SENATOR STEVEN SYMMS

Good afternoon. The Estate and Gift Tax Subcommittee intends to discuss two issues today. The first bill, S. 1430, would permit the election of alternate valuation on a timely filed estate tax return or the first late return filed. In the case of a timely filed return, an executor would not be permitted to change the election after the due date for the return had passed. In the case of a late return, the election could not be changed after the first return had been filed.

I believe that the only matter of controversy is whether an executor should be permitted to elect alternate valuation on an estate tax return that is not timely filed. Since the bill would have a very insignificant revenue impact and would provide a measure of relief to certain estates, I do not believe that there should be much opposition to its eventual passage.

The second bill that we intend to address is S. 1487, legislation which would allow an independent local newspaper to establish a tax-exempt trust fund in order to pay the estate tax of the owners of the newspaper. Essentially, the bill would establish a vehicle whereby independent newspaper owners would be allowed to prepay their estate taxes.

Over the past thirty years, the ownership pattern of newspapers in this country has drastically changed. While the number of daily newspapers has remained fairly constant, the growth of groups or chains has become predominant. Today, almost two-thirds of the daily newspapers are owned by chains and media conglomerates. More significant is the fact that these chains control more than 72 percent of all daily circulation. The four largest chains control 30 percent of the nation's daily newspaper circulation, while the 23 largest chains control over 50 percent of all daily circulation.

In the past few years, the chains have been buying 40 to 50 independent dailies each year. At present, there are just over 600 independently owned dailies left. In ten years time, there will be none. Moreover, the chains will not only be controlling all daily newspapers, but will have extended their ties to television, cable and other electronic media.

The same situation prevails in the weekly newspaper field. Last year, 175 weeklies were purchased by the chains—the same chains buying out the dailies.

The chains are not establishing new newspapers, daily or weekly, but are buying out existing newspapers. And, each purchase results in the loss of an independent community based "voice" and base of opinion.

The reason independent newspaper owners are selling out to the chains is because of the approach used by the IRS in valuing a company in an estate on its potential sale or merger value instead of its going-concern value as a business. Since the chains are paying 40, 50, and even 60 times annual earnings for the remaining independents, the potential sale or merger value of an independent newspaper is many times that of its going-concern value as a business. As a result, the estate tax burden is inflated and the independents are forced to sell because there is no possible way in which they would be able to meet their artificially inflated estate tax payments.

Monopoly concentration of the media is not only detrimental to the ability of many voices to be expressed in our society, but it could actually be a threat to the continued existence of a free society. It has become apparent in recent years that hostile intelligence services have made disinformation a major component of their operations against the United States, Consequently, the concentration of the media makes it much easier for misinformation to be promulgated.

Our current tax code has created this situation, and S. 1487 corrects the serious situation that the estate tax laws have imposed.

I believe that it is absolutely essential that independent voices be heard in each of our communities. Those voices should not be controlled by a conglomerate, feeding controlled information to all of our citizens.

Senator SYMMS. Good afternoon.

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I believe that the only matter of controversy is whether an executor should be permitted to elect alternate valuation on the estate tax return that is not timely filed. Since the bill would have a very insignificant revenue impact and would provide a measure of relief to certain estates, I do not believe that there should be much opposition to its eventual passage.

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In the past few years, the chains have been buying 40 to 50 independent dailies each year. At present, there are just over 600 independently owned dailies left. In 10 years time, there will be none at the current rate of takeover. Moreover, the chains will not only be controlling all daily newspapers but will have extended their ties to television, cable, and other electronic media.

The same situation prevails in the weekly newspaper field. Last year, 175 weeklies were purchased by chains—the same chains buying out the dailies.

The chains are not establishing new newspapers, daily or weekly, but are buying out existing newspapers, and each purchase results in the loss of an independent community-based voice and a base of opinion.

The reason independent newspaper owners are selling out to the chains is because of the approach used by the IRS in valuing a company in an estate on its potential sale or merger value instead of its going-concern value as a business. Since the chains are paying 40, 50, and even 60 times annual earnings for the remaining independents, the potential sale or merger value of an independent newspaper is many times that of its going-concern value as a business. As a result, the estate tax burden is inflated, and the independents are forced to sell because there is no possible way in which they would be able to meet their artificially high-priced estate tax payments.

Monopoly concentration of the media is not only detrimental to the ability of many voices to be expressed in our society, but it could actually be a threat to the continued existence of a free society. It has become apparent in recent years that hostile intelligence services have made misinformation a major component of their operations against the United States. Consequently, the concentration of the media makes it much easier for misinformation to be promulgated.

Our current tax code has created this situation, and S. 1487 corrects the serious situation that the estate tax laws have imposed.

I believe that it is absolutely essential that independent voices be heard in each of our communities, and these voices should not be controlled by a conglomerate feeding controlled information to all the citizens.

So I welcome those witnesses that we will hear from this afternoon. Our first witness, who has been before our committee many times, Mr. David Glickman, Deputy Assistant Secretary for Tax Policy of the Department of the Treasury.

David, welcome to the committee. We are happy to hear from you.

STATEMENT OF HON. DAVID GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. Thank you, Mr. Chairman.

I am pleased to have an opportunity to present the views of the Treasury Department on S. 1430, which would permit an executor to elect alternate valuation on an estate tax return filed after the due date, and S. 1487, the Independent Local Newspaper Act of 1981, which would provide special income and estate tax rules relating to the estate tax payment trusts for owners of interests in certain newspapers.

The Treasury Department does not oppose section 1430, provided the bill is amended to permit an alternate valuation election on a late return only upon a showing of reasonable cause for the late filing, and, two, to delete the transitional rule in the bill.

With respect to S. 1487, Treasury strongly opposes that bill.

With respect to S. 1430, the value of property included in the gross estate of a decedent generally is determined on the date of the decedent's death or, if the executor elects, the alternate valuation date. The alternate valuation date is the date 6 months after the date of the decedent's death. Alternate valuation originated in the 1930's and was intended to lessen the impact of the estate tax when property held by a decedent declines sharply in value shortly after the decedent's death.

Under current law, alternate valuation is available only if the executor makes an election on a timely filed return which includes the extensions for filing. S. 1430 would amend section 2032 of the Internal Revenue Code to provide that an executor would be entitled to elect alternate valuation on an estate tax return filed after the due date.

The Treasury Department, as I stated, does not oppose the substantive change proposed by S. 1430, provided the bill is modified to permit the election on a late-filed return only upon a showing of reasonable cause for the late filing. Without this additional requirement, we believe that the suggested change would exascerbate the potential for income tax abuses that exist under current law and would introduce a substantial degree of uncertainty concerning income tax basis determinations.

The potential for abuse of the alternate valuation election under current law stems from the fact that an heir's basis in the inherited property for income tax purposes is generally equal to the estate tax value of the property. For this reason, executors do not elect alternate valuation only to save estate taxes. In many cases where the estate tax consequences of the election may be relatively insignificant or even nonexistent, the executor may decide to elect alternate valuation solely for the purpose of maximizing income tax basis. The opportunity to increase income tax basis by electing alternate valuation without adverse estate tax consequences is heightened by the inerease in the unified credit and the enactment of the unlimited marital deduction in the Economic Recovery Tax Act of 1981, since those changes will increase the number of estates that will have little or no estate tax liability regardless of whether they may elect alternate valuation. For estates of this type, the decision of whether to elect alternate valuation under current law involves solely income tax considerations.

Use of the alternate valuation election for income tax planning purposes clearly was not the purpose of the alternate valuation provision when it was originally enacted, and thus the ability to use the election for income tax purposes represents a substantial flaw in the current statute.

Now, S. 1430, by permitting the alternate valuation election to be made on a late-filed return, could encourage executors to delay the filing of estate tax returns to obtain maximum income tax advantages in certain cases.

S. 1430 would also increase uncertainty concerning the income tax basis of estate beneficiaries. Our written statement, which has been submitted for the record, contains an example illustrating these problems. However, this problem would be decreased by requiring the showing of reasonable cause for the late filing in cases where the election is made on a late-filed return. For example, requiring a showing of reasonable cause to the satisfaction of the Commissioner within a 90-day period after the due date of the return would likely be satisfactory. Moreover, in view of the potential for income tax abuse under current law, we believe that the subcommittee should consider whether it is appropriate to permit a late election in any case where the only effect is to change the income tax basis of the estate's assets.

I think it is important to note that this abuse potential is not limited to the late-filing cases. We would, therefore, like to take this opportunity to recommend that this subcommittee consider whether the general alternate valuation rules should be amended to permit alternate valuation elections only where the estate tax liabilities are reduced. This would prevent the use of the alternate valuation solely to obtain income tax advantages. It certainly may be appropriate to consider such a change in connection with the present bill, and the Treasury would be pleased to work with this subcommittee in developing a specific proposal in this regard.

With respect to the transition rule, S. 1430 generally will apply to estates of decedents dying after the date of the enactment of the bill. The bill, however, has a transitional rule that permits estates of decedents dying on or before the date of enactment to elect alternate valuation by filing a written statement of election within 1 year after the date of enactment. We believe that this transitional rule is arbitrary and will create administrative problems.

Under the transitional rule, the beneficial estate tax treatment will be available for estates of decedents who die on or before the date of enactment only if the statute of limitations is still open on the estate tax. There are a variety of reasons why the statute of limitations may be open, none of which is necessarily relevant to whether the estate should be able to elect alternate valuation retroactively.

For example, if an estate litigates estate tax liability, the statute of limitations might remain open for years after the expiration of the normal 3-year limitation period. Therefore, under the transitional rule, an estate's ability to reduce its estate tax liability by electing alternate valuation will depend, at least in part, on how litigious the executor has been.

The transitional rule also would increase administrative difficulties in determining income tax basis. If an executor of an estate makes a retroactive election, he would have to notify each heir who receives property from the estate of the effect of the election on the income tax basis of the property to him. Furthermore, if an heir has sold or disposed of any of the distributed property, the heir would have to file one or more amended returns. These problems are all avoided if the bill only applies prospectively.

In view of these problems, Treasury opposes the transitional rule included in the bill. We believe that any change in existing law should apply prospectively only.

Now I would like to move to S. 1487.

As the subcommittee well knows, the impact of transfer taxes on our Nation's economy has been a source of considerable concern to the administration. When I testified 2 weeks ago before this committee, I went into great detail on the President's position with respect to the transfer taxes. This concern has been most recently been reflected in the Economic Recovery Act of 1981, which included major reductions in the estate and gift taxes and also expanded and liberalized provisions designed to ease estate tax liquidity problems for closely held businesses.

Despite the dramatic reduction in the Federal estate tax brought about by the Economic Recovery Tax Act, Congress continues to be faced with proposed legislation that would reduce the Federal estate tax burden of particular segments of society. Such proposals vividly illustrate that when Congress shows its willingness to grant estate tax concessions to one particular group, it will be faced with demands for special relief by other interested groups that believe their particular circumstances also warrant preferential treatment. Special interest provisions significantly hinder efforts to simplify the tax law and to reduce the burden of taxes on our society as a whole.

In view of these considerations, the Treasury Department opposes estate tax relief legislation intended to benefit particular industry groups. Our opposition to such legislation is not based upon revenue impact of each particular bill viewed in isolation; rather, it is based upon our concern regarding the effect of such a proposal on the overall fairness of an estate tax system.

Now, with respect to S. 1487, which is entitled the Independent Local Newspaper Act of 1981, it would create an extraordinary and complicated set of provisions to grant preferential income and estate tax treatment to independent local newspapers and their owners. The bill is divided into two main parts.

The first part would authorize any independent local newspaper to create an estate tax payment trust for each owner of an interest in the newspaper in order to provide a vehicle for funding the estate tax liability attributable to the owner's interest. The trust would be required to have an independent trustee, and it could invest only in obligations of the United States.

Contributions by the newspaper to the trust could be made during the owner's lifetime or during any period after the owner's death prior to the payment of all estate tax liabilities, taking into account any deferred payment period.

The value of an estate tax payment trust could not exceed either 70 percent of the value of the owner's interest, or, in other words, the estate tax computed at the highest marginal rate prior to the rate reduction made by the Economic Recovery Tax Act; or, after the owner's death, the actual estate tax attributable to the interest in the owner's estate, determined at the highest marginal rate applicable to that estate.

The newspaper would be entitled to an income tax deduction for its contributions to the trust, provided there was no excess funding of the estate tax liability and subject to an aggregate maximum deduction for contributions to all such trusts of 50 percent of the newspaper's taxable income, disregarding such contributions.

In addition, the newspaper's contribution to an owner's trust would not be included in the owner's gross income, and the income earned by the trust would be exempt from tax. Finally, the trust property would be excluded from the owner's gross estate, and distributions from the trust to pay estate taxes would not be treated as income to any person.

In order to obtain these benefits the newspaper must not be publicly owned or a member of a chain of newspaper publications, and it must have all of its publishing offices in a single metropolitan area or State. Special rules are provided to permit nontaxable spinoffs of related businesses by newspaper corporations for the ostensible purpose of facilitating the determination of the estate tax liability attributable to their newspaper businesses.

There are various recapture rules in the event of early disposal of the newspaper after the date of death, culminating at the end of 15 years.

Now, the second part of the bill would adopt a special estate tax deferral provision for estates of owners of qualifying newspaper interests. This provision would permit an owner's estate to elect to pay the estate tax attributable to the newspaper's interest, to the extent that it is not funded before death by contributions to an estate tax payment trust, on essentially the same terms as are permitted under present section 6166, except that the deferral privilege would be available without regard to the percentage of the owner's estate represented by the newspaper interest.

The Treasury Department in the past has opposed prior versions of this bill in testimony before congressional committees and continues to oppose the proposed legislation in the current bill. The bill provides preferential tax treatment to a selected group of taxpayers by overriding at least four principles of general applicability in our tax system.

First, the bill grants an income tax deduction to a newspaper for contributions to trusts established to fund estate tax liabilities for individual owners. There is no provision under current law that would permit an income tax deduction for amounts set aside to pay death taxes.

Second, the bill excludes from the owner's income any contribution by a newspaper to pay the owner's estate tax. This contradicts the general rule that would treat such a payment either as a dividend, to the extent of the earnings and profits of the corporation, or as a reduction of the owner's basis in the newspaper's interest.

Third, any earnings of the trust are exempt from income tax, even though the trust will be used to pay the tax obligations of private individuals and the earnings will never be subjected to income tax in the hands of the beneficiary. There is no comparable provision in the Internal Revenue Code providing such a complete and permanent exclusion for income earned by a private trust for the benefit of individual beneficiaries.

Fourth, the exclusion of the trust property from the owner's gross estate is contrary to the general rule that includes in the decedent's gross estate any property in which the decedent or his estate had an interest at the decedent's death.

This combination of extraordinary tax benefits would produce a substantial reduction in the income and estate tax liabilities of qualifying newspapers and their owners. In the case of a newspaper corporation with a 46-percent marginal income tax rate, the deduction at the corporate level would reduce the income tax liability by 46 percent of every contribution to an estate tax payment trust.

In addition, because of the estate tax exclusion for the estate tax payment trust, the estate of an owner in the 50-percent marginal estate tax bracket would have his estate tax liability reduced by approximately 50 percent of the amount of the trust. Thus, contrary to the arguments advanced by some proponents of the bill, the income tax deductions and the estate tax exclusion make it clear that the bill would result in significantly lower taxes for newspaper owners. Indeed, if the bill did not produce an ascertainable net benefit to the newspaper owners, we would question whether it could serve its stated purpose of reducing the estate tax problem faced by such individuals.

The joint committee staff, in their pamphlet, have estimated that the revenue impact would be less than $25 million annually.

In addition to the fundamental deficits noted above, we believe that S. 1478 presents many other questions and problems. These problems include, among other things: the assumption of a 70-percent marginal tax rate for every owner in determining permissible contributions to the owner's estate tax payment trust prior to the owner's death; the failure to require that the newspaper interest represent a specific percentage of the owner's estate to qualify for the benefit; the abuse potential inherent in virtually all of the special provisions included in the bill; the corporate law problems that would be faced by newspaper corporations in determining the amount to be contributed to a trust for a particular taxpayer; and, finally, but not the least, the complexity that the bill would add to the Internal Revenue Code.

Furthermore, we question whether the enactment of the bill would have its intended effect of reducing sales of independent local newspapers to newspaper chains. In this regard, we note that an extensive study recently conducted by the General Accounting Office has found that the special estate tax valuation rules of section 2032A of the Code have had no ascertainable effect in preventing further concentration in the ownership of farm real property.

If increasing concentration of the ownership of our Nation's newspapers is a problem that warrants Congress attention, then the problem should be addressed directly. We strongly object to the approach of S. 1487, which would grant newspaper owners a tax holiday without restricting in any way their ability to obtain the allegedly inflated market price for their newspaper interest. In other words, the bill would simply permit independent newspaper owners to have their cake and eat it, too.

Our opposition to S. 1487 should not be interpreted as indicating any lack of sympathy with the plight of owners of closely held businesses who find it difficult to plan for the payment of their estate taxes while retaining control of their businesses for their heirs. As previously noted, the administration's concerns about the burden of Federal estate taxes on closely held businesses, including independent local newspapers, were reflected in the estate tax reductions and the expansion and liberalization of sections 6166 and 303 in ERTA.

Notwithstanding the substantial estate tax relief measures included in that act, the administration remains concerned about the impact of the estate tax on our economy, in general, and closely held businesses, in particular. However, to the extent that additional estate tax reductions are considered in the future, the Treasury Department believes that such reductions should be accomplished in a way that applies across the board and does not elevate one particular industry to a preferred status over other industry groups. For this reason and the other reasons discussed, the Treasury Department opposes S. 1487.

Mr. GLICKMAN. Mr. Chairman, that is the conclusion of my statement, and I will be happy to answer any questions you might have.

Senator SYMMS. Thank you very much, Mr. Secretary. I appreciate your coming down here.

I have several questions I would like to ask. I may just ask a couple, then Senator Boren has an opening statement that he will make, and then he has some questions, also.

I am glad to see that the Treasury is sympathetic to the problem. I couldn't help but notice at the end of your statement, where you state, "as previously noted * * * the concern about the burden of * * * estate," I suppose the only answer for the newspaper industry and for those small family newspapers around the country that are soaked up at a very overvalued price of what they can earn as far as—in other words, the price paid for the papers, you realize, is usually much higher than what their on-the-street earning capacity is. You agree with that, don't you?

Mr. GLICKMAN. Mr. Chairman, speaking candidly, I have never bought or been involved with the purchase or sale of a newspaper.

This is what I understand you to say, and I assume that that is correct.

Senator SYMMS. Well, I would have to admit it is special legislation just for newspapers; however, we might just make the point that, if we want to solve the problem, we could support another bill that Senator Boren and I have introduced, just abolish the estate tax. That would cure the problem, too, then that would be equal for all.

Mr. GLICKMAN. Well, I think the last time I was here, Mr. Chairman, you and I discussed that issue, and I think we both agreed that the President has stated that if he had his way, that would be exactly the direction he would go in. The problem is that there are a variety of problems with that, including fiscal problems, and I don't think it is timely to do that.

But I think the President and the administration would strongly feel that whatever we do, though, we ought to be cutting evenhandedly across the board and affect all the private businesses and all the small ones, not just one segment of the industry.

Senator SYMMS. Well, I guess what is happening, though—you heard my opening statement about the numbers of papers that are being taken up. There is one other question I did want to ask you. Last year Treasury said that this bill would cost $10 million in tax expenditures, and I think you said $25 million in your statement. Why the big difference?

Mr. GLICKMAN. What I was using was the figure that was in the joint committee pamphlet. I think it said less than $25 million.

Senator SYMMS. So, in other words, that is a very arbitrary figure?

Mr. GLICKMAN. I don't know exactly what it is. Obviously, there is something there. Last year, as you said, we thought it was approximately $10 million. This year the joint committee's numbers indicate that it is going to be something less than 25.

Senator SYMMS. You heard my statements about disinformation, and I think that this administration certainly would be cognizant of the value of independent sources of news media in the country, because I think that how goes the success or failure of the Reagan administration may be dependent on the message that gets carried through the medium of the news media. Would you agree with that?

Mr. GLICKMAN. Oh, I think that this administration certainly would be interested in making sure that there was a free and independent press, however that is done. Yes, sir.

Senator SYMMS. Well, I find it of a little more concerning to me to see, as someone told me sometime, that one of the larger newspaper chains actually owns the single newspaper that is published in 26 of the 50 capitals. And when you determine the extent of foreign disinformation operations in this country, I think there is just no question, that a centralized news media makes it easier for foreign disinformation operations to plant stories that purposefully misrepresent issues to the American people, whether it is the issue of the B-1 bomber or any other issue. That, of course, has an impact on the thinking of the country, because what the people do is oftentimes what Congress responds to.

But I didn't want to talk so long. I want to yield to the prime sponsor of this bill, a very able member of this committee and of the Senate, Senator David Boren.

[The prepared statement of David G. Glickman follows:]

<u>For Release Upon Delivery</u>
Expected at 2:00 p.m. EST
November 18, 1981

STATEMENT OF DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 1430, which would permit an executor to elect alternate valuation on an estate tax return filed after the due date, and S. 1487 (The Independent Local Newspaper Act of 1981), which would provide special income and estate tax rules relating to estate tax payment trusts for owners of interests in certain newspapers.

Summary of Treasury Positions

The Treasury Department does not oppose S. 1430, provided the bill is amended (i) to permit the alternate valuation election on a late filed return only upon a showing of reasonable cause for the late filing and (ii) to delete the transitional rule in the bill.

Treasury strongly opposes S. 1487.

S. 1430 -- Election of Alternate Valuation on a Late Filed Estate Tax Return

The value of property included in the gross estate of a decedent generally is determined on the date of the decedent's death or, if the executor elects, the "alternate valuation date". The alternate valuation date is the date six months after the date of the decedent's death. Alternate valuation originated in the 1930's and was intended to lessen the impact of the estate tax when property held by a decedent declines sharply in value shortly after the decedent's death. Under current law, alternate valuation is available only if the executor makes an election on a timely filed estate tax return (taking any extension of the filing date into account). S. 1430 would amend section 2032 of the Internal Revenue Code to provide that an executor would be entitled to elect alternate valuation on an estate tax return filed after the due date.

Treasury does not oppose the substantive change proposed by S. 1430, provided the bill is modified to permit the election on a late filed return only upon a showing of reasonable cause for the late filing. Without this additional requirement we believe that the suggested change would exacerbate the potential for income tax abuse that exists under current law and would introduce a substantial degree of uncertainty concerning income tax basis determinations.

The potential for abuse of the alternate valuation election under current law stems from the fact that an heir's basis in inherited property for income tax purposes is generally equal to the estate tax value of the property. For this reason, executors do not elect alternate valuation only to save estate taxes. In many cases where the estate tax consequences of the election may be relatively insignificant, an executor may decide to elect alternate valuation for the purpose of maximizing income tax basis. The opportunity to increase income tax basis by electing alternate valuation without adverse estate tax consequences is heightened by the increase in the unified credit and the enactment of the unlimited marital deduction in the Economic Recovery Tax Act of 1981, since those changes will increase the number of estates that will have little or no estate tax liability regardless of whether they elect alternate valuation. For estates of this type, the decision of whether to elect alternate valuation under current law involves solely income tax considerations. Use of the alternate valuation election for income tax planning purposes clearly was not the purpose of the alternate valuation provision when it was originally enacted, and thus the ability to use the election for income tax purposes represents a substantial flaw in the current statute.

S. 1430, by permitting the alternate valuation election to be made on a late filed return, could encourage executors to delay the filing of estate tax returns to obtain maximum income tax advantage in certain cases. S. 1430 would also increase uncertainty concerning the income tax basis of estate beneficiaries. For example, suppose a decedent dies on February 1, 1982 owning only two assets, one of which is worth $250,000 and the other of which is worth $150,000 on the date of his death. The decedent's will leaves one-half of the estate to the decedent's son, the executor of his estate, and the other half of the estate to the decedent's wife. On August 1, 1982, six months after the decedent's death, the asset worth $250,000 at date of death has declined in value to $200,000 and the asset worth $150,000 at date of death has increased in value to $200,000. Assume that, on August 2, 1982, the asset worth $250,000 at date of death and $200,000 at the alternate valuation date is distributed to the wife, and the asset worth $150,000 at date of death and $200,000 at the alternate valuation date is distributed to the son. Both the son's and the wife's bases in their respective assets depend upon whether the alternate valuation date is elected. Under current law if no return is filed, or if no election is made on a timely return, their bases are fixed at date of death values no later than the due date for the estate tax return. Under S. 1430, the son could fail to file a timely return and thereafter at any time could file a late return electing the alternate valuation date. Because of the unified credit and the marital deduction available to the estate, there would be no estate tax liability and no penalties would be imposed for the late filing. Nonetheless, the election would retroactively increase the son's basis from $150,000 to $200,000 and decrease the wife's basis from $250,000 to $200,000. If the wife has sold her asset before the election using a $250,000 basis, she would have underreported the gain on her income tax return by $50,000.

We believe that problems of the sort illustrated in the above example would be decreased by requiring a showing of reasonable cause for the late filing in cases where the election is made on a late filed return. For example, requiring a showing of reasonable cause to the satisfaction of the Commissioner within 90 days after the due date of the return would satisfy our concerns in this regard. Moreover, in view of the potential for income tax abuse under current law, we believe that the Subcommittee should consider whether it is appropriate to permit a late election in any case where the only tax effect is to change the income tax basis of the estate's assets.

It should be noted that the above discussion illustrates a potential for significant income tax abuse in the current alternate valuation statute. This abuse potential is not limited to late filing cases. We would, therefore, like to take this opportunity to recommend that the Subcommittee consider whether the general alternate valuation rule should be amended to permit alternate valuation elections only where estate tax liabilities are reduced. This would prevent use of the election solely to obtain income tax advantages. It certainly may be appropriate to consider such a change in connection with the present bill. We will be pleased to work with the Subcommittee in developing a specific proposal in this regard.

S. 1430 generally will apply to estates of decedents dying after the date of enactment of the bill. The bill has, however, a transitional rule that permits estates of decedents dying on or before the date of enactment to elect alternate valuation by filing a written statement of election within one year after the date of enactment. We believe that this transitional rule is arbitrary and unfair and will create administrative problems.

Under the transitional rule, the beneficial estate tax treatment will be available for estates of decedents who die on or before the date of enactment only if the statute of limitations is still open on the estate tax. There are a variety of reasons why the statute of limitations might be open, none of which is necessarily relevant to whether an estate should be able to elect alternate valuation retroactively. For example, if an estate litigates its estate tax liability, the statute of limitations might remain open for years after the expiration of the normal 3-year limitations period. Therefore, under the transitional rule, an estate's ability to reduce its estate tax liability by electing alternate valuation will depend, at least in part, on how litigious the executor has been.

The transitional rule also would increase administrative difficulties in determining income tax basis. If an executor of an estate makes a retroactive election, he would have to notify each heir who received property from the estate of the effect of the election on the income tax basis of the property distributed to him. Furthermore, if an heir has sold or disposed of any of the distributed property, the heir would have to file one or more amended income tax returns. These problems are all avoided if the bill only applies prospectively.

In view of these problems, Treasury opposes the transitional rule included in the bill. We believe that any changes in the existing law should apply prospectively only.

S. 1487 -- The Independent Local Newspaper Act of 1981

As the Subcommittee well knows, the impact of transfer taxes on our nation's economy has been a source of considerable concern to the Administration. This concern was reflected most recently in the Economic Recovery Tax Act of 1981 (ERTA), which included major reductions in the estate and gift taxes and also expanded and liberalized provisions designed to ease estate tax liquidity problems for closely held businesses. Included among the changes made by ERTA were the following:

(1) the increase in the unified credit to expand the estate tax exemption from $175,625 to $600,000 for each individual;

(2) the decrease in the top estate tax rate from 70 percent to 50 percent;

(3) the enactment of an unlimited marital deduction, which permits an individual to avoid estate tax on an unlimited amount of property transferred to his or her surviving spouse;

(4) the expansion and liberalization of the estate tax deferral rules of section 6166 of the Code, which permit estate taxes attributable to a closely held business interest to be paid in installments if the interest represents 35 percent of the adjusted gross estate (reduced from the 65 percent requirement of prior law); and

(5) the reduction in the qualification test from 50 percent of the adjusted gross estate to 35 percent of the adjusted gross estate for stock redemptions under section 303 of the Code.

Despite the dramatic reductions in the Federal estate tax brought about by ERTA, Congress continues to be faced with proposed legislation that would reduce the Federal estate tax burden of particular segments of society. Such proposals vividly illustrate that when Congress shows its willingness to grant estate tax concessions to one particular group, it will be faced with demands for special relief by other interest groups that believe their particular circumstances also warrant preferential treatment. Special interest provisions significantly hinder efforts to simplify the tax law and reduce the burden of taxes on our society as a whole, since the interest groups that are successful in obtaining special relief are always reluctant to give up their preferential treatment.

In view of these considerations, the Treasury Department opposes estate tax relief legislation intended to benefit particular industry groups. Our opposition to such legislation is not based upon the revenue impact of each particular bill, viewed in isolation. Rather, it is based upon our concerns regarding the effect of such proposals on the overall fairness of our estate tax system.

Description of S. 1487

S. 1487, entitled The Independent Local Newspaper Act of 1981, would create an extraordinary and complicated set of provisions to grant preferential income and estate tax treatment to independent local newspapers and their owners. The bill is divided into two main parts.

The first part would authorize any independent local newspaper to create an estate tax payment trust for each owner of an interest in the newspaper, in order to provide a vehicle for funding the Federal estate tax liability attributable to the owner's interest. The trust would be required to have an independent trustee and could invest only in obligations of the United States. Contributions by the newspaper to the trust could be made during the owner's lifetime or during any period after the owner's death prior to the payment of all estate tax liabilities (taking any deferred payment period into account). The value of an estate tax payment trust could not exceed either 70 percent of the value of the owner's interest (i.e., the estate tax computed at the highest marginal rate prior to the rate reductions made by ERTA) or, after the owner's death, the actual estate tax attributed to the interest in the owner's estate (determined at the highest marginal estate tax rate applicable to the estate).

The newspaper would be entitled to income tax deductions for its contributions to the trust, provided there was no excess funding of the estate tax liability and subject to an aggregate maximum deduction for contributions to all such trusts of 50 percent of the newspaper's taxable income (disregarding such contributions). In addition, the newspaper's contribution to an owner's trust would not be included in the owner's gross income, and income earned by the trust would be exempt from tax. Finally, the trust property would be excluded from the owner's gross estate; and distributions from the trust to pay estate taxes would not be treated as income to any person.

In order to obtain these benefits, the newspaper must not be publicly traded or a member of a chain of newspaper publications and must have all its publishing offices in a single metropolitan area or state. Special rules are provided to permit nontaxable spin-offs of unrelated businesses by newspaper corporations for the ostensible purpose of facilitating the determination of the estate tax liabilities attributable to their newspaper businesses.

If the newspaper interest is sold or the newspaper becomes a part of a newspaper chain within fifteen years after the owner's death, an additional estate tax would be imposed to "recapture" the estate tax benefit resulting from the exclusion of the owner's estate tax payment trust from the owner's gross estate. The recapture tax would be phased out between the eleventh and fifteenth years after the owner's death. There are also rules that would "recapture" the prior benefits of the income tax deduction to the newspaper and the income exclusion to the owner; but these rules apparently would not apply if the recapture event occurs after the estate tax attributable to the newspaper interest is fully paid.

The second part of the bill would adopt a special estate tax deferral provision for estates of owners of qualifying newspaper interests. This provision would permit an owner's estate to elect to pay the estate tax attributable to the newspaper interest (to the extent that it is not funded before death by contributions to an estate tax payment trust) on essentially the same terms as are permitted under present section 6166 of the Internal Revenue Code, except that the deferral privilege would be available without regard to the percentage of the owner's estate represented by the newspaper interest.

Treasury Position

The Treasury Department has opposed prior versions of the bill in testimony before Congressional committees on numerous occasions and continues to oppose the proposed legislation in the current bill. The bill provides preferential tax treatment to a select group of taxpayers by overriding at least four principles of general applicability in our tax system.

First, the bill grants a deduction to a newspaper for contributions to trusts established to fund estate tax liabilities for its individual owners. There is no provision under current law that would permit an income tax deduction for amounts set aside to pay death taxes.

Second, the bill excludes from the owner's income any contribution by a newspaper to pay the owner's estate taxes. This contradicts the general rules that would treat such a payment either as a dividend, to the extent the payment is made from a corporation's earnings and profits, or as a reduction in the owner's basis in his newspaper interest.

Third, any earnings of the trust are exempt from income tax, even though the trust will be used to pay the tax obligations of private individuals and the earnings will never be subject to income tax in the hands of any beneficiary. There is no comparable provision in the Internal Revenue Code providing such a complete and permanent exclusion for income earned by a private trust for the benefit of individual beneficiaries.

Fourth, the exclusion of the trust property from the owner's gross estate is contrary to the general rule that includes in a decedent's gross estate any property in which the decedent or his estate had an interest at the decedent's death.

This combination of extraordinary tax benefits would produce a substantial reduction in the income and estate tax liabilities of qualifying newspapers and their owners. In the case of a newspaper corporation with a 46 percent marginal income tax rate, the deduction at the corporate level would reduce the newspaper's income tax liability by 46 percent of every contribution to an estate tax payment trust. In addition, because of the estate tax exclusion for the estate tax payment trust, the estate of an owner in the 50 percent marginal estate tax bracket would have its estate tax liability reduced by approximately 50 percent of the amount of the trust. Thus, contrary to the arguments advanced by some proponents of the bill, the income tax deduction and the estate tax exclusion make it clear that the bill would result in significantly lower taxes for newspaper owners. Indeed, if the bill did not produce an ascertainable net benefit to newspaper owners, we would question whether it could serve its stated purpose of reducing the estate tax problems faced by such individuals.

In addition to the fundamental defects noted above, we believe that S. 1478 presents many other problems. These problems include, among other things: the assumption of a 70 percent marginal estate tax rate for every owner in determining permissible contributions to the owner's estate tax payment trust prior to the owner's death; the failure to require that the newspaper interest represent a specific percentage of the owner's estate to qualify for the benefit; the abuse potential inherent in virtually all of the special provisions included in the bill; the corporate law problems that would be faced by newspaper corporations in deciding the amounts to be contributed to trusts for particular shareholders; and the complexity that the bill would add to the Internal Revenue Code.

Furthermore, we question whether the enactment of the bill would have its intended effect of reducing sales of independent local newspapers to newspaper chains. In this regard, we note that an extensive study recently conducted by the General Accounting Office has found that the special estate tax valuation rules of section 2032A of the Code have had no ascertainable effect in preventing further concentration in the ownership of farm real property. If increasing concentration of the ownership of our nation's newspapers is a problem that warrants Congressional attention, then the problem should be addressed directly. We strongly object to the approach of S. 1487, which would grant newspaper owners a tax holiday without restricting in any way their ability to obtain the allegedly inflated market prices for their newspaper interests. In other words, the bill would simply permit independent newspaper owners to "have their cake and eat it too."

Our opposition to S. 1487 should not be interpreted as indicating any lack of sympathy with the plight of owners of closely held businesses who find it difficult to plan for the payment of their estate taxes while retaining control of their businesses for their heirs. As previously noted, the Administration's concerns about the burden of federal estate taxes on closely held businesses (including independent local newspapers) were reflected in the estate tax reductions and the expansion and liberalization of sections 6166 and 303 of the Code in ERTA.

Notwithstanding the substantial estate tax relief measures included in ERTA, the Administration remains concerned about the impact of the federal estate tax on our economy in general, and closely held businesses in particular. However, to the extent that additional estate tax reductions are considered in the future, the Treasury Department believes that such reductions should be accomplished in a way that applies across the board and does not elevate one particular industry to a preferred status over other industry groups. For this reason and the other reasons discussed above, the Treasury Department opposes S. 1487.

STATEMENT OF HON. DAVID L. BOREN, U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator BOREN. Thank you, Mr. Chairman. I would like to make a brief statement before directing some further questions to Secretary Glickman.

Over the past 30 years, a profound change has occurred in the ownership structure of newspapers in this country. While the number of daily newspapers has remained fairly constant at 1,750, the growth of groups or chains has become predominant. Today almost two-thirds of the daily newspapers are owned by chains and media conglomerates. More significant is the fact that these chains control more than 73 percent of all daily circulation. The four largest chains control 30 percent of the Nation's daily newspaper circulation, while the 25 largest chains control over 50 percent of all daily circulation. At present there are just over 600 independently owned dailies left out of the 1,750 that I mentioned earlier, and the trend has been alarming, indeed. There has been a rapid shift in the percentage of newspapers owned by chains as opposed to those that are locally and independently owned.

Why do the independents sell out? Obviously, high prices are a great temptation for some. Others find that there is no interest in the next generation of their families tending to operate an independent newspaper. However, I believe, as do many other observers, Mr. Chairman, that the most significant cause of sales to the chains may be found in the Federal estate tax laws. The Internal Revenue Service bases its valuation of an estate on the amount a willing buyer will pay to a willing seller. Thus, while independent newspaper owners may consider value to be something like 10 to 15 times earnings, the IRS must look at an amount a chain would pay for an independent. That sometimes can be as much as 40 times earnings.

Here is an example. If a newspaper were earning $250,000 per year, its value to a chain might be as high as $12 million. The estate tax, at 70 percent, would be over $8.5 million. Of course, that would be reduced somewhat now that we are reducing the estate tax downward; but still, it is a very significant figure.

Should the heir to a newspaper seek to borrow such sums to pay estate taxes, the annual cost of interest on the loan would be more than three times the newspaper's annual earnings. Is it any wonder that the heirs must sell or that an owner sells prior to death to put his estate in order?

The Independent Local Newspaper Act offers a novel approach to the estate tax problem. Rather than seeking a lower tax rate for newspapers or exemption or exclusion from the sum to be paid, the bill provides for a form of prepayment of the estate tax. This is to avoid the catastrophic situation now facing the heirs of a newspaper.

This act would allow the owners of an independent newspaper to establish an advance estate tax payments trust to be funded by corporate earnings, with not more than 50 percent of pretax income of the newspaper in any one year. The contributions to and income of the trust may be invested solely in obligations of the United States. Excess funding of the trust is expressly prohibited. The funds accumulated in the trust may be used only to pay the estate taxes of the owners of the newspaper.

This advance estate tax payment trust does offer major tax benefits to owners of independent newspapers. No one would dispute that. The funding of this trust will come from the pretax income of the newspaper. It is recognized that, with a valuation of 40 to 60 times earnings, it will be difficult to fully fund the trust, and there must be incentives for funding. However, if the owners of the newspapers have established such a trust and sell their newspaper, the bill provides for penalties which would amount to some 118 percent of the funds in the trust. So the amount would be recouped. The bill also has a recapture provision, should the heirs attempt to sell the newspaper after having benefited from the trust.

I think that is very, very important. The Treasury has indicated that they doubt that this would have the effect of preserving these independent, family owned newspapers. If we have had a newspaper set up with this kind of situation, if the heirs do end up selling within a brief period of time after they have taken advantage of this trust operation, or if the owner sells prior to death, then there will be recapture by the Government of any revenues that we lost. So I would say that tax benefit will accrue only if, indeed, those who are involved with the newspaper do continue to maintain the independence of that newspaper and the local ownership of this newspaper.

I think the bill represents a very reasonable approach to a very serious problem, and I would urge the adoption by our full committee and by the full Senate.

[The prepared statement follows:]

Statement of Senator David L. Boren

Mr. Chairman, over the past 30 years, a profound change has occurred in the ownership structure of newspapers in this country. While the number of daily newspapers has remained fairly constant at 1,750, the growth of groups or chains has become predominant. Today, almost two-thirds of the daily newspapers are owned by chains and media conglomerates. More significant is the fact that these chains control more than 73 percent of all daily circulation. The four largest chains control

30 percent of the nation's daily newspaper circulation while the 25 largest chains control over 50 percent of all daily circulation. At present, there are just over 600 independently owned dailies left.

Why do the independents sell out? Obviously, the high prices are too great a temptation for some, and others find there is no interest in the next generation of their families to operate an independent newspaper. However, the most significant cause of sales to the chains may be found in the federal estate tax laws. The Internal Revenue Service bases its valuation of an estate on the amount a willing buyer will pay a willing seller. Thus, while an independent newspaper owner may consider value to be 10 to 15 times earnings, the IRS must look to the amount a chain would pay for an independent, that is, 40 to 60 times earnings.

Here is an example. If a newspaper were earning $250,000 per year, its value to a chain might be a high as $12,500,000. The estate tax, at 70 percent, would be over $8.5 million. Should the heir to a newspaper seek to borrow such sums to pay estate taxes, the annual cost of interest on the loan would be more than three times the newspaper's earning. Is it any wonder that the heirs must sell, or that an owner sells prior to death to put his estate in order?

The Independent Local Newspaper Act offers a novel approach to the estate tax problem. Rather than seeking a lower tax rate for newspaper, or exemption or exclusions from the sums to be paid, the bill provides for a form of prepayment of the estate tax. This is to avoid the catastrophic situation now facing the heirs to a newspaper. This act would allow the owners of an independent newspaper to establish an advance estate tax payments trust, to be funded by corporate earnings with not more than 50 percent of pretax income of the newspaper in any year. The contributions to and income of the trust may be invested solely in obligations of the United States. Excess funding of the trust is expressly prohibited. The funds accumelated in the trust may be used only to pay the estate taxes of the owners of the newspaper.

This advance estate tax payment trust does offer major tax benefits to owners of independent newspapers. The funding of this trust will come from pretax income of the newspaper. It is recognized that with a valuation of 40 to 60 times earnings, it will be difficult to fully fund the trust and there must be an incentive for funding. However, if the owners of the newspapers, having established such a trust, sell their newspaper, the bill provides for penalties which would amount to some 118 percent of the funds in the trust. The bill also has a recepature provision should the heirs attempt to sell the newspaper after having benefited from the trust.

The bill represents a reasonable approach to a very serious problem. I urge its adoption.

Senator BOREN. I would like to express my appreciation to the chairman for his comments earlier, and I would like to just address one or two questions to Mr. Glickman, if I could.

I think you have testified that you do understand the nature of the problem, that there is increasing concentration. And as you indicate, if there were not some ascertainable tax benefit, then of course the bill would do no good. We could certainly pass a bill and call it a newspaper preservation act, but if it had no tax benefit provided, then it would not do anything to help with the problem. So I think we have to recognize that there are going to be some lost revenues to the Treasury if we are going to do anything that is meaningful, and you have indicated there is sympathy with this problem. I think you say here perhaps we should address the problem directly.

I guess what I ask you is, what do you, then, advocate to help us? What kind of tax advantage would you give, would you favor, to help maintain independent newspaper ownership? Or, if you are opposed to that, are you suggesting direct regulation to prevent the sale of newspapers?

Mr. GLICKMAN. Well, Senator Boren, in response to your first question, I guess my answer would be none. I don't think that this type of thing should be done through the tax system. I think our tax system, as the chairman pointed out to me so vividly 2 weeks ago, is overly complex right now, and I think the more we do in this nature, all we do is make it that much more complex.

All I specialize in is tax. Now, as you know, this administration has at least expressed some feeling that there ought to be a free market system. Thus, I am really not in a position to advise you if this administration would say that this problem in the local newspaper is something that should be addressed directly or whether the marketplace itself should direct it. But what I really had in mind was that if Congress itself deemed that there was a problem here, it seems to me the Congress ought to face the problem head on, but not through the tax system, saying we are going to do this or we are going to do that to prevent it, and not burden the tax system in this fashion.

Senator BOREN. Let me ask, do you think the free market would take care of the problem by itself?

Mr. GLICKMAN. I don't know the answer to that, sir.

Senator BOREN. Has it, so far?

Mr. GLICKMAN. Well, I guess that, in theory, as long as the marketplace is going to set the price for the newspaper, that at some point in time newspapers are going to reach a point where even the big ones can't go out and buy every one of the little ones up. Otherwise, I don't see how there is going to be any profit motive for the large newspapers there. Like I said, I have not gone through the economics of how the large ones make their profit and how they cut their costs, et cetera. What I did say was that, overall, anytime we see a situation where people are forced to take action because of the tax problems involved, we become concerned with that. That is why we liberalized the rules under 6166 and section 303 and tried to move in the direction of allowing people a method of paying out their taxes in such a fashion where that there won't be the great problems that there are.

As you also know, whenever you start valuing a piece of property, whether it is a newspaper or a piece of land or whatever it is, there are various types of discounts that the Internal Revenue Service and the laws regularly look at, and I guess that that would have to depend on a case-by-case basis as to how it would affect a given newspaper.

Senator SYMMS. Well, I'll ask a question on that point. Do you think Treasury would look at this more favorably if we just expanded it to everyone?

Mr. GLICKMAN. I think if you expand it to everyone, what you are doing is going to be reducing dramatically the overall transfer tax situation. If we adopted this type of provision and credit across the board with every corporation of this nature in the United States, I don't know how severe the revenue impact would be, but I would gather it would go up dramatically at that point in time. Because, then, how can we just limit it to corporations? It seems to me that we ought to limit it to closely-held businesses that are not in corporate solution. That means that we are talking about every business in the United States at that point in time, and I just don't know exactly, at that point in time, how much the revenue impact would be.

Senator SYMMS. Well, you have to admit, though, don't you, that the tax code, the way it now is written, is causing a distortion in the market for newspapers? Would you agree with that?

Mr. GLICKMAN. Mr. Chairman, again, ~~I~~ listen to what you say, and that is basically most of the information I have on this. I mean, I assume the statistics that you are giving me are correct.

Senator SYMMS. Well, I can give you a specific example: The Lewiston Morning Tribune in my State, a family newspaper, which has a circulation of around 25,000 in central Idaho. The family that has owned and operated the paper for 50-plus years, sold it this summer. The publisher, one of the principals in the family, told me that the only reason that they were selling the paper was because of diluted interest from various members of the family and no way to pay the estate tax in the event some of the members of the family start passing away. They got through one generation without losing it, but they say that they have figured out their accounts, and there is no way that they can afford to have anybody in the family die and operate the paper. He said they had to sell the paper because of the estate tax. I think Senator Boren's example was typical of what they experienced. I mean this is a real life case that I know of that happened in my State just this year.

Mr. GLICKMAN. Well, in the Economic Recovery Tax Act some of the changes we made, one of them was the unlimited marital deduction, which means to start off with you can pass it from husband to wife without any tax at all. If you start spreading it out among children and among other people—when I mentioned to Senator Boren a few minutes ago the concept of discounts, I believe that it is fairly well recognized in the law that there are minority-ownership discounts that are applied in valuing ~~property~~ for estate tax purposes.

What I am saying to you is, when you take that into consideration, together with our 6166 approach, I guess the final point that you always get into is, is this the only asset there? I mean, is there no other cash to pay the taxes with? Because, you know, the value is there, and it seems to me that the consideration of some of these things are much more complex than sometimes we realize.

Senator SYMMS. Unfortunately, they can't print money at most of those newspapers. We keep the monopoly on that down here.

Do you have some more questions, Senator?

Senator BOREN. I just wonder, going back to this point, we do have a bill, a draft bill, that would make comprehensive reforms of this nature applied to all closely held businesses. Can I interpret your testimony today as being in favor of such a proposal, since it would not be limited only to newspapers?

Mr. GLICKMAN. No, Senator Boren. If we were going to go in that direction, knowing what we did in the last bill, the direction in which we would ~~probably be~~ going is some sort of either reduction in the estate tax rate or something which is much simpler than in the type of bill we are talking about here, something which will simplify the law rather than just adding additional complexity to the law.

Again, I think that the President has stated that that is the direction in which he would like to be going, and that would undoubtedly be the direction that we would be moving, as we did the last time.

Senator BOREN. Going back to what you said about the free market earlier, certainly you are not saying, are you, that the way the free market functions is not impacted by the taxes? Because tax considerations often have a very important impact on how the free market functions, so we are, in fact, already greatly impacted in the functions of the free market by tax policy over it.

Mr. GLICKMAN. I guess in the most philosophical sense, if a free market system is working perfectly, the taxes would be neutral. In other words, they would not affect it. Unfortunately, the way our tax system is developed, and again, as it has been pointed out to me a number of times, because of the complexities in the provisions which do favor various groups, one over the other, unfortunately it does have an impact. And thus, it is not the most efficient system that we have; but I think we should be striving to make it as efficient as possible and as simple as possible.

Senator BOREN. Philosophically, does the administration have a concern about the concentration of newspapers in this country in the hands of a very small number of people? Is that recognized as a problem with a socially undesirable and intellectually undesirable result in our country, or is this something toward which we are just absolutely neutral and will let things take the course that they should?

Mr. GLICKMAN. Senator, I think if I responded to that question I would just be speaking my own mind and not the position of the administration. I think that the Department of Justice, the Attorney General, would probably be in a better position to respond to that than I would.

Senator BOREN. Well, I would just say that I am very disappointed with the Treasury's attitude, because, obviously, we could talk all day long about the complexity of the tax law, and none of us want it to be complex; but this isn't a problem of complexity of the tax law we are dealing with here, it is a problem of the amount of the tax owed. It is all well and good to say we are sympathetic to the problem, but there is only one way that that sympathy can be expressed in a meaningful way to a family faced with paying inheritance tax that is many, many times over their annual earnings, when they can't even pay the interest on what they would have to borrow to pay the inheritance tax from the total earnings of the newspaper. It seems to me that protestations of sympathy, and we wish something could be done, and we wish the tax law was not so complex, are absolutely and utterly meaningless. And I say that, with all due respect, the only way you can help them is to reduce the amount of the tax that they have to pay or to provide some mechanism for them to prepay the tax.

I would just say that it sounds like crocodile tears for people to come up and say, "My, this is sure a problem," and "my, the tax law is too complex," and what in the world does that have to do with the $8 million in the example I gave that these people have to pay in inheritance tax and no way to borrow the money and make it pay on the earnings of the newspaper?

I would just say that I feel that the administration has the responsibility. And I cannot help but feel that if the Treasury were to convey this to the Chief Executive so that he would be personally briefed on the matter, that he would not feel that there was some obligation to come forward with an alternative.

I would say back to the Treasury, if you don't like this approach, please come forward with a constructive alternative that will enable us to prevent continuing concentration of the newspaper businesses in this country, because I think the vast majority of the citizens of our country view it with great alarm.

Mr. GLICKMAN. Senator, I will make your views in that regard known to the Secretary, and I am sure that he will take the appropriate action at the White House on that.

Senator SYMMS. Thank you very much, David. And Mr. Glickman, I thank you very much for being here, too. Please mention to the Secretary, on our behalf, that the problem has been created by high taxes. What we need to have you do is to recognize that there is a problem created by the tax system, and that there isn't anything wrong with trying to solve the problem by the same inappropriate tax system under which we are operating.

We don't have any choice, as far as being members of the legislative body, but to try to correct a gross injustice that is taking place and a real disservice, not only to those families that own the newspapers but a disservice to the general public. Disinformation, misinformation, and a concentration of news has a tremendous impact on the direction of this country.

The President has told me personally that he favors the total abolition of the death tax in this country. And, viewing that, it appears to me that anything we can do to help specific areas, we ought to do it. This problem needs immediate attention, and we would urge you to get the Secretary and the Chief Executive of the country aware of the problem, because the chains are gobbling up independents every day.

Thank you very much.

Mr. GLICKMAN. Thank you, sir.

Senator SYMMS. We appreciate your time.

Next we have a panel consisting of Mr. Seidman from Memphis, Tenn., and Mr. Pies from Washington, D.C. Is that correct?

Mr. PIES. That is correct.

Senator SYMMS. Gentlemen, go right ahead. When we hear the second bells, I am going to have to put the committee in recess for 1 minute and run over to record a vote.

Mr. Seidman, do you want to go first, here?

Mr. SEIDMAN. Yes, sir.

Senator SYMMS. Welcome to the committee. We are glad to have you here from Memphis today.

STATEMENT OF P. K. SEIDMAN, MEMPHIS, TENN.

Mr. SEIDMAN. Thank you. Mr. Chairman, Senator Boren, my name, as you know, is P. K. Seidman. I am a certified public accountant and lawyer and I reside in Memphis, Tenn. I have with me this afternoon as counsel Mr. Roger Pies, who is a partner in the law firm of Cohen and Uretz here in Washington. I also appreciate this opportunity to appear before you and state my views in support of Senate bill 1430. That is a bill which was introduced by

Senators Baker and Sasser and which would amend section 2032(c) of the Internal Revenue Code in order to permit an estate to elect the alternate valuation date in its original return, even if that return is filed late or not on time.

I have a written statement which I would like to submit and offer to the record, and I hope you will accept that, Mr. Chairman.

Senator SYMMS. Your entire written statement will be made a part of our record.

Mr. SEIDMAN. Thank you, sir.

[The prepared statement follows:]

STATEMENT OF P.K. SEIDMAN

CONCERNING S. 1430

BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION,

SENATE COMMITTEE ON FINANCE

November 18, 1981

My name is P.K. Seidman. I am a certified public accountant from Memphis, Tennessee. My testimony today is in support of S. 1430, a bill introduced by Senators Howard H. Baker and Jim Sasser, which would amend section 2032(c) of the Internal Revenue Code in order to permit an estate to elect the alternate valuation date on its original estate tax return even if it is not filed on time.

Adoption of S. 1430 is necessary in order to remove a punitive and inappropriate provision of estate tax law relating to the election of the alternate valuation date. The alternate valuation date is a provision of the estate tax law, section 2032 of the Internal Revenue Code, that permits an estate to value its property as of a date six months after the decedent's death. Thus, the executor may value all of the assets either on the date of a decedent's death or on the alternate valuation date. Election of the alternate valuation date is intended to protect the heirs and avoid confiscation of an entire estate where the value of the estate's assets declines shortly after the date of death.

This rule, which had its origins in the economic decline in the 1930's, is intended to prevent the inequity of imposing the estate tax on the date of death value of property where that value no longer exists just six months after the date of death. Without this provision, estate taxes could consume the entire value of an estate, leaving nothing to the heirs.

Under existing law, the alternate valuation date election must be made on a timely filed estate tax return. Thus, if the estate tax return is filed late, even if one day late, and even if in the judgment of the I.R.S. the delay is due to reasonable cause, the estate is prohibited from using the alternate valuation date. This result is incongruous. It is inconsistent with reasonable tax or administrative policy and with other analagous provisions.

There is a specific and substantial penalty provided by law, section 6651 of the Internal Revenue Code, if an estate tax return is filed late. This penalty, however, is inapplicable if there is "reasonable cause" for the late filing. If the specific late filing penalty may be excused for reasonable cause, there is no reason to impose what may be a much harsher "penalty" -- loss of the alternate valuation date -- and make the penalty applicable regardless of the existence of reasonable cause. Yet the loss of the alternate valuation date is mandatory under the statute. Such a result is incongruous.

The restriction on the alternate valuation date election is also inconsistent with the election requirements of section 2032A relating to the alternate valuation of certain farm and real property. The election under section 2032A can be made even if the original estate tax return is filed late. The same rule belongs in section 2032(c). Enactment of S. 1430 would provide the correct rule.

To the best of my knowledge, there is agreement on the part of the Treasury Department, and Congressional Staff that the provisions of existing law should be amended. The only question which remains is the proper effective date of this change in law.

Certainly the change will apply to all estates in the future. There are also strong policy reasons for making the legislation applicable to estates of decedents dying before the date of enactment. During the 96th Congress, this legislation was considered by the Senate Finance Committee. The Finance Committee agreed to apply the legislation to the estates of decedents dying before the date of enactment, in certain circumstances.

As it is proposed, S. 1430 would remove the inequitable effect of present law in those cases in which estate tax returns have not yet been filed, as well as those cases where estate tax returns have been filed late, but where the tax liablity of the estate has not been finally determined. Thus, the adoption of S. 1430 would eliminate the harsh penalty otherwise imposed by existing law in the circumstances involved in the Estate of Sylvia Buring, with which I am personally familiar.

Sylvia Buring died November 24, 1972. At the time of her death, Mrs. Buring owned a substantial amount of stock of a New York Stock Exchange Company, and this was the most significant asset of the estate. The value of this stock declined almost 50 percent during the six months after the date of death. This is exactly the situation to which the alternate valuation date is intended to apply.

Unfortunately, the estate tax return was filed late due to the sudden illness of one of the co-executors, and the resulting inability of the other co-executor to file a tax return within the prescribed time. The election of the alternate valuation date was never in doubt. Moreover, there is no dispute that the failure to file the return on time was due to reasonable cause -- the Internal Revenue Service agreed that no late filing penalty was appropriate. If the alternate valuation date election cannot be made by the Estate of Sylvia Buring, the estate tax liability will consume almost 74 68 percent of the estate.

The circumstances of the Buring Estate are presented to show just how terribly harsh and incongruous a result may occur because of the current law. However, it is not the particular facts of the Buring Estate which require that section 2032(c) be amended. The provision of current law, which may impose a harsh result on the Buring Estate, is incorrect in all cases regardless of the reason for the late filing. There is simply no justifiable reason to impose what may be an arbitrary and grossly excessive penalty simply because the estate tax return was filed late.

In these circumstances, a change in law should be made retroactive to eliminate for all taxpayers the inappropriate consequences of the old rule. Although the most equitable rule would provide that the legislation is retroactive in all cases, in considering this type of situation in the past, Congress frequently has adopted a compromise. That is, legislation has been made retroactive, but limited to circumstances in which the statute of limitations remains open. In this way, Congress has avoided the administrative difficulties involved in reopening estates closed under the statute of limitations, but provided the benefit of the proper rule where administratively feasible.

The Treasury Department has concurred in this approach on a number of occasions. For example, from 1958 through 1978, section 1372(c) of the Code provided that the Subchapter S election had to be made either in the first month of the taxable year for which the election is made, or in the preceding month. If an election was made at any other time, the election was invalid for the intended year and any subsequent taxable year. No extension of time to make the election could be granted. Thus, if a Subchapter S election was found to be untimely upon an audit several years after the election was filed, the corporation was taxed under the general rules for the intervening years, not the Subchapter S rules. Such treatment generally had disastrous consequences to the taxpayer. See, e.g., Opine Lumber Co., Inc. v. Commissioner, 64 T.C. 700 (1975).

The provisions of section 1372 which specified that the Subchapter S election had to be filed within a 2-month period served no useful purpose and frequently resulted in a harsh and inequitable penalty. This provision was reviewed by the Treasury Department and it was agreed that a change in law should be made so that an election filed any time in the preceding taxable year would be a valid election for the taxable year. This change in section 1372(c) was one of several technical changes in the tax law supported by the Treasury Department and enacted by P.L. 95-628 (H.R. 7320). Moreover, the Treasury Department concurred in adoption of a retroactive effective date so that taxpayers who had filed an election under Subchapter S which was ineffective could elect to apply the new rule, thereby validating their Subchapter S election, under certain specified conditions. Although the retroactive effective date provided relief to some taxpayers, problems of administration were avoided since the retroactive effective date did not open the statute of limitations for filing a claim for refund. Thus, Subchapter S corporations or their shareholders who were adversely affected by the old rule were provided relief only to the extent that the statute of limitations on assessment and collection was open on the date of enactment.

The considerations which supported a retroactive change in the Subchapter S election requirements are directly analagous to those presented here. In both cases, the required time for making an election was incorrect. In both cases, relief from the consequences of the incorrect rule should be made retroactive.

Another analagous situation also involved the Subchapter S provisions. Prior to 1969, a corporation's election of Subchapter S could be terminated under section 1372(e)(5) because more than 20 percent of a corporation's gross receipts were from gain realized upon the complete liquidation of a corporation whose stock was owned by the Subchapter S corporation. Termination of the Subchapter S election could occur even if, for example, the Subchapter S corporation owned more than 50 percent of the stock of the liquidated corporation and, therefore, the stock represented an "active" rather than a "passive" or portfolio investment. Termination of the Subchapter S election in these circumstances appeared to be inappropriate.

In 1969, P.L. 91-633 was adopted, in part, to add the last sentence of section 1372(e)(5)(C) which excluded from the gross receipts test of section 1372(e)(5) amounts received by a Subchapter S corporation in complete liquidation of another corporation more than 50 percent of whose stock is owned by the Subchapter S corporation. This change in law was applied retroactively to taxable years ending after 1957, provided the statute of limitations on allowance of a refund remained open on the date of introduction of the legislation. In this manner, taxpayers were provided with relief from the harsh result of termination of the Subchapter S election.

In 1981, in the Economic Recovery Tax Act, Congress amended the incentive stock option provisions and these new provisions were applied retroactively to years after 1976.

There are many other circumstances in which Congress, with the concurrence of the Treasury Department, has agreed to extend the benefits of a change in law retroactively in order to ameliorate the consequences of the prior incorrect rule. The willingness of Congress to redress the inequitable consequences of an improper rule is desirable as a matter of policy. Both Congress and the Treasury Department have an interest in maintaining and improving the fairness of the tax law. But taxpayers will be discouraged from undertaking the time-consuming and expensive process of calling the attention of Congress to arbitrary and improper provisions if the only consequence is that the provisions will be improved for the future, without redressing the inequitable consequences for the taxpayers who have been injured by the improper provisions. Thus, there are compelling policy reasons why remedial legislation of this type should be effective as to all taxpayers, consistent with considerations of administrative feasibility.

Legislation similar to S. 1430 was introduced in the 96th Congress. The Treasury Department agreed with the substantive change in the estate tax alternate valuation date election. However, the Treasury Department objected to the effective date of the legislation. As introduced, S. 1430 addresses the concerns stated by the Treasury Department during the 96th Congress. The effective date provision has been revised in order to extend the relief provided to more estates while at the same time not giving rise to administrative difficulties. Thus, although the Treasury Department's reasons for opposing equitable treatment of estates of decedents dying prior to the date of enactment were weak, the revised effective date addresses and responds to the Treasury Department's objections. I am hopeful that the Treasury

Department will support the bill in the 97th Congress based upon the changes which have been made in the effective date provision.

Estates to which the transitional rule in S. 1430 applies do not receive a windfall. No election not otherwise provided by law is made available nor may any estate change an election. The alternate valuation date remains the date exactly six months after the date of death, regardless of the date the original estate tax return was filed. The effective date provision does not bestow an advantage over any other estate. It merely allows for equal treatment of all estates in similar circumstances. An estate which is permitted to make an alternate valuation date election is required to pay the amount of estate tax which Congress intended -- the amount of estate tax which is computed using the value of property on the alternate valuation date -- and not an excessive and inequitable amount of tax based upon property values that do not exist.

Adoption of the transitional rule provided in S. 1430 is sound as a matter of tax policy and provides nothing more than simple justice to the estates which otherwise would be forced to pay estate tax based upon an arbitrary value which did not in fact exist just six months after the date of death. On the other hand, adoption of S. 1430 without an appropriate transitional rule would mean that the alternate valuation date election will be denied because the estate tax return is filed late, thereby producing a wholly unjustified, unintended, and inequitable penalty in the circumstances of the Buring Estate and others similarly situated.

I hope that this Subcommittee will act promptly and favorably report S. 1430 to the full Finance Committee for its consideration.

Mr. SEIDMAN. I would like to first explain briefly why the rule of the current law needs to be changed. I will be brief because, as you already know, and to the best of my knowledge there is full agreement by the Treasury Department and the congressional staff, that current law should be changed in the manner provided by S. 1430.

Let me present a summary of its financial and principal points. I have a summary which will also appear in the record, Mr. Chairman.

Senator SYMMS. Yes.

Mr. SEIDMAN. I have 12 essential principal points I would like to present to you.

One, the existing estate tax law, as you know, section 2032(c), permits an election on a timely filed estate tax return for the valuation date of the property of a decedent. It can either be the value as of the date of death or the value as of 6 months after date of death.

Two, this choice, born of the economic depression of the thirties, avoids a harsh and unfair result when shortly after death property values decline severely, and estate taxes leave nothing for the heirs.

Three, however, if the estate tax return is filed just 1 day late, the existing law disallows the alternate valuation date election and requires property to be valued as of the date of death. This is an incongruous, inconsistent, and unreasonable tax policy which S. 1430 would cure.

Four, section 2032(c) is inconsistent with the more understandable section 2032(a), allowing alternate valuation of certain farms and real property even on a late-filed return.

Five, this loss of the alternate valuation election is automatic and applies even if there is unavoidable reasonable cause to a late filing of the return.

Six, there are other adequate penalties for late filing. Moreover, those other penalties may be excused if there is reasonable cause for the late filing. And it certainly seems to be incongruous to impose a harsher penalty when there is reasonable cause.

Seven, there is general agreement by the Treasury and congressional staff that the existing rule regarding the alternate valuation date election provides an unfair and unintended result and that it should be changed, which S. 1430 does.

Eight, the proposed S. 1430 new rule would merely permit the alternate valuation date election to be made on the first estate tax return which is filed with the Internal Revenue Service, even if it is not filed on time. It would not change the property valuation dates of the present law or have any other effect on the determination of the estate tax liability.

Senator SYMMS. I guess I could let you go ahead and complete. Do you have an airplane you are trying to catch, or are you in any rush for time?

Mr. SEIDMAN. Well, I think I can make my flight schedule at the convenience of you, sir.

Senator SYMMS. I won't keep you here if you wish to go on. I do have to recess the committee for 1 minute to go and vote.

Mr. SEIDMAN. No. I can stay until you get back, sir.

Senator SYMMS. Thank you.

[Whereupon, at 3:03 p.m., the hearing was recessed.]

AFTER RECESS

Senator SYMMS. The hearing will come to order.

Please go right ahead, sir.

Mr. Seidman. Mr. Chairman, in order to make sure that the recorder cut out at the same time that we recessed, let me read the last item that I recited, and that's No. 8.

The proposed S. 1430 new rule would merely permit the alternate valuation date election to be made on the first estate tax return which is filed with the Internal Revenue Service, even if it is not filed on time. It would not change the property valuation dates of the present law or have any other effect on the determination of the estate tax liability.

No. 9, the proposed new rule in S. 1430 would seek relief from consequences of an incorrect rule and would be applicable to all estates which have not yet filed returns and to estates which have filed returns but which are still open under the statute of limitations. This provides an administratively feasible procedure which Congress has adopted in the past and which has gained Treasury concurrence: more particularly, in the retroactive subchapter S election, that is, Public Law 95628, which is H.R. 7320, and, in 1969, Public Law 91633, which reached back to 1957 in retroactive application.

No. 10, this bill and its effective-date provisions would not result in any unwarranted relief to any estate. It would merely provide the result Congress intended to estates which would otherwise be unfairly penalized. It does not bestow an advantage over other estates. It provides equal treatment, as Congress intended. The estate gets not one penny more tax adjustment than before S. 1430; only a timing procedure is here involved.

No. 11, without S. 1430, the heirs of the estate I represent, some of whom are minors, are stripped of approximately 74 percent of the decedent's distributable estate, only because 6 weeks before the estate return was due, emergency heart surgery felled the coexecutor, a C.P.A. and attorney, decedent's personal accountant, brother-in-law, and the only person with knowledge of the details. And the late filing of the estate return would otherwise deny the estate application of the alternate valuation, even though the IRS assessed no late-filing penalty in recognition of reasonable cause, and would otherwise leave 70 percent of the estate available to the heirs instead of stripping almost 74 percent.

It is interesting to note, Mr. Chairman, that around midyear of this year the IRS issued instructions to their agents as to what constitutes "reasonable care." And the No. 1 on that list is the death or serious illness of the taxpayer or someone in the immediate family of that taxpayer.

Now let me proceed to item 12. I believe that S. 1430 is sound tax policy, and with its transitional rule provides simple justice to estates called upon to pay estate tax on arbitrary values nonexistent 6 months after date of death. Without an appropriate transitional rule, a wholly unjustified, unintended, and inequitable penalty results because the estate tax return is filed late.

S. 1430 does not constitute a loophole; it serves to proclaim the original congressional intent to protect the heirs of an estate. It eliminates a terribly harsh penalty in circumstances where none was intended. It does not involve new elections for any estate and does not jeopardize the Government's interests.

I hope that this subcommittee will act promptly and report S. 1430 to the full Finance Committee for its favorable consideration.

And before we close this presentation, Mr. Chairman, I would like to have Mr. Pies make a few comments, with your permission.

Senator SYMMS. Go right ahead.

STATEMENT OF ROGER A. PIES, COHEN, AND URETZ, WASHINGTON, D.C.

Mr. PIES. I will be very brief, Mr. Chairman.

We have had an opportunity to read and listen to the Treasury testimony, and, if I may, I would like to briefly respond. It appears to us that the Treasury opposition to the transitional rule misses the mark and misses the point which we have tried to establish.

The Treasury admits that the current law is wrong and it is unfair, and it also is clear that the consequences of current law are terribly harsh and inflict an arbitrary and inequitable penalty on estates. In these kinds of circumstances, in our view, a change should be retroactive, limited by administrative feasibility.

The Treasury statement envisions administrative difficulties if the provisions are made retroactive to any extent, and in our view these administrative difficulties are largely illusory and nonexistent. Congress has recognized this type of situation in the past, and the Treasury has concurred in adopting an effective date which ameliorates these kinds of harsh and unintended consequences.

We are unable to reconcile the current Treasury position with the position they have taken in similar circumstances in the past.

Thank you.

Senator SYMMS. Thank you both very much. I think you made a very excellent statement, Mr. Seidman. I appreciate the points you made, Mr. Pies, and I agree with what you said.

I support the bill, I would say in the first place, and I will do what I can to see that we can get favorable action on it and try to get a favorable ruling on this committee and move it forward.

I also think that we should not make those changes that were recommended by Treasury, and I really would be surprised if they would make that big of an issue over it. If it is correct, as they say, well then I would think that they don't really have anything that they would bite that hard over. I hope I am not incorrect on that. But, in view of the fact you have the majority leader as the prime sponsor, I think that would be helpful with Treasury, also.

Thank you very much. I appreciate your being here today.

Mr. SEIDMAN. Again, we appreciate the opportunity you have given us to present our side of it.

Senator SYMMS. Godspeed on your trip back to Memphis.

Mr. SEIDMAN. Thank you, sir.

Senator SYMMS. We would now hear from a panel on the behalf of the Independent Local Newspaper Association: Joseph Iannucci and Morris Levin.

Gentlemen, I guess Mr. Iannucci would like to go first?

Mr. LEVIN. Let me start it, if I might.

Senator SYMMS. OK. Mr. Levin.

Mr. LEVIN. Mr. Chairman, I have a statement which I ask be included in the record.

Senator SYMMS. Both of your entire statements will be included in our record as though entirely stated. If you want to summarize your remarks, that would be acceptable.

STATEMENT OF MORRIS J. LEVIN, ATTORNEY, WASHINGTON, D.C.

Mr. LEVIN. Well, I think the chairman in his opening statement and Senator Boren in his statement have better than summarized my remarks. I believe that there is a serious problem which is caused by the tax laws and which requires or forces owners of independent newspapers to sell their newspapers. I don't think there is any question but that the tax laws play a most significant role in this, and we can think of no other solution to correct this other than the tax laws themselves.

I heard the chairman's questions of Secretary Glickman with regard to these sales and how serious they were. I have a note before me that says that in 1980, 48 daily newspapers were sold to chains. A year earlier, again, the same number, 48 dailies, were sold to chains. I would like to have included as a part of my remarks some material I have taken out of a trade press magazine called Editor and Publisher, which gives you a breakdown of the chain control of daily circulation. Two chains today have 7.5 million daily circulation in the United States. As to the chairman's remarks with regard to misinformation and disinformation, with that broad and that widespread impact upon the public, something that is misstated once can never be erased, because it has gone from coast to coast, north, south, east, and west. And, if I may, I would like to make these a part of the record.

Senator SYMMS. Without objection, they shall be part of our record.

[The statements follow:]

Statement of
MORRIS J. LEVIN
Counsel
INDEPENDENT LOCAL NEWSPAPER ASSOCIATION
Before The
SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
SENATE COMMITTEE ON FINANCE
In Support of
S. 1487

Mr. Chairman. I am Morris J. Levin, an attorney with offices here in Washington, D. C. I appear today as counsel for the Independent Local Newspaper Association, and am accompanied by Joseph S. Iannucci and Joseph Schiffhouer of the law firm of Jones, Day, Reavis & Pogue.

The Independent Local Newspaper Association (ILNA) is a trade group, whose membership is composed of newspapers which would benefit from the legislation proposed in S.1487. That is, newspapers which are not part of interstate newspaper chains or publicly traded.

Over the past 30 years, a profound phenomenon has occurred in the ownership of newspapers in this country. While the number of daily newspapers has remained fairly constant, at 1750, the growth of groups or chains has become predominant. Today, almost two-thirds of the daily newspapers are owned by chains and media conglomerates. More significant is the fact that these chains control more than 73 percent of all daily circulation. The four largest chains control 30 percent of the nation's daily newspaper circulation, while the 25 largest chains control well over 50 percent of all daily circulation.

In the past few years, the chains have been buying 40 to 50 theretofore independent dailies each year. At present, there are approximately 600 independently owned dailies left. In 10 years, the independently owned daily, now an endangered species, may be extinct. Moreover, 10 to 12 chains or media conglomerates may by then control virtually all of our daily newspapers, with ties to television, cable and other electronic media.

The same situation prevails in the weekly newspaper field. Last year, some 175 weeklies were purchased by the chains -- the same chains which own and control daily newspapers. The trade press reports continued incursions into the weekly newspaper field by these media giants.

The chains are not establishing new newspapers, daily or weekly, but are buying out existing newspapers. And each purchase results in the loss of an independent, community-based "voice" and base of opinion.

The chains buy newspapers, not to enhance the scope of their editorial and reportorial coverage, but to maximize greater profits. This has been referred to as bottom-line journalism. They are paying 40, 50 and even 60 times annual earnings for the remaining independents. They know the number of newspapers remains constant, and they are pulling out all of the stops in this inter-chain competition to snap up the remaining independents.

Why do the independents sell out? Obviously, the high prices are too great a temptation for some, and others find there is no interest in the next generation of their families to operate an independent newspaper. However, the most significant cause of sales to the chains may be found in the federal estate tax laws. This has been attested to by present and former owners of newspapers. The president of the Evening News Association, a chain which publishes the Detroit News, has commented:

> "Speaking from the point of view of my experiences with this company, I would like to reinforce the extreme importance of the federal estate tax in media merger decisions. There is no other single factor of such importance, in my opinion."

The Internal Revenue Service bases its valuation of an estate on the amount a willing buyer will pay a willing seller. Thus, while an independent newspaper owner may consider value to be 10 to 15 times earnings (which is also the price/earnings ratio of publicly traded chains), the IRS must look to the amount a chain would pay for an independent, i.e., 40 to 60 times earnings.

For example, if a newspaper were earning $250,000 per year, its value to a chain might be as high as $12.5 million.

The estate tax, now at 70 percent, would be over $8.5 million. Should the heir to a newspaper seek to borrow such sums to pay estate taxes, the annual cost of interest on the loan would be more than three times the newspaper's earnings. Even if, in its wisdom and within its discretion, the IRS should find the value of this newspaper to be "only" $7.5 million, the tax rate (still at 70 percent) would require payment of over $5 million. This would be more than the owner could borrow, since interest charges would be better than double the earnings of the newspaper. Is it any wonder that the heirs must sell, or that an owner sells prior to death to put his estate in order? There are no other options.

The Independent Local Newspaper Act offers a novel approach to the estate tax problem. Rather than seek a lower tax rate for newspapers, or exemptions or exclusions from the sums to be paid, or valuation of newspapers at an artificial rate, the bill provides for a form of prepayment of the estate tax. This is to avoid the catastrophic situation now facing the heirs to a newspaper.

The Independent Local Newspaper Act would allow the owners of an independent newspaper to establish an advance estate tax payment trust, to be funded by corporate earnings, with not more than 50 percent of pretax income of the newspaper in any year. The contributions to and income of the trust may be invested solely in obligations of the United States. Excess funding of the trust is expressly prohibited. The funds accumulated in the trust may be used only to pay the estate taxes of the owners of the newspaper.

This advance estate tax payment trust does offer major tax benefits to owners of independent newspapers. The funding is with pretax income of the newspaper, and sums in the trust are not a part of the owner's estate for tax purposes. It must be recognized that with a valuation of 40 to 60 times earnings, it will be difficult to fully fund the trust, and there must be an incentive for funding. However, if the owners of the newspaper, having established such a trust sell their newspaper, the bill provides for penalties which could amount (under ERTA) to some 146 percent of the funds in the trust. Thus, there is a "carrot" to induce maintaining independent newspapers, and there is a "stick" to preclude an attempt to take advantage of this proposal. The bill also has a recapture provision should the heirs attempt to sell the newspaper after having benefited from the trust. This recapture provision follows the format established in the Tax Reform Act of 1976.

Also, tracking provisions of the Tax Reform Act of 1976, the bill provides for an extension of the time for payment of estate taxes where the estate includes the interests in an independent local newspaper. Such extensions would be subject to payment of interest which, I believe, has recently been pegged to 20 percent.

This proposed bill has been criticized as special interest legislation. (The same was said of the Family Farm or Tax Reform Act of 1976.) This bill is, at this time, limited to newspapers. An economic reason is only newspapers are now selling at such egregious ratios, with the exacerbating effects this has on estate tax liabilities. Another important basis for this legislation is that only the "press" is referred to and protected in the First Amendment of the Constitution. Preservation of the marketplace of ideas through maintenance of independent editorial voices is in the national interest, and is a valid basis for this legislation.

The Joint Committee on Taxation has estimated the cost of this proposal at $10 million. This may be an overstatement of cost, and it is possible that the bill could provide a favorable revenue flow and a positive gain to the Treasury.

Finally, this proposal could serve as a precursor for other family-controlled businesses. If, after passage of the Independent Local Newspaper Act, it is demonstrated that the Act resulted in stemming the tide of newspaper mergers without burdening the Treasury, the terms of the legislation could and should be expanded to include other categories of industry. While the idea of prepayment of estate taxes is novel at this time, if this proves successful with newspapers, the coverage of the legislation could be broadened so that it is not limited to one industry.

One final note. Delay in passage of this legislation will limit the benefits it is intended to provide. Every week, at least one daily and approximately four weekly newspapers will be absorbed by the chains, and their independent voices stilled forever. Unless early action is taken, the independent, community-based newspaper may be as fondly recalled as the carrier pigeon and other species of an earlier time.

SPECIAL REPORT

Morning circulation tops P.M. total for 155 groups

Up-to-date profile of the newspaper groups in the United States:

•1,136 daily newspapers are represented in 155 groups (two or more dailies in different cities under the same ownership).

•45 of these groups are comprised of two papers.

•28 groups are comprised of three papers.

•These 73 groups represent 5,030,426 weekday circulation, slightly more than 10% of the total for all groups and 8% of all weekday circulation.

•The group total of 45,781,724 weekday circulation is 72% of the circulation of all dailies as shown in the 1981 edition of the *Editor & Publisher International Year Book*.

•Groups are predominant in the morning field with approximately one-half of the weekday circulation of all groups.

•514 group members have Sunday editions whose aggregate circulation is 41,262,609, or roughly 75% of total Sunday circulation.

•Knight-Ridder holds the lead among the groups with weekday circulation of 3,783,070, barely ahead of Gannett Company's 3,736,577 (including acquisitions up to September 15).

The number of groups has declined in recent years, due mainly to mergers. Twenty years ago 109 groups owned 552 dailies. Then there was a rapid rise in group ownership and in 1967 there were 817 dailies in 160 groups. The peak was reached in 1978 with 167 groups owning 1,095 dailies.

In this latest compilation the most significant development is the fast-growing accumulation of circulation on the morning cycle. This reflects the trend toward conversion of afternoon dailies to the morning field and the gradual shifting of metro dailies from p.m. to all-day circulation. In the latter category the aggregate circulation of a.d. papers has soared to 3,747,280. If that figure is split between a.m. and p.m. (as it is done in the Year Book), the evening total would still fall below the morning total for group-owned dailies. The morning total is 22,354,351 and the evening total is 19,687,295.

Ten groups have circulation in excess of 1,000,000 copies weekdays. Together—ranging from Knight-Ridder to the New York Times Company—they account for 21,454,840 copies, or 46% of the total for all groups. In Sunday circulation, although groups vary from 289,186 to 4,320,000, the proportion is close to 50% of the group total. Gannett with 86 and Thomson with 75 are far out front in numbers of dailies they publish.

Independent (non-group) dailies are published in competition with group dailies in 18 cities, eight of them having agency (combined business and production facilities) arrangements. Four cities—Houston, Salt Lake, Tulsa and Oil City, Pa.—are unique, having two dailies with no group affiliations.

Group ownership of dailies in the 14 Sun Belt states (71%) runs slightly below the national level, according to a study made by the Southern Newspaper Publishers Association. In this connection the SNPA's Smaller Newspaper Committee has compared financial benchmarks for independents and group-affiliated dailies. Five groups and six dailies participated.

A study of the advertising departments provided such information as:

—the percent of space devoted to paid advertising was 59.98% (independent papers) and 49.56% (group papers). (Number of pages not reported.)

—the percent of space devoted to house ads was 2.52% (independent) and 3.64% (group).

—the percent of advertising revenue to total revenue was 81.41% (independent) and 77.56% (group).

The committee's study of news departments showed:

(Continued on page 44)

The group picture

45 groups with 2 papers	90
28 groups with 3 papers	84
15 groups with 4 papers	60
14 groups with 5 papers	70
7 groups with 6 papers	42
9 groups with 7 papers	56
5 groups with 8 papers	40
5 groups with 9 papers	45
3 groups with 10 papers	30
2 groups with 12 papers	24
1 groups with 13 papers	13
4 groups with 15 papers	60
1 group with 17 papers	17
2 groups with 18 papers	36
2 groups with 19 papers	38
3 groups with 21 papers	63
1 group with 23 papers	23
1 group with 25 papers	25
1 group with 27 papers	27
1 group with 28 papers	28
1 group with 31 papers	331
1 group with 34 papers	34
1 group with 39 papers	39
1 group with 75 papers	75
1 group with 86 papers	86
155	1,136

GROUP OWNERSHIP OF DAILY NEWSPAPERS IN THE UNITED STATES

Group	No. of papers	Circulation A.M.	P.M.	A.D.	Total	Sun.	No. of papers
Albion	2		7,252		7,252		
Allbritton	5	93,489	22,910		116,399		
American	8	19,182	23,874		43,056		
Alford	2	24,468	6,294		30,672	25 009	1
Anniston	2	11,492	31,577		43,069	31 965	1
Attaway	3	17,456	12,059		29,515	30,507	3
Barnes	7		38,875		38,875		
Belo	7	286,955	36,698		323,653	396,898	6
Biddle	2	7,413	11,919		19,332		
Bliss	3		51,997		51,997		
Block	4	180,772	230,304		411 076	293,445	3
Boone	9	20,933	65,440		86,373	88,305	8
Bryan	2	15,548			15,548	17,492	2
Buchheit	7	40,852	68,587		109,439	70,494	2
Buckner	6	35,144	38,428		73,572	7,856	1
Byrd	2	28,556	19,054		47,610		
Calkins	5	92,652	106,841		199,493	191,004	4
Cap Cities	9	395,805	532,294	51,916	980,015	744,838	4
Central	7	487,261	276,818		764,079	764,106	3
Chronicle	2	560 853			560,853	708,665	2
Clay	3	21 542	67,365		88,907	33,889	1
Coquine	2	5,028	5,640		10,668		
Conland	2		19,769		19,769		
Copley	10	258,706	368,896		627,602	619,109	6
Cowles	10	604,451	371,091		975,542	1,360,958	7
Cox	18	641,164	554,824		1,195,988	1,239,869	11
Daugntry	4	19,749	5,174		24,923		
Dear	4	14,280	26,451		40,731	39.899	3
Delphos	2		6,753		6,753		
Dix	8		148,172		148,172	34,240	2
Donrey	39	94,355	371,544		465,899	452,423	33
Dow Jones	21	1,994,964	341,888		2,336,852	289,168	7
Drukker	2		86,178		86,178	72,720	2
Dwelle	2		8,956		8,956	5,670	1
Emmerich	2		20,266		20,266	20,445	2
Enterprise	3		10,158		10,158		
Evening News	5		51 710	629,598	681,308	829 240	1
Evening Post	5	69,062	33,421		102,483	100,700	1
Fackelman	3		17,195		17,195	5,490	1
Fargo Forum	2		16,541	58,048	74,589	62,111	1
Florida Pub	3	150,658	56,437		207,095	195,912	1
Fournier	3	38,587			38,587	38,587	3
Freedom	31	92,894	458,515	235,909	787,318	703,227	18
Freeman	3	3,198	26,567		29,765	26,980	2
Gadsden	3		41,577		41,577	33,803	2
Galvin	6		42,710		42,710		
Guy Gannett	4	101,540	30,245		131,785	118,298	1
Grimes	3		19,545		19,545	6 660	1
Gannett	86	1,680,750	2 014 855	40 972	3,736 577	3 576 091	56
Hagadone	6	58 290	91 833		150,123	62,114	2
Hammell	2		16,376		16 376	10,138	2
Harris	2		10 455		10,455		
J P Harris	9	19,658	87 627	44,090	151 375	137,935	5
Harte-Hanks	27	280,909	262,830		543,739	573,495	20
Hartman	2	4,508	53,670		58,178	56,845	1
Haskell	2		26,109		26,109	27 891	2
Hearst	15	496,298	832,303		1,328,601	586,379	9
Hederman	3	63,521	64,255		127,776	114,693	1
Home News	3		41,346		41,346		
Horvitz	5		188,141		188,141	83 538	2
Howard	15	108 330	201,977		310,307	211 785	7
Huckle	2	7,012			7,012		
Independent	4	26,165	49 949		76 114	51,638	1
Ingersoll	21	171,395	272,186		443 581	125,607	5
Jeff Pilot	7	131,564	35 983		167,547	163,182	5
Johnson	2		56 858		56,858		
Carl Jones	3	4,169	29,973		34,142	28,569	1
John Jones	3		35,483		35 483	12,226	1
Joy	2		26 076		26 076	18,809	
Knight-Ridder	34	2,423,622	1,051,191	308 257	3,783 070	4,320,004	22
Landmark	12	300,910	241 967		542,877	433,558	3
Kuser	4		34,488		34 488	13,294	1
Lavine	4		30 773		30,773		
Lee	19	292,991	224 268	64,306	581 567	581,615	11
Lehman	3		39 401		39,401		
Lesher	6	141,185	56 751		197 936	168,360	4
Lewis	2		13 229		13 229		
Livermore	2		13 455		13 455	13 455	2

(Continued on page 14)

GROUP OWNERSHIP

(Continued from previous page)

Group	No. of papers	Circulation A.M.	P.M.	A.D.	Total	Sun.	No. of Sun. papers
Lorain	2	16,614	37,492		54,106	37,774	1
Lynett	3	9,140	62,888		72,028	48,409	1
McClatchy	5	424,869	39,417		464,286	489,669	4
McClelland	3	27,558	40,706		62,264	14,096	1
McCraken	6	32,796	11,649		44,445	27,737	2
McGiffin	4	12,800	19,023		31,823	12,800	1
McNaughton	4		55,906		55,906	16,209	1
Mayborn	2	25,977	14,224		40,201	44,487	2
Mead	3	37,056	50,427		87,483	93,833	2
Media Gen'l	6	395,167	175,982		571,149	541,453	3
Mendocino	2	8,778	6,497		15,275	8,778	1
Mid America	5		19,256		19,256		
Miller	4	31,638	28,124		59,762		
Moffitt			19,553		19,553		
Morris Coms	10	218,578	102,239		320,817	323,162	5
Morris News	7	6,829	44,983	12,207	63,819	32,794	3
Murdoch	3	79,901	75,340	639,604	794,845	181,921	1
Murphy	4	8,253	40,668		48,921	26,028	2
Multimedia	13	181,077	139,539		320,616	320,782	7
Mystic	3		15,931		15,931		
N Y Times	12	998,250	115,138		1,113,388	1,634,639	7
Newhouse	28	1,570,212	1,308,343	285,448	3,164,003	3,559,603	21
New England	4		62,734		62,734		
News-Observer	3	128,244	41,002		169,246	164,057	1
Nixon	9		64,028		64,028		
Nowata	2		7,110		7,110	4,127	1
Opubco	3	210,519	82,868		293,387	322,008	2
Ogden	15	76,761	153,458		230,219	118,347	3
Palmer	8	125,584	15,536		141,120	149,930	2
Park	19		181,381		181,381	91,493	9
Patrick	2		33,384		33,384	9,805	1
Pioneer	17	7,200	135,231		142,431	86,900	6
Post	4		83,443		83,443	60,198	1
Press Ent	2	19,778			19,776		
Pulitzer	2	68,099	236,769		304,978	558,156	2
Red Wing	2		14,842		14,842		
Rowley	5	2,037	29,518	21,178	52,733	46,127	1
Rutland	2	21,633	12,519		34,152	30,505	2
Sandusky	6		44,863	42,000	86,863	71,143	2
Sault News	2		13,251		13,251		
Scaife	2	44,459	29,138		73,597	99,434	2
Schurz	8	19,085	197,687		216,772	178,475	3
Scripps Howard	15	699,510	799,415		1,498,925	1,441,582	6
J P Scripps	7		176,434		176,434	61,787	2
Scripps League	21	7,163	211,469		218,632	16,245	2
Seaton	7	3,176	51,428		54,604		
Shaw	5		41,943		41,943		
Shearman	3	39,261	13,489		52,750	53,759	2
Small	7		157,724		157,724	73,081	2
Smith	3	5,790	18,814		24,604		
Sowers	2		12,473		12,473		
Sparks	3	33,418	43,912		77,330	78,429	3
State-Record	4	130,749	67,454		198,203	187,162	3
Stauffer	18	27,817	149,345	83,914	261,076	113,969	3
Swift	3		50,384		50,384	41,179	2
Taylor	5		29,241		29,241	20,741	3
Taylor (D S)	2	73,134	35,803		108,937	77,143	1
Terry-Hanley	2	8,148	30,853		39,001	31,037	1
Thomson	75	74,511	1,092,907		1,167,418	671,829	32
Times Mirror	8	1,211,209	845,516	249,890	2,306,615	2,528,016	5
Tribune (Chi)	8	1,816,159	191,306	979,941	2,987,406	3,962,377	6
United	2		53,124		53,124	31,372	1
Walls	25	33,610	172,211		205,821	131,447	2
Wash Post	3	584,500	128,298		712,798	898,245	2
Waters	2	3,699	17,872		21,571	20,245	2
Western Coms	3		29,093		29,093		
Western News	4		37,355		37,355	33,465	3
Western Pub	2	34,860			34,860	35,948	2
Wick	9	6,137	64,897		71,034	32,573	3
Winsor	3		19,981		19,981		
Witwer	2		12,648		12,648		
Woodson	4		32,444		32,444	35,290	4
Worrell	23	56,570	231,215		287,945	172,081	8
Worcester	4	55,954	98,365		154,319	108,555	1
Yellowstone	2		7,974		7,974		
Totals	1,136	22,354,351	19,687,293	3,747,280	45,781,724	41,262,609	514
All U.S. dailies		29,414,036	32,787,804		62,201,840	54,676,173	

Special report

(Continued from page 12)

—the percent of space in the paper used by the news department was 44.24% (independent) and 49% (group).

—the average number of column inches of the total daily news hole was 1,746 (independent) and 1,648.18 (group).

—the department salaries as a percent of total revenue was 7.39% (independent) and 7.46% (group).

An examination of the production departments showed:

—the percent of total newsprint waste was 3.40% (independent) and 5.17% (group).

A study of the circulation departments provided such information as:

—the percent of monthly subscription price that goes to the newspaper was 58.12% (independent) and 58.72% (group). The percent that goes to the carrier was 41.88% (independent) and 41.28% (group).

—the annual circulation expense per subscriber was $13.36 (independent) and $15.83 (group).

—the average cost of obtaining a new subscriber was $3.32 (independent) and $3.88 (group).

The study of administrative departments showed:

—the percent of profit before tax was 19.59% (independent) and 27.04% (group).

—the average publisher's salary was $46,400 (independent) and $53,400 (group). (The salary paid to one publisher in the group study was deleted in order to provide a more realistic average. That publisher's annual salary was $95,000.)

Mr. LEVIN. And may I also, at the same time, make as part of the record statements by six present or former publishers with regard to this legislation?

Senator SYMMS. Without objection.

[The statements follow:]

Before the Subcommittee
on
Estate and Gift Taxation
Finance Committee
United States Senate
in support of
S.1487

I am Amon C. Evans of Nashville, Tennessee. My family owned the Nashville Tennessean for 42 years. On July 5, 1979, my mother and I sold the Tennessean to Combined Communications, Inc., a wholly owned subsidiary of Gannett Co., Inc.

One major reason for our selling the newspaper was the anticipated effect of the federal estate tax laws upon our situation. My mother, who was then 78 years of age, and not in good health, owned a substantial share of the stock of the Tennessean. If she were to have passed on, this likely would have placed us in the position of having a forced sale in order to pay estate taxes.

To state it simply, if my mother had died owning her stock in the Tennessean, under the circumstances as they exist in Nashville, there is every reason to believe I could not have paid the estate taxes which would have been levied against this stock, nor could I have borrowed the amount necessary to pay these taxes without further jeopardizing financially my family. This is because newspaper chains have been paying such high multiples, 30 and 40 times earnings, for newspaper properties, and estate taxes are based on what a willing buyer will pay for the property. Thus, we either had to sell under relatively favorable conditions, or face a situation where a sale likely would have been required.

This really wasn't much of a choice. Acting in the best interests of the Evans family, we determined to accept Combined's offer.

We supported the Independent Local Newspaper Act, in predecessor legislation during the 95th and 96th Congresses. We were very much aware of the problem we faced under the estate tax laws, and sought the legislative relief your subcommittee is now considering. We had seen many of our friends sell their properties at the death of a major owner of the newspaper. We had hoped that the Independent Local Newspaper Act would be enacted in time to meet our problem.

Let me add that it was not the fact that we had repeated, if not constant suitors seeking to purchase the Tennessean. That has been the case for years, though the offers had increased substantially in the past two or three years. Nor was it just a matter of a buyer meeting our price. Were it not for the impact of the estate tax laws and the particular situation in the Nashville market, we would not have felt obligated to sell.

I urge the members of this Subcommittee to give serious and favorable consideration to the bill now before you. I sincerely believe that enactment of S.1487 will aid other owners of independent local newspapers in maintaining their properties.

Statement of
Douglas L. Manship
Editor and Publisher
Baton Rouge Advocate and State Times
in Support of S.1487
The Independent Local Newspaper Act

I am Douglas L. Manship, the Editor and Publisher of the Baton Rouge Advocate and State Times. I am submitting this statement to the Subcommittee on Estate and Gift Taxation of the Committee on Finance, United States Senate, in support of the Independent Local Newspaper Act, S.1487.

The Advocate and State Times are the largest locally owned newspapers in the State of Louisiana. Only three other cities in Louisiana have independent daily newspapers which are not owned by newspaper groups or chains. However, not too many years ago, the majority of our daily newspapers were owned and operated by local families. The last several years have witnessed, in Louisiana and throughout the United States, the purchases of newspapers by groups. In the recent past, industry statistics show that approximately one daily newspaper is sold to the chains each week. In 1978, there were 47 daily newspapers purchased by newspaper groups, and it is my understanding that the pace quickened during 1979 and 1980.

While I cannot state the underlying cause for each sale to a group, there is no question but that the Federal estate taxes have played a major, if not the most predominant, role in bringing about the sales. Obviously, estate tax problems affect all businesses, but they have a particularly egregious effect upon newspaper ownership. That is because the newspaper groups have been paying 30, 40, and even over 60 times earnings to purchase formerly independent newspapers. For example, the purchase of the Shreveport and Monroe newspapers in Louisiana in 1977 was estimated to be at over 80 times earnings.

The inflated prices paid for independent newspapers - which are now eligible for designation as an endangered species - have an exacerbating effect upon the estate taxes due from owners who do not want to sell their properties. The Internal Revenue Service bases its value on a property for estate tax purposes at what a willing buyer will pay a willing seller. Thus, if the owner of a newspaper dies, the IRS will assess estate taxes based primarily on the amount a chain would pay for the newspaper, and not on its earnings or plant value. The heirs, who want to continue to own and operate the newspaper, find themselves unable to borrow sufficient sums to pay the taxes, in that their earnings will not even cover the interest charges on the monies owed to the Government.

This phenomenon, peculiar to newspapers, is the basis for the legislation you are now considering, just as the inflated (but not as inflated) prices being paid by shopping centers and developers for farm land was the basis for the Family Farm Act of 1976. As was stated by the Executive Vice President of the American Newspaper Publishers Association in testimony before the Senate Small Business Committee during the 96th Congress:

> ANPA feels strongly that decisions by owners on whether to buy, sell or retain a newspaper should not be affected by laws which penalize one party to a transaction and thereby serve to reward another. Unfortunately, that is the case today in the federal estate-tax laws. And this presents an arena in which the Congress can and should act--not to influence or direct newspaper ownership decisions, but to remove a bias in those laws so that buy/sell decisions can be made in an atmosphere of tax neutrality.

I have a very parochial interest in this legislation, as well as a firm belief that the public is best served by ownership and operation rooted in the community served by the newspaper. The Advocate and State Times are now being operated by the third generation of our family. We want the newspapers to remain with our family, and not be required or forced to sell our newspapers because of the anomalies in the estate tax laws which have a pernicious effect upon newspaper ownership.

We could sell our newspapers today in response to one of the very attractive offers we regularly receive. We could certainly make more money investing such sums in treasury notes that we earn operating our newspapers - and with a lot less headaches. This is not our interest or intent. We hope to continue to serve our community by operating the Advocate and State Times. We do not ask this Subcommittee and the Congress for special favors, but only for tax law neutrality, so we can continue the local ownership of these newspapers.

I am not versed in the tax laws. It is my understanding that S.1487 would enable an owner of an independent newspaper to prepay, during his lifetime, his estate taxes, in order to be able to pass his newspaper on to his heirs. That is why I favor this proposal.

Maybe there is a better way to accomplish the purposes of S.1487. If so, I would hope the Congress would expeditiously address this problem and provide a fair and workable solution.

In conclusion, I would like to state my appreciation for the consideration being extended by the Congress to a situation which affects not only one industry, but also the public at large. I would like to believe that any relief offered by legislation which corrects the current unbalance in the estate tax laws would redound to the benefit of the public by allowing for the continued existence of family owned newspapers rooted in their own communities.

Statement of
Robert M. White, II
in support of
The Independent Local Newspaper Act
S.1487

I am Robert M. White, II, the Editor and Publisher of the Mexico Ledger, a daily newspaper published in Mexico, Missouri. The Mexico Ledger has been owned and operated by my family for three generations and over 105 years, beginning on September 21, 1876. My statement in support of S.1487, The Independent Local Newspaper Act, may be interpreted as an expression of my desire and intent to see this newspaper remain in my family during future generations.

Since the close of World War II, while the number of daily newspapers has remained fairly constant, there has been a tremendous growth in the number of newspapers owned by chains, with a concomitant decrease in the number of locally owned newspapers. Today, the chains own over two-thirds of our daily newspapers, and have over 72 percent of daily circulation and some 76 percent of Sunday circulation. This trend continues, with chains now buying locally owned newspapers at a rate of one each week, and weekly newspapers at the rate of three to four each week.

My complaint is not with chain newspapers, or how they may be operated. Without question, there are good and bad chain newspapers, just as there are good and bad newspapers published by local owners. I do object to the fact that decisions as to the sale or maintenance of newspapers are taken out of the hands of local owners because of the estate and inheritance tax laws.

Newspapers are being purchased at remarkable price-earnings ratios. The newspaper chains and media conglomerates are paying 30, 40 and even over 60 times earnings. I do not know of any other industry where the prices paid approach these levels. The inflated values placed upon the remaining locally owned newspapers result in excessive estate taxes being levied upon the death of a publisher. The Internal Revenue Service values a property at the amount a willing buyer will pay a willing seller, or the amounts being paid for like properties. In the case of newspapers, the values for estate tax purposes are far beyond the abilities of the heirs to pay, since the newspaper's earnings are not sufficient to cover the interest costs of the sums required to be borrowed.

Not only are locally owned newspapers being sold in order to pay estate taxes, but publishers are inclined to sell in order to put their estates in order, rather than having a forced sale thereafter.

It seems to me a serious mistake for Government policy to favor sales of independent newspapers to chains. At the least, the Government should be neutral. That is definitely not the situation that faces us today.

As a member of the Government Affairs Committee of the American Newspaper Publishers Association, I had the opportunity to hear a review of the purposes as well as the provisions of S.1487. It is my understanding that this bill would permit owners of locally owned newspapers to prepay their estate taxes during their lifetimes. As explained to me, there would be little if any cost to the Government, in that the Treasury would have the use of the prepaid sums before they were due and owing to the Government. I have been advised that Congressional supporters of S.1487 are not particularly concerned about the individual owners, but are seeking enactment of the legislation in order to retain in the public interest independent, locally owned daily and weekly newspapers.

I strongly endorse these purposes. Although I recognize that the Family Farm Act of 1976 was enacted to provide estate tax relief for independent farmers, I have been reluctant to seek like relief for newspapers. I would prefer it for all small business. However, I do sincerely believe our shrinking, diverse press is such an important part of our democratic process, it must be protected soon - before it is further diminished. Further, I believe a locally owned newspaper has an important role to play in its community which usually cannot be filled as well by a chain newspaper. Lastly, in America, too much power - press power or any other kind of power - in too few hands, is unacceptable.

I urge that the Senate Finance Committee give favorable consideration to S.1487, in order to save from extinction the species know as the locally owned newspaper.

Statement of
Thurston Twigg-Smith
Publisher
The Honlulu Advertiser
in Support of
The Independent Local Newspaper Act
S.1487

I am Thurston Twigg-Smith, Publisher of The Honolulu Advertiser, Honolulu, Hawaii. The Honolulu Advertiser is a family owned enterprise, owning no other newspapers or media interests. Our newspaper serves the Island of Oahu and, as a morning newspaper, is also distributed on the other islands which comprise the State of Hawaii.

I am making this statement in support of the Independent Local Newspaper Act, S.1487. This bill is designed to alleviate the primary problem facing owners of independent (non-group) newspapers today, that is, their present inability to pay Federal estate taxes while retaining ownership of their news-papers. S.1487 does not excuse or exempt newspapers from estate taxes, but makes it possible for the owners of independent newspapers to pre-pay their estate taxes during their lifetimes in order to avoid having to sell to newspaper chains.

Of the approximately 1,750 daily newspapers published in the United States, less than 600 are owned locally. The rest are owned by multi-state groups or chains or other media con-glomerates. Most of the larger newspapers are so owned, and the chains now have over 72 percent of daily circulation and over 75 percent of Sunday circulation.

The chains are buying out the remaining independents at a rate of better than one each week. We, at The Honolulu Advertiser, are regularly solicited by such chains or their agents or brokers. While it is nice to feel wanted, the effect of the efforts by the chains to accumulate the remaining independents has resulted in greater than premium prices being offered and paid for such properties. This, too, sounds good, but has a deleterious affect upon the independents, like The Honolulu Advertiser, who want to stay independent.

The Federal estate tax on a property, including a newspaper, is based primarily on the amount a willing buyer will pay a willing seller for that property. Thus, when the owner of a newspaper dies, his heirs must pay estate taxes based on what a buyer would offer for that newspaper, or the amounts being paid for like newspapers. In the past few years, the prices being paid for independents have escalated dramatically to 30, 40 and even over 60 times earnings. (I might note that stock in publicly traded newspaper companies normally sell for 10 to 13 times earnings.)

These exaggerated values placed upon independent newspapers result in estate taxes far out of proportion to the amounts earned by these newspapers. To put it simply, estate taxes are levied at levels far beyond the ability of the heirs to borrow sufficient sums to pay such taxes. The newspaper's earnings are just not sufficient to pay the interest on the sums required to be borrowed, without considering payment of principal.

We would like to see control of The Honolulu Advertiser pass on to our heirs. Under the present situation, we just do not know of any way to insure that this will happen. S.1487 provides a means for us to pre-pay our estate taxes, and thereby guarantee our ability to remain independent by assuring that the newspaper will remain locally owned.

In recent months, a number of formerly independent newspapers have been sold to chains because of present or anticipated estate tax problems. The owners of at least one of these newspapers has publicly stated that, but for the estate tax laws, the paper would not have been sold to a chain. We do not want this to happen to The Honolulu Advertiser.

Obviously, the Congress cannot dictate the prices to be paid for newspapers. While Congress could, if it chose, provide us with an exemption from the estate tax, that is not what we are seeking. We do request equitable treatment so that we are not punished by the present laws. Therefore, we urge support of S.1487, which will authorize prepayment of our estate taxes during our lifetimes. It is my understanding that S.1487 will not have an adverse affect upon the Treasury, but may, in fact, produce a revenue windfall for the Government.

Finally, in supporting S.1487, I believe that I am not acting solely because of our own interests. Together with many other publishers, I believe that a newspaper has certain responsibilities to the public. Without any criticism of newspaper groups or chains, I sincerely believe that the public is best served by a locally owned newspaper with its roots in the community it serves.

Statement of John F. Wolfe
before the Subcommittee on Estate and Gift Taxation
Senate Committee on Finance
in support of S.1487
the Independent Local Newspaper Act

I am John F. Wolfe, President of the Dispatch Printing Company, publisher of The Columbus Dispatch, Columbus, Ohio. I am offering this statement in support of S.1487, the Independent Local Newspaper Act.

I support this bill for what may be considered to be parochial and even selfish reasons. My family, which owns The Columbus Dispatch, and has owned it for 76 years, wants that ownership to remain with our family. We do not want to sell our newspaper, even though the current offers from newspaper chains are extremely attractive.

Not too long ago, newspapers used to sell for normal multiples of earnings. In fact, the stock tables show that stock in publicly traded newspaper chains still sells for 10 to 15 times earnings. This is not the ratio paid by the chain in acquiring independent newspapers.

The chains are paying much higher multiples to buy out control of independents. As the number of independents declines, the amounts offered increase as the competition for these remaining newspapers heightens. Chains are buying independents at a rate of better than one each week. Today, there are less than 600 independent daily newspapers left, and the countdown continues unabated.

The reason so many newspapers are being sold may be traced to the unusually harsh effects the estate tax laws have on newspapers. Because the chains are competing to buy out the remaining independents, the prices being paid are out of line with the profits to be earned by such properties. Neverthless, in determining the value of a newspaper for estate tax purposes, the Internal Revenue Service looks to the amount the newspaper is worth on the open market, or what a willing buyer will pay a willing seller.

The exacerbation in prices being paid for newspapers has made it just about impossible to pass a newspaper on to one's heirs. If you do not sell prior to death, in order to put your estate in order, your heirs will be forced to sell to pay estate taxes.

This fact is recognized throughout the newspaper industry, by chains and independents alike. A couple of year ago, Lindsay Schaub newspapers were sold to the Lee Newspaper chain for the stated reason of estate taxes. The late John Knight, of Knight-Ridder newspapers, and Peter Clark, of the Detroit Evening News, both have stated that the single most important factor for new-papers selling out to chains is to be found in the particularly pernicious affects of the estate tax laws on newspapers.

Let me add another thought here. If we were to sell our newspapers at the premium prices available, we could probably make more money by investing the sums received in tax free bonds than we presently earn. Of course, we could, as well, engage in a tax free tax swap, eliminating any immediate payment of tax.

The owners of The Columbus Dispatch do not want to sell, even at today's inflated prices. We want to continue publishing our newspaper, serving our city and its citizens.

We have deep roots in Columbus, and I honestly believe we are better able to serve the people of Columbus than could a chain with its headquarters hundreds or thousands of miles away. Assuredly, all of our readers do not agree with our points of view, but we do the best we can to put out a newspaper that serves Columbus and the State of Ohio.

We believe that we do a good job, worthy of the trust reposed in our newspaper, and true to the concepts of a free press.

I believe that S.1487 properly addresses the problems of the independent owner. I do not seek any "pie in the sky" relief, in exemptions or exclusions. Nor do I wish to see laws enacted which would further enhance the positions of newspaper chains, be they publicly traded or owned by closely controlled groups. By enabling the owners of independent local newspapers to pre-pay their estate taxes, the Congress would rectify an inequity in the estate tax laws, and provide for the preservation of a free and diverse press.

Statement of J. Hart Clinton before the Sub-Committee on Estate and Gift Taxation of the Senate Finance Committee In Support of S.1487 - The Independent Local Newspaper Act

My name is J. Hart Clinton. I am Editor and Publisher of the San Mateo Times and Daily News Leader in San Mateo, California, and President of the Amphlett Printing Company, the corporation which owns and publishes said daily newspaper.

The San Mateo Times is a daily which is published six days a week, Monday through Saturday, and is circulated among approximately 46,000 paid subscribers. In addition to publishing and circulating the San Mateo Times, the Amphlett Printing Company also circulates and publishes several weekly newspapers in San Mateo County. The San Mateo Times is the only daily newspaper published in San Mateo County.

I favor the passage of S.1487 by the Congress and I also hope that this Sub-Committee on Estate and Gift Taxation will favorably report S.1487. My reasons for this position and this request are as follows:

I am concerned both as a newspaper publisher and as a citizen about the excessive concentration of the media in the hands of a few powerful newspaper chains. Unless the present trend is checked there will be few, if any, independent newspapers left in the United States.

I am editor and publisher of an independent family-owned newspaper, the stockholders of which, in addition to myself, are my two sisters-in-law. My three children have a small nominal interest by reason of stock transfers which I have made to them during the past years. All of us stockholders in our corporation desire to keep the San Mateo Times, which is our daily newspaper, an independent family-owned newspaper and we do not wish to be forced by reason of Federal estate taxes to sell our newspaper to a newspaper chain.

On the San Francisco Peninsula where we operate, we are the only remaining family independent newspaper. In San Francisco at the tip of the Peninsula, the two major daily newspapers are owned by the Hearst chain and by the Chronicle Publishing Company and operate under a joint operating agreement pursuant to the Newspaper Preservaton Act. The San Francisco Progress, another San Francisco newspaper, is owned by the Harte-Hanks newspaper chain which is headquartered in Texas. To the south of us on the San Francisco Peninsula, the Palo Alto Times, a daily newspaper of about our size, and the Redwood City Tribune, a daily newspaper of approximately 20,000 subscribers, were recently purchased by the Chicago Tribune chain for the reported sum of $23 million cash. The Chicago Tribune has stopped the publication of the Redwood City Tribune and now operates the two newspapers in a single newspaper published in Palo Alto under the combined name of Peninsula Times-Tribune. The ultimate direction of the Peninsula Times-Tribune is by the heads of the Chicago Tribune newspaper chain in Chicago, Illinois. Still further south on the San Francisco Peninsula are the San Jose Mercury and the San Jose News, which are morning and evening dailies formerly owned independently by the Hayes and Payne families, but for many years now owned and operated by the Knight-Ridder chain.

Accordingly, we find ourselves a lone survivor as an independent family newspaper amidst a host of chain newspapers which, for the most part, are owned, operated and directed from headquarters in other states of the United States. In fact in the area east of the Bay, we have the only independently owned daily between Santa Rosa and Santa Cruz.

Newspaper chain acquisition representatives have been calling on us for several years to endeavor to induce us to sell, but we have steadfastly refused to do so. However, I will be 77 years of ages on my next birthday, and the other two principal owners are older than I am, so that our combined life expectancy is not what you would call extravagant. From this you will see that we will shortly be facing estate tax problems. and while we are endeavoring to arrange our estates in a manner which will permit us to retain ownership of the San Mateo Times as an independent newspaper, it would greatly enhance the chances of our doing so if S.1487 were adopted. I favor this bill because S.1487 was proposed as a means of encouraging independent newspaper owners, such as ourselves, to retain ownership rather than being forced to sell our properties to newspaper chains in order to pay Federal estate taxes and inheritance taxes.

I do not question that in many cases newspapers owned by chains are better designed and possibly offer broader news coverage than was the case prior to their acquisition by the newspaper chain which now owns them. Nevertheless the fact remains that a community is much better served by a newspaper which is owned and controlled independently by a local family residing in the community.

Before I became a full-time editor and publisher of the San Mateo Times I practiced law in San Francisco for approximately 50 years, and I recall distinctly the admonition given to us by one of my law school professors, namely, "It's all-right to take a little bit not too much"; and I simply submit that unless the current trend towards media concentration is stopped the newspaper chains of this country will be owning too much, and our newspaper readers throughout the country will be denied that diversity of ownership and expression of opinion which they would otherwise enjoy if newspapers could remain in the hands of independent family owners.

I see nothing on the horizon which will in any way tend to restrain or inhibit the ravenous desire of expanding newspaper chains to acquire more and more newspaper properties in their portfolios. While legislation directly controlling the growth of these newspaper chains may be one possible remedy, I submit that the first step should be to attack the cause of family newspapers selling to chains, and that cause in most cases is the inability of independent families to raise sufficient funds from their newspaper properties to pay the necessary Federal estate taxes which apply when the Internal Revenue Service undertakes to value these properties on the basis of comparable and recent sales of similar newspapers to newspaper chains.

If we are permitted and authorized by S.1487 to establish a trust for the purpose of accumulating pretax earnings for the sole and exclusive purpose of paying Federal estate taxes, the Congress will have gone a long way toward encouraging independent family owners to retain ownership of independent newspapers and thus foreclose their being forced to sell to newspaper chains.

I sincerely urge, therefore, that your honorable committee report out S.1487 with a "DO PASS" recommendation.

Mr. LEVIN. I would like to refer to one, specifically—it's the one on top, when the set gets to you—by a gentleman named Amon Evans, whom I had the pleasure of representing for many years. He was the publisher of the Nashville Tennessean. He sold that newspaper 2 years ago, and he states clearly in his statement that but for the estate tax laws he would not have sold his paper. He had a mother, aged 78, who controlled a significant portion of the stock of the newspaper, and there was no way, absolutely no way that they could find, to hold on to the newspaper after her death, so he made the best deal he could before her death. He felt that he had no choice.

The other statements are from publishers in Louisiana, California, Missouri, Hawaii, and Ohio. They range in age from midthirties to late seventies. They all face the same problems. They all are concerned about these problems and have no other way of finding a means of holding on to their newspapers other than some form of tax relief.

Now on one point, and Mr. Iannucci who is a tax expert will go much more deeply into this, but both the chairman and Senator Boren inquired of the Treasury Department did they have a better way of doing this. I think the answer is almost axiomatic in something that Secretary Glickman said with regard to the Family Farm Act. He said it really doesn't work. Well, it doesn't work because they don't want it to work. As the chairman knows, in both the House and Senate in the last several years, you tried to do something to make the Treasury follow the Family Farm Act, so that the valuations would be reasonable, so that there would be an opportunity for a farmer to maintain his property. That hasn't worked. I agree with them.

Two years ago and 3 years ago, under the prior administration, I went to the Department of the Treasury with Mr. Iannucci and asked, "Would you rather do this on a valuation basis?" And they said, "No, we never liked the Family Farm Act, and we are trying to kill that; and we are certainly not going to do that for newspapers."

So we have sought in direct confrontation an alternative means of accomplishing what we are seeking here. We have been told "The answer is No. We have no other alternative. We think it is sad that all these newspapers have to be sold, but don't blame us. Find somebody else to talk to."

Let me turn it over to Mr. Iannucci. I see there is another vote coming.

Senator SYMMS. Well, thank you very much for a very excellent statement. We will have all of these statements that you presented here made a part of our record.

I find it very hard to believe that if we could get this legislation through the Senate and the House and sent to the White House, that President Reagan would veto it. I think your legislation is totally consistent with the beliefs that he espouses to try to allow for private ownership to be a diverse expression of what people would want, to be able to hold capital together at the family, small level. I think it is an excellent piece of legislation, and I am really happy to be a part of the sponsorship of it. And I appreciate your statement very much.

Mr. LEVIN. Mr. Chairman.

Senator SYMMS. Yes, sir.

Mr. LEVIN. We have great hope that this administration will see the light with regard to the merits of this bill. But, as you will notice from the sponsors both in this body and in the House, they are across the political spectrum from left to right.

Senator SYMMS. That is correct. And I know that there is no partisanship as far as the sponsorship is concerned here. It is bipartisan sponsorship. It is very interesting that once the Treasury staff get infected by whatever it is the water has in it down at the Treasury, all they want to do is raise taxes on people. It doesn't seem to matter if we have an election, it doesn't seem to change. That is not a partisan thing, either. I can say that.

Go ahead, Mr. Iannucci.

STATEMENT OF JOSEPH S. IANNUCCI, PARTNER, JONES, DAY, REAVIS AND POGUE, WASHINGTON, D.C.

Mr. IANNUCCI. As to the technical aspects of the bill, this bill was conceived as a financing mechanism for the prepayment of taxes, and the fundamental concept is that the Government obligations that would go into the trust would not be income-bearing, or would earn income at below-market rates. So that the trade-off that is taking place is that the Treasury would obtain use of money before the death of the decedent, and, therefore, would realize an economic benefit in return for the reduction of the estate tax that the owner would pay.

If you use an example of $1, the Treasury would collect the 46 cents which it otherwise would collect but for the tax deduction provided by the bill, so that leaves 54 cents that the owner is contributing to the trust that is being transferred to the Treasury long before the owner dies. If you assume the owner lives for 30 years and makes level annual contributions throughout that period to the trust, the Treasury will gain an average of $1.69, over the 30-year period from the 54 cents contributed by the owner.

Now the tax benefits that come out of that $1.69 are less than the $1.69. First, there is the 46 cents corporate tax. Second, there is a 50 cents tax benefit arising from the exclusion of the trust from the gross estate. So that's a total of about 96 cents. And there also would be a 50-cent tax under ERTA, starting in 1982, imposed on dividends distributed from a corporation. The total of these amounts is $1.61, which is less than the $1.69 use of money benefit realized by the Treasury and gives the Treasury a net benefit, if you live 30 years, of 8 cents.

If you looked at example 2 in the appendaged examples to our statement, the example illustrates the tax benefits. We assumed a newspaper interest having a value of $5 million. The tax in 1982 on that interest would be $2.4 million. If you funded a trust over a 30-year period, you would put $82,000 in the trust per annum. The pretax income of the paper that would have this value would be $307,000. There will be a tax deduction of $82,000, and there would still be a tax payable to the Treasury of $103,000 after the deduction. Of the $82,000 contribution, $32,000 would otherwise go to the Treasury in the form of a normal corporate tax, if this bill were not enacted. So you back out that $38,000. That leaves a contribution by the owner of $44,000 per annum, money that would not otherwise go into the Treasury.

Over a 30-year period, if you use actuarial tables using a 9.5 interest rate, you come up with a total benefit to the Treasury of $6.5 million. If you back out the estate tax payment of $2.4 million, the Treasury realizes a net use of money benefit of $4.1 million. Now from that $4.1 million, if you take off all of the taxes to which the Treasury has objected, the 46 percent corporate tax on the 2.4 will be a tax of 1.1. If you subtract that from the use of money of 4.6, you are left with 2.9. If you deduct a 50 percent dividend tax on the principal amount of 2.4, that is an amount of 1.2, and there is still a remaining balance of 1.7.

If in the year 1982 you subtracted or you imposed an estate tax of 65 percent on the 2.4 that was in the trust, you would have a tax of 1.6, leaving a net benefit to the Treasury of $200,000 after subtracting all the taxes that are being imposed under current law.

Now I must concede that this bill does reduce the amount of money that an owner needs to keep his paper. If you go out to 1987 when there is a 50 percent estate tax rate, which is an easy rate to work with, to pass on a $5 million interest in a newspaper the owner would need $10 million, for at a 50 percent rate, the $10 million would be reduced by 50 percent because you would pay $5 million to the Treasury. This bill would reduce that tax to $2 million. But as an offset it would give the Treasury the use of money for 30 years, and that use of money more than makes up for the revenue lost. This is the fundamental concept of the bill.

The concept of the bill is to give the Treasury a positive cashflow plus the earnings on the positive cashflow to offset the benefits that the owner is realizing.

Senator SYMMS. You don't buy treasuries in $25 million figures.

Mr. IANNUCCI. No, I don't. I don't buy it.

Mr. LEVIN. It went from $10 million to $25 million, and I'll guarantee there is not a stick of paper to demonstrate the change from $10 million to $25 million.

Senator SYMMS. It would go just as fast as changing the time from daylight to standard.

Mr. IANNUCCI. Right.

But what Treasury contemplates is that the obligations that are in the trust fund will bear marketplace rates, which are 13 percent today on Treasury-bills. We are assuming that these obligations would bear no interest, whatsoever. We made our assumptions on an average interest rate of about 9 percent over the next 30 years, which I think in today's economy is rather conservative for Treasury-bills. So it is a function of the use of money for an extended period of time.

There will be cases, if a person dies prematurely, that the Treasury would lose; but if a person lives for a more extended period of time, the Treasury gains. If we assume that the person lived 35 years, there would be a major benefit to the Treasury. And if you assume that the interest rate for Treasury-bills is at 12 percent over the 30-year period, there is a significantly greater benefit to the Treasury. So I can't necessarily agree with the Treasury.

Senator SYMMS. Thank you very much.

Mr. LEVIN. I wanted to raise one point, because Senator Boren came back. On that suggestion that you made this applicable across-the-board to all closely held or family-held businesses, and the Treasury, of course, backed off from that, too. What we have suggested in the past and would bring to your attention is you are dealing with a finite number when you are dealing with 600, or what have you, newspapers. This bill could provide a reasonable test. And, if this bill were enacted, even though it were limited, day one, to newspapers, within 3 or 4 years your computer operations down at Treasury, or at GAO as the case may be, would show whether the bill works: whether Treasury loses money, whether Treasury gains money. It could be a precursor or a bell cow for whatever should be done within this industry.

Excuse me.

Senator BOREN. Mr. Chairman, I want to thank the members of the panel, and I apologize that I got detained. I had two meetings scheduled at the same time today, with the vote intervening. But I think that is a very good point that has just been made, that this could well be a good test of this theory. I would provide a limited test, and I hope that that is something that Treasury will consider, will reconsider their objection to the bill and decide that it would be very worthwhile to have this kind of test.

I think, also, the testimony we have just heard, in terms of the Government's ability to have some cashflow and the use of the money in the intervening time—I was just sitting here reviewing the statement of Mr. Glickman to see if there was any mention of that in his statement. I don't find any.

Mr. IANNUCCI. We communicated that to the Treasury in conference.

Senator BOREN. Well, it is obvious that the testimony that the Treasury has given us today does not even take into consideration the fact they would have some immediate cashflow and the very substantial benefit from the use of money over this period of time, which would greatly reduce the cost of the bill and perhaps turn it into a revenue gainer in terms of the ultimate effect to the Treasury, as you have indicated.

I think this is very, very helpful testimony, and I hope that all the members of this committee will not only read the testimony that has been given today and the comments that have been made, but I hope that the Treasury will also review the testimony today and reconsider their position, because I don't think that the position they have taken today reflects a full understanding, even, of what this proposal is.

I want to commend both of you for the contribution which you have made to a better understanding of what we are trying to do here. I just express my appreciation for your support on this piece of legislation. I also want to express my appreciation to the Chairman.

Senator SYMMS. Thank you very much, Senator Boren. And I might just say that in your absence those of us that are here, agreed that if we could get this through the Congress, it wouldn't be vetoed by the White House, and that it would be supported by the President.

I want to advise you that you have my support to push this bill through. One newspaper a week, being gobbled up by a chain, just can't be beneficial to a free society. At least, if they don't all get their information from the same source they are not all going to be wrong. They may not all be right, either, but at least there would be some divergence of viewpoint, which I think would be healthy.

So, I thank you very much. We will keep our record open for additional testimony for about the next 25 days. I thank you very much, and if there are not further witnesses to testify, we will stand in recess.

[Whereupon, at 3:20 p.m., the hearing was recessed.]

[By direction of the chairman the following communications were made a part of the hearing record:]

. WEBER
. DISTRICT, OHIO

COMMITTEES:
BANKING, FINANCE AND URBAN AFFAIRS
SMALL BUSINESS

Congress of the United States
House of Representatives
Washington, D.C. 20515

512 CANNON BUILDING
WASHINGTON, D.C. 20515
202-225-4146

DISTRICT OFFICE:
414 NORTH ERIE STREET
SUITE 100
TOLEDO, OHIO 43624
419-259-7379

November 3, 1981

Honorable Robert Dole
2213 Dirksen Office Building
Washington, D.C. 20510

Dear Senator Dole:

It is my understanding that the Finance Committee has under consideration legislation pertaining to the so-called "generation-skipping tax" on gifts, bequests, and other transfers.

Let me express to you my strong support for the repeal of this impractical, and cost-ineffective and unwise tax.

Until my election to Congress last November, I was a specialist in probate and trust law in private practice in Toledo, Ohio for 22 years.

Based on my experience I know that many millions of dollars will be spent by clients across the country in order to avoid this tax. Many millions of tax dollars will be spent to hire and train IRS agents to audit the tax returns of those who may or may not have successfully avoided the tax.

Many millions of dollars that ought to remain for productive investment in our economy will thus be wasted to avoid (on the one hand) or to enforce (on the other hand) payment of this terribly complex tax on the accumulated capital of those members of our society to whom we look for the necessary capital investment to keep our economy expanding.

For these reasons I urge action to repeal the "generation-skipping tax" as promptly as possible.

Sincerely,

Ed Weber

Ed Weber
Member of Congress

EW/eb

UNION UNIVERSITY
ALBANY LAW SCHOOL
80 NEW SCOTLAND AVENUE
ALBANY, NEW YORK 12208
518-445-2355

IRA MARK BLOOM
PROFESSOR OF LAW

November 18, 1981

Mr. Robert E. Lighthizer
Chief Counsel, Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Lighthizer:

Regarding S. 1695, repeal is justified if it is replaced with an effective, targeted and relatively simple generation-skipping tax. Repeal alone will mean that wealth concentration can be more readily perpetuated.

The ineffectiveness of the present system may be demonstrated by comparing two taxpayers, A and B, each owning \$5 million at death. (The \$5 million figure may seem high, but it is purposely used to illustrate how it is the very wealthy who can effectively avoid the current generation-skipping tax system.) If A wants a child to enjoy the property, for example the life income, a generation-skipping tax will be imposed on the child's death under the current system. Overall A's grandchildren will receive A's property reduced by transfer taxes imposed at two different times - when A transfers his property to his child and again when A's child dies. On the other hand, if B transfers property directly to his grandchildren - typically by way of trust - B's grandchildren will receive much more than A's grandchildren. Assuming an effective rate of 40%, A's grandchildren would receive \$1.8 million, while B's grandchildren would receive \$3 million.

The failure to tax all generation-skipping transfers by the current system facilitates the perpetuation of concentrated wealth. Repeal alone, however, would be even more beneficial to the wealthy. Property could be placed in trust and income paid to the members of each generation during their lifetimes, with the corpus preserved intact. The spectre of generations of wealthy heirs living off such dynastic trusts should be shocking. You may also be surprised to know that Wisconsin has no effective rules restraining such dynastic trusts and by application of conflict of laws rules any citizen can subject their property to these favorable Wisconsin rules. (Wisconsin has no effective rule against perpetuities.) As a result, repeal of generation-skipping taxation would enable and encourage the creation of dynastic trusts. These consequences are developed in my recent article, <u>Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation</u>, 45 Albany L. Review 261.

I believe that there is a solution to the generation-skipping problem: the repeal of the current system and the enactment of an effective one. Since an effective tax would be directed towards preventing the perpetuation of concentrated wealth in this country, the average person and practitioner need not be concerned with the tax. The mechanism for achieving these desirable goals is high exemption levels. For example, a generation-skipping tax need not be imposed unless the amount of generation-skipping transfers exceeds, for example, $1 million. Returns would have to be filed only if annual generation-skipping transfers exceeded $100,000 (or whatever level) each year. In addition, it will be possible to devise a relatively uncomplicated substantive system.

This proposal would be relatively easy to administer, would affect only the very wealthy for whom the tax is designed and should generate appropriate revenues.

Sincerely,

Ira Mark Bloom

IMB/m

AMERICAN COUNCIL ON EDUCATION
ONE DUPONT CIRCLE
WASHINGTON, D.C. 20036

DIVISION OF GOVERNMENTAL RELATIONS
(202) 833-4736

November 16, 1981

The Honorable Steven D. Symms
Chairman,
Subcommittee on Estate and Gift Taxation
Committee on Finance
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the American Council on Education and the National Association of Independent Colleges and Universities, representing over 1600 public and private colleges, universities, and associations in higher education and the organizations below, we forward this letter for inclusion in the hearing record on S. 649, S. 851, and S. 852, relating to the restoration of incentives for authors and artists to donate their creative work to charitable entities.

The higher education community strongly supports the spirit of the proposed legislation which would renew the ability of libraries and museums connected with colleges and universities to acquire, preserve, and make available for study contemporary art, literature, and music, which constitute such an integral part of our cultural heritage.

Prior to the Tax Reform Act of 1969, an author or artist who donated literary, musical, or artistic compositions or papers to a library or museum could take a tax deduction equal to the full fair market value of the items at the time of the contribution. But under the 1969 Act, the value of artistic property contributed to charity must be reduced by the amount of gain that would not have been long-term capital gain if the property had been sold by the donor. The effect of this rule is to limit the creator donor's deduction to the cost of materials used to produce the compositions. The 1969 legislation was motivated in substantial part by a twofold concern on the part of Congress: a belief that some taxpayers could benefit substantially more from contributing their property than by selling and the fact that public officials could secure charitable deductions for the donation of their public papers produced while on the public payroll.

The result of the 1969 legislation has been a precipitous decline in the charitable contributions by living artists to museums and libraries. The testimony of the 1973 hearings on general tax reform before the Committee on Ways and Means demonstrates this effect. For example, the Library of

Congress showed that contributions of donor-generated manuscripts to both the Manuscript Division and the Music Division of the library plummetted to zero since 1970. 1/

At the 1973 hearings, the education community also expressed concern over the result of the 1969 legislation, 2/ and we again express our continuing concern. Following the effective date of the 1969 Tax Reform Act, educational institutions have lost a significant and vital group of gifts. Living authors, artists and composers do not give their work products to educational institutions, museums and libraries, but rather, retain their works, sell their collections on the open market, or place them on deposit with some libraries or museums.

With regard to acquisition through purchase, in these times of scarce economic resources, institutions of higher education are unable to compete with other private purchasers for many of the collections available on the open market, since private purchasers are often financially unable to purchase entire collections, many valuable collections are divided and items become unavailable or even lost for appreciation and research. If we are fortunate enough to have items placed on deposit, they are generally deposited on a restricted access basis, which hampers research. Thus, the 1969 amendments diminish access of students, researchers, and the public at large to contemporary artistic, literary, and musical works.

We favor the concept of full fair market value deductibility provided in S. 649 compared to either the concept of tax credit or percentage-of-fair-market- value deduction provided in S.851 and S.852 respectively. Implementation of a credit or percentage would not fully restore the pre-1969 level of giving to our institutions, while restoring a tax deduction equal to the full fair market value at the time of a contribution would enable museums and libraries to acquire works of art without cost and benefit the public served by our institutions.

Unfortunately the percentage credit or deduction would appear to limit the usefulness of the incentive to donate, since creator/donor's with high adjusted gross income would get a substantially smaller tax benefit than those with low AGI who could get a credit or deduction worth 86%. The effect of such a provision would probably mean that there would be little incentive for highly sought after artists to donate their works, just the works that institutions cannot afford to purchase, while artists etc. whose works might be within a charitable

1/ Hearings on General Tax Reform before the Committee on Ways and Means, 93d Cong., 1st Sess. 6172 (1973).

2/ Id. at 5515-5640, 6021-6147.

institution's budget, would be given the maximum incentive to donate. Such a result would seem,at best unfortunate.

With regard to the certification provisions in S.851 and S.852, it is certainly reasonable to require the donee to certify that the use of a composition will be related to the purpose or function constituting the basis for its exemption under section 501 of the Internal Revenue Code. However, we view a requirement that the donee certify in writing that the donated composition "represents material of artistic, musical, or literary significance" as unnecessary paperwork. Also, we recognize that valuation is a particularly difficult problem. Concern over this area is reflected in the 1981 tax act in section 722, which provides a penalty for overvaluation of charitable contributions of appreciated property. The President's Task Force on the Arts and Humanities, which recommends restoration of full fair market value deductibility of artists' own works, has pointed out that the Internal Revenue Service presently has a panel which monitors the value of artistic works for tax purposes. 3/ Thus suggesting that issues of valuation are properly between the taxpayer and the Service. We share this view, and feel the Service is well-equipped to handle the valuation area and can assure uniformity of result in this area more so than our institutions. We suggest that the panel of experts that advise the Commissioner on the valuation of artistic works should also have authority to review materials donated under this proposed legislation.

In fact we commend to the Committee the full recommendation of the White House Task Force on gifts of a creators own works. The Task Force suggested: "that the value of the contribution shall be governed by the most recent arms-length sale, by the creator, of a comparable work, or by another appropriate appraisal mechanism."

We also note that in no longer limiting creators to the costs of materials as a deduction, the proposed legislation would restore equality of treatment between collectors ~~and~~ creators. In addition, S.649 would extend beyond mere literary, musical, or artistic compositions to embrace any letter or memorandum which the donee believes to be of merit.

In conclusion, these bills represent a substantial effort to rectify a problem that has plagued our institutions for over a decade. The higher education community strongly supports S.649 and the general spirit of these bills. A modest change in the tax law will enhance the research environment for college and university students and faculty, and most importantly, benefit

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3/ Presidential Task Force on the Arts and Humanities, Report Report to the President 20 (October 1981.)

the public at large who will be able to study, preserve, and appreciate our living cultural heritage in the best possible manner.

We would be pleased to meet with you or your staff to discuss some of concerns relating to this issue.

Sincerely,

Christine T. Milliken
General Counsel
National Association of
Independent Colleges
and Universities

Sheldon E. Steinbach
General Counsel
American Council on Education

The following associations wish to join in this statement:

American Association of State Colleges and Universities
Association of American Universities
National Association of State Universities and Land-Grant Colleges

SES/dpr

cc: Members of the Subcommittee

Committee of Banking Institutions on Taxation

This Committee consists of National and State Banks, Trust Companies, Private Banking Institutions and Agencies of Foreign Bankers. The members of its executive committee and its officers are selected from representatives of these institutions. Its objects are (a) to cooperate in assisting in the administration of tax laws; (b) to disseminate among its members information pertaining thereto; and (c) to act as a clearing house for communications to or instructions from Federal and State tax authorities.

Robert F. Neuburger, Chairman
Daniel N. Leiter, Vice Chairman
George R. Stokes, Secretary
Patrick A. Naughton, Treasurer

Address all communications to

Albert G. Doumar, 2VP
The Chase Manhattan Bank, NA
Tax Services Division, 36 Floor
1211 Avenue of Americas
New York, New York 10036

November 19, 1981

Honorable Steven Symms
Chairman of Subcommittee on Estate
and Gift Taxation
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Symms:

Representatives of our organization attended your November 4th hearings on Generation-Skipping Transfer Tax-Chapter 13 of the Internal Revenue Code of 1954.

Our organization, which represents the major banks in New York City and various banks throughout the country, strongly supports S.1695 which would repeal the generation-skipping transfer tax.

We not only heard but read the comments of the various organizations who gave testimony in favor of repeal and we are in full accord with their positions. Briefly, we also espouse repeal for the following reasons.

1. Even though this law has been in existence for the last five years, it has not generated any revenue. In addition, it is anticipated that there will be little revenue generated over the next twenty years. Further, the expenses already incurred and to be incurred by Congress, Treasury and the public sector is immeasurable and completely disproportionate to any revenues that may be generated in the future.

2. The generation-skipping transfer tax is a highly elusive concept which requires the utmost vigiliance and technical expertise and even with both of these qualities a trustee could inadvertently be in violation of the law. Continuous unintentional noncompliance will undermine the integrity of our tax system.

3. While the Economic Recovery Tax Act of 1981 provided for increased estate planning benefits, especially in relation to the marital deduction, many taxpayers will find themselves in a "Catch-22" position because if they take advantage of the new law they may be trapped by Chapter 13.

4. The vital data for computing the generation-skipping transfer tax must be furnished by the Internal Revenue Service. However, we believe that under the Freedom of Information Act the Internal Revenue Service cannot automatically furnish this information. Can the Internal Revenue Service release information where the deemed transferor objects? If not, what would be the liability of the trustee or transferee?

The Treasury's position seems contradictory. Their basic premise is that the Chapter 13 tax is an integral part of the total unified transfer tax system. However, they suggest that for simplicity sake the Chapter 13 tax would not relate back to prior transfers of the deemed transferor, but rather the tax would be imposed at a flat rate. The imposition of a flat rate would not preserve the integrity and fundamental fairness of the overall transfer tax system which seems to be the prime reason the Treasury is opposing S. 1695.

Let's not perpetuate a concept which the Treasury seems enamored by and which has proven to be ineffective and very costly from our experience of trying to work with it over the last five years. Apparently, the Treasury, from a practical point-of-view, has met similiar problems in that they have been unable to issue Regulations or the basic tax form.

We congratulate and applaud your keen perception in identifying a law which is extremely ineffective and which would require the expenditure of more resources than anticipated revenues.

We fully support your Bill "S.1695" and urge prompt repeal of the generation-skipping transfer tax.

Respectfully submitted,

Albert G. Doumar

Albert G. Doumar
Chairman of the Conference Committee

nysba new york state bankers association
Eline N. Hancock, Vice President, Trust Division & Education Department
485 LEXINGTON AVENUE
NEW YORK, N.Y. 10017
(212) 949 1155

TAX COMMITTEE
John K. Daly, Chairman
Vice President
The Chase Manhattan Bank, N.A.
New York, New York

November 19, 1981

Honorable Steven Symms
Chairman-Subcommittee on Estate
and Gift Taxation
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Symms:

In my capacity as Chairman-Tax Committee, Trust Division, New York State Bankers Association, and on behalf of the 100 member trust companies of our association, I should like to add our collective voice to the support of S.1695 which advocates the repeal of the generation-skipping transfer tax.

When tax law becomes so complex that neither the Internal Revenue Service nor those whose responsibility it is to comply with the law can understand the law and apply it with reasonable certainty in all cases, then the law is bad law and should be repealed. The Internal Revenue Service has for five years labored to produced proposed regulations and having had the occasion to review the proposed fifth draft of those regulations, we found them to be incomprehensible. No lay person acting as a trustee could understand or apply these regulations with certainty. Professionals will have difficulty. This type of uncertainty will lend to noncompliance and we do not need this type of problem in a tax system that is based upon self-assessment. For the integrity of the tax system alone, the law should be repealed.

The Reagan Administration with the support of the Congress enacted the Economic Recovery Act of 1981. A fundamental portion of this law concerns itself with an overhaul of estate and gift taxes. The increase in the unified credit so that by 1987 an estate of $600,000 can pass without being subject to Federal Estate or Gift Tax and the introduction of the unlimited marital deduction and the qualified terminable interest trust seems to us to be a beacon that simplicity is the order of the day and all of these new benefits are vastly complicated and in fact may not be availed of because of the potential impact of the generation-skipping transfer tax system. This is a further argument for immediate repeal of Chapter 13 of the Internal Revenue Code of 1954.

Finally, the cost to the Trust Industry in attempting to identify generation-skipping transactions and in the ongoing maintenance of records related thereto seems disproportionate to the revenues ultimately to be derived from this tax. If a tax is not cost effective it should not be continued unless the Treasury is prepared to admit that it is not revenue that is being sought but the termination of the trust concept, which we do not believe to be the case. We think that this tax was a mistake and its only remedy is repeal.

Thank you for your consideration of these comments and we support your efforts to repeal Chapter 13 I.R.C.

Respectfully,

LAW OFFICES
LOWE, BRESSLER AND KAUFMAN
2700 QUE STREET, N.W., GEORGETOWN
WASHINGTON, D.C. 20007
CABLE ADDRESS "LOBAK"
(202) 337-8688
(202) 483-6777

IRA M. LOWE
D.C., N.Y. AND MASS. BARS
MARTIN BRESSLER
N.Y. AND N.J. BARS
JOSHUA J. KAUFMAN
D.C. AND MD. BARS
JOHN L. SIMSON
D.C. AND N.Y. BARS
JAMES L. SILVERBERG
D.C. BAR

NEW YORK OFFICE:
ONE WORLD TRADE CENTER
SUITE 1535
NEW YORK, N.Y. 10048
(212) 466-1123

MASSACHUSETTS OFFICE:
MAIN STREET, VINEYARD HAVEN
MARTHA'S VINEYARD, MA. 02568
(617) 693-4569

December 10, 1981

Senator Baucus
Senate Finance Committee
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Baucus:

In reading the "Artist's Equity and Donation Act of 1981 proposed by you (S. 649) and the two "Pen and Ink Acts of 1981" proposed by Senator Moynihan (S. 851 and S. 852), to amend the Internal Revenue Code §170(e), we feel obligated to express our thanks for the concern of the Senators proposing the amendments and to confirm our past statements on the need to correct the inequities against artists practiced by the current law, denying them proper deductions when making charitable donations of their work.

B. Current Tax Laws

1. Charitable Deductions

The current tax law does not treat an artwork in the hands of its creator as a "capital asset." IRC §1221(3). Thus, a donation by an artist of his own work is not a "qualified contribution" under IRC §170(e)(3)(A). This means that, upon making a charitable contribution, an artist may deduct only the value of the materials he used in creating the donated work, not the fair market value of the work which a purchasor of the work would deduct. Furthermore, he has probably already deducted the cost of his materials.

This provision gives an artist little incentive indeed to make charitable contributions. If he keeps the art work in his collection, he might eventually sell it, realizing a profit. In most cases, then, the only benefit an artist will derive from a contribution, important as this may be, is the intangible benefit of seeing his work displayed. This law (1) economically discourages artists from continuing to produce (there is evidence from a survey that among artists, the median cost of art materials exceeds the median income from art); and (2) denies citizens the obvious benefit of artist donations -- particularly in small town communities and cities with only small museums, concert halls, libraries, etc.

Important gifts to the American public have already been lost because of this archaic tax provision. For example, Igor Stravinsky had intended to will his manuscript collection to either Yale or the Library of Congress. When he discovered that such a gift would yield no tax benefits to his heirs, he refused — how many equally significant gifts must we lose before we realize the folly of our law?

2. Estate and Gift Tax

To the amazement of the rational mind, while the situation regarding charitable deductions may seem publicly disadvantageous and unfair to artists, it is purely inconsistent that when an artist makes a noncharitable gift of an artwork, *inter vivos* or testamentary, he is taxed based on the full fair market value of the work. IRC §2032.

The mischievous workings of the tax laws pertaining to artists are perfectly portrayed by the following hypothetical case. An artist died one evening. The inheritance tax on all his works was based on their fair market value at the time of his death. Yet, if earlier that evening he had decided to donate his works to a museum, he would have received a charitable deduction of only his cost of material and supplies. On the other hand, had he decided that afternoon to give his work to a friend, he would have been assessed a gift tax based, again, on the fair market value of the works. Finally, had he awakened on that morning and found his entire work destroyed by fire, he would only have been entitled to a casualty-loss deduction for the materials he had used.

C. The Proposed Amendments

1. S. 649

We support enactment of Senator Baucus's amendment to the tax code §170(3) giving to artists a deduction for charitable gifts equal to the fair market value of the work donated. This amendment is long overdue. It would publicly encourage important gifts to museums, libraries, schools, etc.. Gifts of unknown artists' work, being of less monetary value, would generate only very small charitable deductions (sufficiently offset by the benefits they would engender to permanent collections in small museums and libraries).

2. S. 851 and S. 852

Senator Moynihan's alternative proposed amendments, while laudible in intent, reflect a less attractive proposition.

Both propose a "graduated" charitable deduction based on the artist's adjusted gross income. If the deduction is to be based on fair market value, why denigrate this principle by discounting the fair market value. Why not deal with it the same way the Code deals with it for any other donor (up to 50% of the donor's income with a five-year carryover provision). There seems to be no justification for the graduated system, unless its sole purpose is the support of unknown artists. It is at least equally important to encourage donations by successful artists deriving substantial income from their work.

In summary, while we applaud the spirit of all the amendments discussed above, we support Senator Baucus's bill. This piece of legislation is important both to the large community of artists and to the U.S. public and could help to create an environment in this country which is conducive to continued creative efforts of living artists and worthy of our reputation for excellence in the arts.

Sincerely yours,

Ira M. Lowe (REK)

Ira M. Lowe Esq.

Rebecca E. Kapell

Rebecca E. Kapell, Esq.

NATIONAL REALTY COMMITTEE INC.
2033 M Street, N.W.
Washington, D.C. 20036

November 23, 1981

Senate Finance Committee
Subcommittee on Estate and Gift Taxation
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Internal Revenue Code Section 6166

Gentlemen:

The National Realty Committee Inc. is a nonprofit business league whose membership includes owners, operators and developers of all types of real estate throughout the United States.

In connection with your November 4, 1981 hearings relating to estate tax reform, including proposals for amending Internal Revenue Code Section 6166, we appreciate this opportunity to submit for your consideration several proposals which we believe are necessary to clarify, in the face of needlessly restrictive Internal Revenue Service interpretations, the "trade or business" requirement of Section 6166, to adjust certain of the dollar limitations contained in Section 6601(j) consistent with current rates of inflation and the treatment of comparable items under the recently enacted Economic Recovery Tax Act of 1981 ("ERTA"), and to simplify the computation of estate tax liability where Section 6166 is applicable.

Introduction:

As part of the Small Business Tax Revision Act of 1958, Congress enacted former Code Section 6166 in order to prevent the hardship involved in forcing an estate, in order to pay estate taxes, to sell generally illiquid assets constituting a closely held business or a stock or partnership interest in such a business, at a price generally below the value which would be obtainable in a sale under less precipitous circumstances.

In an effort to provide additional relief for estates with interests in closely held businesses, Congress enacted in 1976 a somewhat similar, companion provision, designating the new provision as Section 6166 and redesignating the former provision as Section 6166A. As part of ERTA, Congress made further amendments to Section 6166 and repealed in its entirety Section 6166A. As amended by ERTA, Section 6166 presently allows the estate taxes attributable to a closely held business to be deferred up to fifteen (15) years, with interest only payable for five (5) years, followed by up to ten (10) annual installments of principal and interest, and with at least a portion of the deferred tax incurring interest at four (4%) percent per annum.

Despite the recent amendments to Section 6166, the National Realty Committee believes that the following four aspects of Section 6166 deserve legislative attention:

1. Clarification of the trade or business requirement;
2. Treatment of holding companies;
3. Increasing the amount of estate tax qualifying for deferral at four (4%) percent interest;
4. Simplifying the estate tax treatment of all interest payable with respect to amounts deferred under Section 6166.

Definition of a Trade or Business:

Code Section 6166(a) provides that if the value of an "interest in a closely held business" included in determining the gross estate of a decedent exceeds thirty-five (35%) percent of the adjusted gross estate, the executor may elect to pay the portion of the estate tax attributable to that "interest" in installments. An "interest in a closely held business" is defined as "an interest as a proprietor in a trade or business carried on as a proprietorship" or, subject to certain limitations, an interest as a partner or a shareholder in a partnership or corporation "carrying on a trade or business" [emphasis added].

Despite the plain reading of this statutory provision, and the fact that the term "trade or business" is contained in various other sections of the Internal Revenue Code, including among others Sections 162, 166, 172 and 1231, the Internal Revenue Service (the "Service") in applying Section 6166 to the ownership and operation of real estate has read into the "trade or business" requirement of Section 6166 two additional limitations not contained in the statutory language, the legislative history nor administrative and judicial interpretations of the same term in connection with other Code provisions.

In three companion Revenue Rulings, the Service concluded that the trade or business standard contained in Section 6166 required more business activity than other Code Sections similarly employing a "trade or business" test. Rev. Rul. 75-365, 1975-1 C.B. 471; Rev. Rul. 75-366, 1975-2 C.B. 472; Rev. Rul. 75-367, 1975-2 C.B. 472. The Service concluded that in the case of rental real estate, tax deferral under Code Section 6166 is available only where the real estate assets constitute "part of an active enterprise producing business income ..." and that although the management of such property by the owner may for other purposes be considered the conduct of a "trade or business", such management did not constitute a sufficient "trade or business" to qualify without more under Section 6166.

The imposition by the Service of this additional requirement is inconsistent with the interpretation of the term "trade or business" in connection with other Code provisions utilizing the same language and appears to clearly exceed Congress' intent. In those cases where Congress has determined to impose a more stringent standard than the "trade or business" requirement, it has done so with specific language. For example, Code Sections 195, 346(b) and 355 utilize the term "active trade or business".

No policy reason implicit in Section 6166 appears to require any more stringent standard than Congress has imposed by repeatedly utilizing the term "trade or business" in connection with all of the numerous versions of Section 6166 from 1958 through the latest ERTA amendments. The policy underlying Section 6166 has always been to preserve the business enterprise for the benefit of the family and heirs of the decedent and to allow estate taxes to be paid out of the future earnings of the business rather than the proceeds of a forced sale.

There is no reason to deny families engaged in the business of owning and managing rental real properties the benefits of this policy depending on how "active" one business may be in comparison with another business. Except in the case of real property rented to a single tenant pursuant to a long-term net lease, where the owner of the property would not be deemed to be in "business" under generally accepted criteria, the ownership and operation of rental real estate ordinarily involves sufficient activity to be considered to constitute a "trade or business" and should therefore come within the policy underlying Section 6166.

In addition to the imposition by the Service of a more stringent "activity" requirement in determining the existence of a "trade or business" under Section 6166, the Service's audit policy has been to deny an estate the benefits of Section 6166 even where the business is sufficiently "active" to meet the Service's "active enterprise" test unless the decedent was personally and substantially involved in the operations of the business. This additional limitation is certainly not imposed by the statutory language nor is it consistent with the Congressional purpose underlying Section 6166.

For these reasons, the National Realty Committee proposes that Congress make clear that the term "trade or business" for purposes of Section 6166 have the same meaning as used in connection with Code Section 162 which provides for the allowance of deductions for expenses incurred "in carrying on a trade or business ..." and that Code Section 6166 does not require for qualification that the decedent have been personally involved in the business activity.

Corporate and Partnership Holding Companies:

The Service has determined that the ownership of stock in a non-operating corporation which in turn owns all the stock of subsidiary corporations engaged in trades or businesses does not qualify as an interest in a closely held business under Code Section 6166. Letter Ruling 813532. A similar issue arises in the case of an interest in a partnership the only assets of which are interests in partnerships carrying on trades or businesses. The position taken by the Service is not necessarily required by the statute. Section 6166(b)(2)(C) attributes property from a corporation or partnership to its shareholders or partners. That section could be read to attribute the assets constituting the trade or business of the corporation or partnership carrying on the trade or business to the corporate or partnership holding company.

For various reasons, rental real estate is often owned by layers of partnerships and/or corporations. There is no justifiable reason to exclude per se interests in partnership and corporate holding companies from the benefits of Section 6166. Section 6166 should be neutral with respect to the entity or entities through which the decedent owned his interest in an otherwise qualifying trade or business. The National Realty Committee therefore proposes that Section 6166 be clarified to clearly permit qualification for benefits under Section 6166 by the estate of a decedent owning a requisite indirect interest in a corporation or partnership carrying on a qualified trade or business. For example, if the decedent owned 100% of the stock of a nonoperating corporation which owned 20% or more in value of the voting stock of a corporation carrying on a trade or business or 20% or more of the total capital interest in a partnership carrying on a trade or business, the decedent should be treated as having owned an interest in a closely held business for purposes of Section 6166.

Amount of Estate Tax Qualifying for Deferral at 4% Interest

In the Tax Reform Act of 1976 Congress provided that the estate tax attributable to the first $1,000,000 of closely held business property may be deferred pursuant to Section 6166 with interest payable at the rate of 4%. This reduced interest rate was a reflection of Congressional concern that many closely held businesses would be unable to generate enough cash flow both to pay the estate tax liability as well as interest thereon at the otherwise applicable rate (then 7%, to be 20% beginning February 1, 1982). H. Rept. No. 94-1380, 94th Cong. 2nd Sess. 28-32.

For the purposes of computing the amount of deferred estate tax liability that qualifies for the 4% interest rate, Section 6601(j) determines that the first $1,000,000 in value of the closely held business interest is the asset in the decedent's estate that is taxed at the lowest rates. Thus, the estate tax on $1,000,000 is $345,800 and the portion thereof eligible for the 4% rate is that amount less the unified credit.

In 1977, the first year the special 4% rate was effective, the unified credit was $30,000. Thus the amount of estate tax that could be deferred at 4% interest was $315,800 ($345,800 - $30,000). Once the increases in the unified credit made by ERTA are fully phased in, the amount of estate tax that can be deferred at the special 4% rate will be $153,000 ($345,000 - $192,800). The remainder of the estate tax attributable to the closely held business can be deferred with interest payable at the prevailing rate (20% beginning February 1, 1982.) The National Realty Committee believes that the $1,000,000 amount (which has not been adjusted for inflation since its enactment in 1976) should be increased. We propose that the $1,000,000 amount be increased to $2,000,000 immediately and be gradually increased to $4,000,000. These increases are intended to reflect the compounded effect of both inflation since 1976 and the reduction in the amount of estate tax that can be deferred because of the increases in the unified credit.

<u>Interest Payable under Section 6166 and the Deductibility of Such Interest as an Administrative Expense</u>

An estate that elects to pay the estate tax in installments under Section 6166 may deduct the amount of interest on the installment payments as an expense of administration under Section 2053 in computing its estate tax liability. Estate of Bahr v. Commissioner, 68 T.C. 74 (1977), acq., 1978-1 C.B. 1; Rev. Rul. 78-125, 1978-1 C.B. 292.

However, the Service has taken the position in Revenue Ruling 80-250, 1980-2 C.B. 278 that such interest is deductible only when it is actually paid or accrued. In Revenue Procedure 81-27, 1981-27 I.R.B. 21, the Service set forth detailed, complex and cumbersome procedures for estates to follow in accounting for the reduced estate tax attributable to the deduction for Section 6166 interest as it accrues or is paid. In essence, the estate must recompute the estate tax and file a supplemental estate tax return each time the Section 6166 interest is paid or accrued. Future installments are to be recalculated and any overpayment of interest or estate tax will be applied to the next installment payment.

The Service's procedure is overly complex, costly and time consuming and often results in the denial of the interest deductions to the estate.

In dealing with this problem, the Task Force on Technical Revision of Section 6166, in their written statement submitted to your Subcommittee, suggested that one solution might be to permit a deduction for estimated interest attributable to the Section 6166 deferral period. Under that proposal estimated interest based upon the then prevailing yield on Treasury obligations with a maturity comparable to the Section 6166 deferral period would be permitted as an adminstration expense under Section 2053. In the event an estate terminated the deferral privilege prematurely, one recalculation procedure would be required at that time; otherwise no recalculation would be necessary.

The National Realty Committe supports consideration of this proposal as a method for simplifying and making more equitable the treatment of interest payable with respect to amounts deferred under Section 6166.

We very much appreciate the consideration of our views by the members of your Subcommittee.

Respectfully submitted,

NATIONAL REALTY COMMITTEE INC.

KLEINBERG, KAPLAN, WOLFF & COHEN, P. C.
ATTORNEYS AT LAW
551 FIFTH AVENUE, NEW YORK, NEW YORK 10176-0027
(212) 490-0800

INTERNATIONAL TELEX
237639 (KKWC)

CABLE ADDRESS
"LAWECAP"

November 23, 1981

Robert E. Lightizer,
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

RE: November 4, 1981
Hearing on Generation-Skipping Tax

Gentlemen:

I am a tax and estates attorney. I have a master of laws degree in taxation and head my firm's estates' department. I also write a weekly syndicated tax column for the Gannett Newspaper chain.

I urge the repeal of the generation-skipping tax. It is largely irrelevant and, in the few instances where it does apply, is unworkable.

I have planned hundreds of estates during the time that the generation-skipping transfer tax has been the law, including a substantial number of large estates. During this period of over five years, there have only been two estate plans to which it has been relevant. I have discussed this matter with estates attorneys at other firms and their experience also has been that the statute is largely irrelevant.

In the two instances where the objectives of my clients' made the law relevant, there were many unanswered questions which made proper estate planning extremely difficult.

The law is extremely complex, with many traps for the unwary, and many points still unresolved. It is doubtful that any amount of amendment can make it into a rational and reasonably workable law.

Robert E. Lightizer
Chief Counsel

November 23, 1981

RE: November 4, 1981
Hearing on Generation-Skipping Tax

In the rare instances where the law does apply, it motivates taxpayers to adopt an unnatural and often inappropriate estate plan generally referred to as "layering." Thus, wealthy individuals avoid the tax but adopt ill-advised estate plans as a result.

The generation-skipping tax should be repealed.

Sincerely,

James R. Cohen

James R. Cohen

JRC/bah

Association of American Publishers, Inc.

aap

1707 L Street, N.W.
Suite 480
Washington, D.C. 20036
Telephone 202 293-2585

STATEMENT OF THE
ASSOCIATION OF AMERICAN PUBLISHERS
ON THE
ARTIST'S TAX EQUITY and DONATION ACT of 1981 (S-649)
Subcommittee on Estate and Gift Taxation
Senate Finance Committee
October 26, 1981

The Association of American Publishers (AAP) is the general association of book publishers in the United States. It comprises Professional and Scholarly Publishing; College; International; Direct Marketing/Book Club; School; and General Trade divisions. Our some 300 member publishing houses produce the vast majority of general trade, educational, reference, professional and religious books published in this country and found in the nation's libraries as well as considerable related audio-visual materials.

The Association of American Publishers supports an amendment to the Internal Revenue Code to restore the provision in the law which would permit an author or artist who donated his literary, artistic or musical work to a library, museum or other non-profit institution to take a tax deduction equal to the fair market value of that donation. This was the law before 1969 when the statute was amended to forestall elected public officials from enjoying such a tax deduction and, as has been stated in the Senate, an inadvertent and unintended result was the termination of the tax deduction for artists and writers.

We wish to cite two principal reasons for enactment of this legislation:

1. As a result of the enactment of present law in 1969, donations by writers and artists to libraries, museums, etc. have been dramatically curtailed; several studies bear this out. This has had the result of the public being deprived of these works which now are going into private collections or are destroyed, as has been the unfortunate case in some instances of note because of the estate tax provision referred to below.

2. The present law is unjust. Under current law, if a writer or artist dies, the estate is required to pay Federal estate taxes on the fair market value of the literary or art work. Thus, while he is alive the artist's works are valued by the Internal Revenue Code at the cost of the materials only; once dead, the works are valued by the Code at fair market value. This is unfair to the artist, his heirs and to the general public which is deprived of the opportunity to enjoy the literary and art works.

We understand that this proposed legislation would have only a minor negative impact on Federal revenues. It is a proposal which has bipartisan support in the Senate in the form of the Artist's Tax Equity and Donation Act of 1981 (S-649). It enjoys the support of the library communicty and those who love libraries, including this association of book publishers. It merits enactment at this time.

STATEMENT

on

S. 1695

REPEAL OF THE TAX ON GENERATION-SKIPPING TRANSFERS

for submission to the

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION

in behalf of the

NATIONAL FAMILY BUSINESS COUNCIL

by

BRUCE M. FLEISHER*

November 25, 1981

On behalf of the National Family Business Council, an organization comprised of family-owned businesses, the repeal of the generation-skipping transfer tax is strongly urged. This tax is a deterrent to the perpetuation of small and closely-held businesses. The current law has been counter-productive due to its complexity, cost, and negative impact on capital retention.

The cost to the public in both dollars and unproductive time spent deciphering the law outweighs the minimal revenues

* Chairman, Government Affairs Committee, National Family Business Council

generated by the tax. Current revenue projections indicate that the generation-skipping transfer tax raises no monies in the short run and is projected to raise only $400 million in the year 2001. However, the negative impact and the costs of the tax to the economy in lost productivity are current and ongoing.

Smaller and medium size businesses are disproportionately affected, since the very wealthy often have methods available, such as separate trusts, with which to preserve capital. A family-owned business typically must commit scarce and otherwise efficient resources to contend with the unnecessary complexities of the law.

The stated intention of taxing property as though it had been transferred outright has not been achieved. The law attempts to presuppose the sequencing of generations and, in doing so, compounds the confusion. Distrust and misunderstanding of the law has resulted in individuals not properly using trusts to protect their families from uncertain and most likely inflationary futures.

By taxing generation-skipping trusts and inhibiting the preservation of capital, Chapter 13 of the Internal Revenue Code of 1954 works against the stated economic goals of this Congress and Administration. In particular, this law has deterred many from using trusts as a tool to perpetuate family businesses. Chapter 13 is a drain on our economy and society and should be repealed.

HEARTLAND·FINANCIAL·CORPORATION
HEARTLAND

November 23, 1981

TO: Committee on Finance
United States Senate
Subcommittee on Estate and Gift Taxation

WRITTEN STATEMENT REGARDING SENATE BILLS 1695, 1733 AND 1734 WITH RESPECT TO WHICH PUBLIC HEARINGS WERE HELD ON NOVEMBER 4, 1981

INTRODUCTION

Our corporation specializes in tax, financial and estate planning. We appreciate the opportunity to present this written statement at the request of and on behalf of the Independent Business Association of Wisconsin with respect to the topics discussed in the November 4, 1981 public hearing held by your Committee. We will now explain our views with respect to the proposed legislation.

SENATE BILL 1695 - REPEAL OF THE TAX ON GENERATION SKIPPING TRANSFERS

We unequivocally support the repeal of the tax on generation skipping transfers as contained in Chapter 13 of the Internal Revenue Code. Chapter 13 of the Internal Revenue Code is a veritable maze of highly complex and unworkable provisions. If this law is continued in effect, it will lead to ineluctable problems of administration, enforcement and application. The ultimate $280,000,000 revenue loss, as projected by the Joint

Post Office Box H, Racine, Wisconsin 53405
6216 Washington Avenue, Racine, Wisconsin 53406 (414) 886-1466

Committee on Taxation, is de minimis in relation to the savings by both the Treasury Department in not having to oversee the application of these provisions and by taxpayers who will not have to seek sophisticated help in circumventing an ambiguous and uncertain law.

We urge your Committee not to be persuaded in accepting the proposed amendments of the Department of Treasury as the resolution of the problem; the solution lies in total abolition and not with the alchemy inherent in the proposed changes suggested by the Treasury to simplify this law.

SENATE BILL 1733 - JUDICIAL REVIEW OF DETERMINATIONS MADE UNDER SECTION 6166 OF THE INTERNAL REVENUE CODE

Judicial review of the applicability of the provisions for the deferred payment of Federal Estate Taxes as contained in Section 6166 of the Internal Revenue Code is essential to the implementation of these salutary provisions of the Internal Revenue Code. Qualifying a closely held business for the deferred payment of Federal Estate Taxes can mean the difference between a family or closely held business continuing in existence or being forced to sell in order to pay Federal Estate Taxes. Presently, if there is a dispute between the estate of a decedent and the Internal Revenue Service as to whether "an interest in the closely held business" qualifies

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for the deferred payment of Federal Estate Taxes, there is no immediate and defined remedy for the taxpayer. This unfortunate result has the effect of eviscerating a statute designed to permit the closely held or family business to continue in existence.

An example of a typical dispute which can arise is a situation where the Internal Revenue Service will not permit the deferred payment of taxes because the trade or business of the decedent was not an "active" trade or business. Nowhere in the statute is there a requirement that "an interest in a closely held business" must be an "active" trade or business. However, the Internal Revenue Service through its rulings has made this a requirement, thus depriving access to deferral provisions as a result of its narrow construction of the statute. This in itself is an issue which should be clarified through legislation, but to deny the taxpayer the right to challenge the Internal Revenue Service in the Tax Court or other form, is an unfair and intolerable situation and one which should be immediately rectified.

<u>SENATE BILL 1734 - EXPANSION OF THE ACCELERATION EXCEPTION UNDER 6166 OF THE INTERNAL REVENUE CODE</u>

While the Economic Recovery Tax Act of 1981 purportedly liberalized the acceleration provisions under Section 6166(g)1(A) of the Internal Revenue Code, by permitting either dispositions of up to 50% of the value of the decedent's business interest (instead of up to one-third) or withdrawals of up to 50% of the business assets (instead of up to one-third) before triggering acceleration of unpaid deferred taxes, this rule requiring aggregation of all dispositions and withdrawals to determine the applicability of the 50% acceleration test is more restrictive than the prior law.

Another limiting provision in the new law pertains to the "interest" which is looked to in determining whether or not an accelerating event has occurred. The new rule provides for acceleration where aggregate dispositions and withdrawals are 50% or more of the "value of such interest" in the trade or business, thus referring only to the value of the portion owned by the decedent. Under the old acceleration rules, unpaid installments were accelerated if withdrawals were one-third or more (for Section 6166) or 50% or more [for Section 6166(A)] of the "value" of such trade or business. This test took into account the entire value of the business. The result is that a smaller amount of withdrawals would be needed to accelerate payments under the new rule, assuming the entire trade or business isn't included in the decedent's estate.

We urge the Committee to adopt legislation which would use the entire value of the trade or business as opposed to the value of the decedent's interest in the trade or business, when determining whether or not there has either been dispositions and/or withdrawals which would trigger an accelerating event. Furthermore, the rules pertaining to aggregation of dispositions and withdrawals should be liberalized to permit either dispositions or withdrawals of up to 75% of the entire value of the business to provide more flexibility for the closely held family business in meeting estate tax obligations.

ADDITIONAL ISSUES UNDER SECTION 6166 AND SECTION 303 OF THE INTERNAL REVENUE CODE

Active Trade or Business Requirement

The Internal Revenue Service's position with respect to the active trade or business requirement under Section 6166 of the Internal Revenue Code was discussed above. We recommend that your Committee promulgate legislation which will permit the use of these deferral provisions where a decedent owns an interest in underlying assets which constitute an active trade or business. For example, in many closely held family businesses, a common estate planning technique is to form a holding company where an older generation family member contributes his stock in exchange for a fixed interest preferred stock and the younger generation family member, who is active in the business, receives all or part of the common stock. This technique is used to shift growth to the younger generation family member and provide incentive for he or she to remain in the business. This result can also be accomplished in a recapitalization, but a recapitalization might not always be possible for a number of reasons. The Internal Revenue Service says that stock in a holding company, formed to shift growth to younger generation family members, does not constitute an "interest in a closely held business" since the decedent does not own an interest in an "active" trade or business. Therefore, this stock will not qualify for the deferred payment of Federal Estate Taxes, where clearly preferred stock received in a recapitalization will qualify.

Holding companies are also used to acquire interests in family held businesses and are often used by banks as a means of providing common control. In all of these situations, the underlying asset is an interest in an active trade or business, but because of the form of ownership, the Internal Revenue Service would deny the use of Section 6166 of the Internal Revenue Code. This is a ridiculous and inconsistent result and one which should be remedied.

Qualifying Interest as an Administration Expense

The Internal Revenue Service in Rev. Rul. 80-250 held that interest on deferred estate tax was not deductible in full on the Estate Tax Return, but could instead only be deducted as it is accrued over the deferral period. The basis for its conclusion is that if an administration expense is not actually incurred (accrued) at the time of the final audit of the Estate Tax Return, no deduction will be allowed for the expense at that time, unless the expense is ascertainable with reasonable certainty. Since under Section 6166, the executor has the option of accelerating payment of deferred estate tax, and in some circumstances must accelerate payment, the IRS concluded that the amount of interest expense attributable to the deferred estate tax could not be ascertained with reasonable certainty at the time the Estate Tax Return was filed and thus could not be deducted on the return.

The position taken by the Internal Revenue Service requiring that the interest actually accrue before a deduction is permitted, will result in tremendous amounts of additional paperwork and expense. This is because as the amount of the interest expense deduction increases, the estate tax must be recomputed. Each recomputation is extremely burdensome because the interest deduction and the estate deduction are mutually dependent variables. Each increase in the amount of accrued interest reduces the amount of estate tax, which in turn reduces the amount of interest, leading to a circular computation which can be resolved only by simultaneous equations or a computer program. Furthermore, Rev. Rul. 80-250 provides that no refund will be made until the entire tax liability has been paid. Thus, during the first four years under 6166 when only interest is paid, the IRS will not permit a refund of any part of the reduction in estate tax already paid attributable to this interest. Instead, it will only credit reduced estate tax against the installment payments which begin at the end of the fifth year.

Executors will be required to make annual recomputations of estate tax and interest over the 14 year deferral period, which is obviously very time consuming and an expensive burden which would befall the taxpayers whose liquidity problems led to the enactment of 6166 of the Internal Revenue Code. It would also result in the prepayment of estate tax and interest which, as a practical matter, accelerates the payment of taxes instead of postponing them as is intended under the deferral provisions.

The solution to this problem is for Congress to permit an immediate deduction for all estimated interest on the deferred payment of taxes. In the event there is an acceleration of these taxes or the executor elects to prepay all or a portion of the taxes, the total tax liability could be recomputed to take into consideration the interest which was deducted but not actually paid.

<u>Broadening the Acceleration Exception for Section 303 Redemptions</u>

The restrictive acceleration provisions under Section 6166 of the Internal Revenue Code discussed above, enacted as a result of ERTA, work an even greater hardship with respect to Section 303 redemptions. The statute currently states that in determining whether or not there has been a disposition of 50% or more of the value of the decendent's interest in a closely held business, Section 303 redemptions shall not apply; however, the value of the decedent's interest in the closely held business is reduced by the value of the stock redeemed. This can result in an unintended acceleration of the estate tax liability. For example, if the total value of a closely held business is worth $3,000,000 and the decedent's interest is worth $2,000,000, if the decedent's estate is required to redeem $1,000,000 worth of stock in order to pay federal and state death taxes and interest thereon, over a 15 year period, a separate sale of stock or other redemptions in the aggregate of $500,000 during this deferral period, will cause an acceleration of the unpaid tax liability; and, depending upon the circumstances, it could be retroactive to a prior year, causing increased hardship. This is because the decedent's $2,000,000 business interest is reduced by the one million dollars' worth of Section 303 redemptions for purposes of the 50% acceleration test and with the subsequent disposition of $500,000 of stock or assets, this results in an acceleration.

We urge your Committee to consider eliminating any reduction in the value of the decedent's interest in the closely held business for Section 303 redemptions for purposes of the 50% or more acceleration test under Section 6166. The interaction of the more restrictive acceleration provisions of Section 6166 of the Internal Revenue Code as a result of ERTA, coupled with the impact of Section 303 redemptions, is just another example of legislation working against the closely held family business.

Reduction in the Interest Rate for Taxes Attributable to a Closely Held Business Interest

The present high interest rate (20% effective February 1, 1982) almost entirely negates the benefits of estate tax deferral for the closely held business. For example, if $1,000,000 of taxes is owed (over and above the limited 4% interest for the first $350,000 of taxes), interest for the first five years at the current rate of 20% will equal the $1,000,000 tax liability. Very few businesses will be able to afford this tremendous drain on working capital caused by the combination of high taxes and even higher interest rates; the result will lead to the eventual sale of the business. The solution is to extend the 4% interest rate to at least the first $10,000,000 of taxes attributable to a closely held business interest and place a ceiling on the interest for taxes over this amount at no more than 12%.

<u>Eliminating the Distinction Between Voting and Nonvoting Stock in Defining the Term "Interest in a Closely Held Business"</u>

Requiring that 20% or more in value of only <u>voting</u> stock will meet the definition of an interest in a closely held business for purposes of Section 6166 is an unnecessary restriction. In many recapitalizations, an older generation wishes to shift both growth and control to a younger generation family member active in the business. The requirement that the older generation owner hold at least 20% in value of voting stock in the business in order to qualify for Section 6166 restricts the shifting of these ownership rights. There is no reason why an individual who owns 75% of the total value of the business in the form of a nonvoting preferred stock and whose son and/or daughter holds the remaining 25% in value in the form of a voting common stock, should not be permitted at death to qualify for Section 6166. This distinction between voting and nonvoting stock should be eliminated and we hope your Committee will consider doing so.

Respectfully submitted,

HEARTLAND FINANCIAL CORPORATION

William F. Kolbe
President

WFK/nb

NATIONAL ASSEMBLY OF
NASAA
STATE ARTS AGENCIES

STATEMENT OF THE NATIONAL ASSEMBLY OF STATE ARTS AGENCIES ON LEGISLATION RELATIVE TO THE TAX TREATMENT OF ARTISTS (S.649, S.851 and S.852) BEFORE THE SUBCOMMITTEE ON ESTATE AND GIFT TAXATION OF THE SENATE COMMITTEE ON FINANCE, NOVEMBER 10, 1981.

The National Assembly of State Arts Agencies, representing at the national level the interests and concerns of the fifty-six state arts agencies, supports legislation before the Senate Committee on Finance that would provide equitable tax treatment to artists.

Passage of legislation allowing an artist an income tax deduction for the charitable contribution of a creative work equal to its fair market value would give artists the same tax privileges now enjoyed by their patrons who collect and donate their work to museums and libraries. The enactment of an artist's tax equity bill would in fact restore to artists, writers and composers the tax treatment afforded them before changes made in the tax code in 1969 had the unintended effect of preventing artists from receiving the tax deduction at fair market value.

Because public officials were able to take advantage of the charitable deduction, prior to 1969, when donating their personal papers to libraries or archives, Congress changed the tax code to prevent this practice. Artists at the same time were denied the use of the tax deduction, although Congress never intended to penalize artists that way. Since then artists have been allowed to deduct only the cost of materials when giving a work to a museum while the collector still enjoys a charitable deduction at full market value of the work.

Suite 316 1010 Vermont Avenue NW Washington DC 20005 202 347-6352

The consequences of this situation have been severe. Artists are denied the same incentive that collectors have to give their work to museums and libraries for the public to study and enjoy. The work of artists must be sold into private collections where its accessibility to the public is often limited. Artworks and manuscripts of a related nature may be dispersed or sold abroad, hampering scholarly study and denying the public its appreciation of modern American artists.

Since 1969, the donation of artistic works to museums and libraries by their creators has seriously diminished. With the passage of the legislation now being considered, the nation's cultural institutions would be able to acquire without cost works of art which they must now purchase in many cases. At a time when the financial resources of museums and libraries are limited, a restriction on the donation of artworks is oppressive.

Artists, too, would enjoy some measure of economic benefit through a charitable deduction from income tax, but one no different from that already afforded the art patron. This legislation should not be viewed as creating a tax shelter of which artists could take unfair advantage. The Internal Revenue Service already has an operating advisory panel to monitor the value of artistic works for tax purposes. In addition, the estimated loss of tax dollars through the enactment of this legislation is, given the value to the preservation of our cultural heritage, a modest one -- no more than $5 million a year.

Before 1969, most state income tax laws allowed artists a full fair market value charitable deduction for donated art. With the change, however, most states followed suit and applied the cost-of-materials rule. Now the inequity of that move has been realized and several states, in 1979 and 1980, amended their tax laws to allow artists the same charitable contribution deduction given to collectors donating works of art.

Qualifications for the deduction differ under the state laws, but their agreement to offer a measure of tax fairness to artists is unanimous. Other states are expected to follow suit during the next few years. These changes in state income tax laws should spur Congress to restore the same provisions in the federal law.

The three bills before the Committee would carry out the recent recommendation of the Presidential Task Force on the Arts and Humanities, that artists contributing their works be given the same tax treatment now available to other donors. As a tax incentive to increase private support to the arts this measure is apt. In view of the endorsement the proposal has received and with the tightening of government support for the arts, the time is fit for the enactment of this legislation.

In another important way -- the valuation of an artist's estate -- the legislation before the Committee would improve the tax treatment of artists. As the law is now written, an artist's estate is taxed at the fair market value of the work left after the artist's death. Because such a valuation can create huge tax debts for the heirs, there have even been instances of artists resorting to the destruction of their work rather than burden financially their heirs.

In other cases, the heirs are forced to sell off the art work in order to pay estate taxes. With the market unable to absorb a large number of sales soon after an artist's death, each work receives a lower price than the actual fair market value at which taxes are assessed. Legislation to rectify this situation is indeed necessary.

The National Assembly of State Arts Agencies urges passage of legislation to establish equal tax treatment for artists and commends the efforts of Senators Max Baucus and Daniel P. Moynihan in bringing this measure before Congress.

testimony of

LEN R. SMALL
publisher and editor
Moline (Ill.) Daily Dispatch

and chairman of the newspaper
TAX LAW ACTION GROUP

jointly supported by the
AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION
and the
NATIONAL NEWSPAPER ASSOCIATION

submitted for the hearing record of
Nov. 18, 1981
on S 1487
Independent Local Newspaper Act

before the

Subcommittee on Estate and Gift Taxation
Committee on Finance
United States Senate

We agree that federal estate taxes are a major reason for the sale of family-owned newspapers during recent years. We neither support nor oppose S 1487, the Independent Local Newspaper Act, but we think broad-based legislation affecting all family-owned businesses is preferable to special-interest, newspaper-only legislation. As an alternative, we recommend two immediate changes in federal estate tax law designed to help owners of all family-owned businesses prepare for death tax liabilities, and to ease qualifications for use of extended time payment provisions.

First, we urge that Congress state in law that continuation of a family business is a reasonable business need. The law should allow family-owned businesses to accumulate funds (on which income taxes have been paid) which can be used to facilitate payment of estate taxes upon the death of an owner. Second, the shareholder test for eligibility under extended time payment provisions of current federal estate tax law should be liberalized in recognition that family-owned businesses today may often have several generations sharing in ownership and thus often have more than 15 shareholders.

I am Len R. (Rob) Small, publisher and editor of the Moline (Ill.) Daily Dispatch, and chairman of the newspaper Tax Law Action Group. This informal committee represents the interests of family-owned newspapers nationwide and enjoys the support of the American Newspaper Publishers Association, the National Newspaper Association and other national, regional and state newspaper organizations in the United States. As you may know, ANPA is a non-profit trade association representing more than 1400 daily and non-daily newspaper members. Membership accounts for more than 90 percent of U.S. daily and Sunday newspaper circulation. NNA represents some 5,000 weekly and some 500 smaller-city daily newspapers throughout the nation.

The Tax Law Action Group was formed late in 1979 to seek to implement the recommendations of an ANPA Tax Law Task Force which made a year-long study in 1977-1978 of the effect of federal estate tax laws upon newspaper sales. At the same time, NNA formed a similar study group. Both organizations concluded that burdensome, some would say "punitive," federal estate tax laws are one of the reasons that owners of independent, locally-owned newspapers sell their properties. Believing the tax laws should be neutral on an owner's decision regarding sale, ANPA and NNA agreed that broad-based legislation affecting all family-owned businesses would be preferable to specialized legislation addressed only to estate taxes applied to newspaper assets.

Preserving individual and family ownership of businesses will help increase the productivity, competition and diversity of the nation's economy.

The Economic Recovery Tax Act (PL 97-34) included a number of constructive changes in federal estate tax law. The subcommittee is familiar with these improvements, but the changes do not solve the very significant liquidity problems faced by newspapers and other family-owned businesses upon the death of a major owner who was the last of his or her generation.

The problem is especially difficult for newspapers and other business properties which have a large marketable value compared with annual earnings. A common situation was reported in The Wall Street Journal of Aug. 19, 1981, in an article by Daniel Machalaba. The Salisbury (N.C.) Post, a daily newspaper with 24,700 circulation, was reported to have earned in the previous year $400,000 on revenue of nearly $4 million — from a business property with an asset value of $3 million and a market value of around $20 million. The federal estate tax on $20 million, even under the new law which is not fully effective until 1987, is some $9.8 million — a figure 24½ times the Post's $400,000 annual earnings.

Family business owners do not seek to avoid their fair share of tax, but federal estate tax laws should not force sales of independent businesses in order to pay those taxes.

The Tax Law Action Group believes the valuation problem should be dealt with directly, but we recognize that Congress may not be able to act quickly in this area. We suggest the subcommittee may wish to examine valuations of family businesses on their value as going business concerns rather than market value.

For now however, we recommend two comparatively simple changes in federal estate tax law which could more easily be enacted and which would do much to help all family-owned businesses deal with liquidity problems resulting from federal estate taxes.

First, we suggest amendment of Section 537 of the Internal Revenue Code to include, as a "reasonable business need" under the law, funds accumulated to facilitate payment of taxes on estates of major owners of the business. The subcommittee may wish to define a major owner as one who owns at least 20 percent of the business -- a test consistent with other provisions of estate tax law including the test for extended time payments.

The change would allow businesses to accumulate funds year by year (as they do to prepare for most major purchases) to facilitate redemption of stock by heirs to pay estate taxes without forcing sale of the business. These accumulations would be free of the accumulations penalty tax which currently renders useless any effort by a family business to save funds to facilitate estate tax payments. We believe this change would cost the government little -- if any loss in tax revenues. Accumulations are not being made now, so there would be no loss in accumulations penalty tax collections. There would be no loss in corporate income tax collections because only taxed funds would be accumulated.

The subcommittee may wish to take this suggestion a step further and simply repeal the existing accumulations penalty tax. We understand this tax was enacted due to the disparity which once existed between corporate income tax rates and the top personal income tax rate. Little disparity remains since passage of the Economic Recovery Tax Act.

Our second suggestion would also cost little if any tax revenue, but it would open the extended time payment provisions of existing federal estate tax law to more family-owned businesses. There are three tests in the current law, Section 6166: 1) the interest of the deceased in the business must be at least 20 percent; 2) such business interest must constitute at least 35 percent of the estate; and 3) the business must have 15 or fewer shareholders. While the first two tests indicate the probability of a liquidity problem which might force sale of the business, the third test simply is an arbitrary limitation. It excludes many family-owned businesses, especially ones with roots reaching back into the early history of our nation, which are now in their fourth, fifth or sixth generation of ownership. Solution of the estate tax problems of a major owner ought not depend, for example, on whether a remaining 15 percent share is owned by one person, or by 15 people each owning a one percent share.

We favor repeal of the shareholder test. The subcommittee may wish at least to make it consistent with the test used for Subchapter S election, which in the Economic Recovery Tax Act was raised to 25 or fewer shareholders.

The Tax Law Action Group wishes to stress that both these recommendations are needed by any family business with a significant disparity between annual earnings and market value.

In the newspaper business, and in a number of other businesses, valuations based on sales of business properties at many times earnings result in a heavy estate tax burden on heirs who desire to continue a business which enjoys only modest earning power. In many cases, earnings over the next several years would fall far short of the federal estate taxes levied upon the maket value of the business. The business cannot realize its taxable value in such cases short of actual sale. The result can be detrimental to the community and to the nation's economy.

The two changes in federal estate tax law we now urge would not render completely neutral the impact of the law on decisions regarding the sale of all family-owned businesses; but they would do much to help owners to meet the financial liability which death brings to many family-owned businesses. They are comparatively simple steps. Owners of family businesses should have a fair opportunity to meet federal estate tax requirements without having to devote sizable portions of time and money away from business operations and into sophisticated and complex tax exercises.

The Tax Law Action Group of the newspaper business is encouraged by the interest the subcommittee has shown in the effect of federal estate tax laws upon family-business ownership.

We stand ready to cooperate more fully with the subcommittee in efforts to achieve broad-based estate tax relief for all family-owned businesses.

Subcommittee on Estate and Gift Taxation, Senate Committee on Finance, Hearings on Estate Tax Issues, November 4, 1981

Statement on behalf of David R. Tillinghast and Interested Clients Relating to: Application of Section 6166 of the Internal Revenue Code to Interests held through Holding Companies

This Statement is submitted to urge a technical clarification confirming the application of the relief provisions of Section 6166 of the Internal Revenue Code to holding company situations.

In general, federal estate tax is payable by the estate of a decedent at the time of filing the estate tax return, nine months following the decedent's death. (Sections 6075(a) and 6151(a).*) In some cases, however, such a payment requirement would create hardship because the assets in the estate are not readily marketable. This is particularly true in cases where a large portion of the taxable estate consists of shares in a family-owned company, where an overly strict time schedule for payment of estate taxes might require the sale of the company (or a major interest in it) to the public or to a large corporate acquiror.

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* All references to Sections are to the Internal Revenue Code of 1954, as amended.

In recognition of this potential hardship,* the Congress has enacted provisions which, in the case of estates consisting largely of shares in closely-held corporations, permit extension of the time for payment of estate tax. While various provisions have existed over the years, the recent Economic Recovery Tax Act of 1981 has subsumed them into a single relief provision, Section 6166.**

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* See H.R. Rept. No. 2198, 85th Cong., 1st Sess. 7 (1958), reprinted in 1959-2 C.B. 709, 713 ("Where the decedent had a substantial proportion of his estate invested in the business enterprise, under existing law this may confront the heirs with the necessity of either breaking up the business or of selling it to some larger business enterprise, in order to obtain funds to pay the Federal estate tax."); S. Rept. No. 94-938-Pt. II, 94th Cong., 2d Sess. 18 (1976), reprinted in [1976] U.S. Code Cong. & Ad. News 4030, 4034-44 ("additional relief should be provided to estates with liquidity problems arising because a substantial portion of the estate consists of an interest in a closely held business"); Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 546 (1976) (then-existing provisions "proved inadequate to deal with the liquidity problems experienced by estates . . . forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax"). See also H.R. Rept. No. 94-1380, 94th Cong., 2d Sess. 5, 30-31 (1976), reprinted in [1976] U.S. Code Cong. & Ad. News 3356, 3359, 3384-85.

** Under Section 6161(a)(2), the Internal Revenue Service has discretion to extend the time for the payment of estate tax for up to 10 years for "reasonable cause". Since this authority is discretionary, however, it may not be relied upon.

Under this provision, if at least 35% of the adjusted gross estate of a decedent consists of an interest in a closely-held business, the executor may elect to pay the estate tax in installments, beginning five years after the date of death and continuing for not more than 10 additional years. Interest is payable annually on the deferred installments at the rate generally applicable to tax deficiencies (with a special 4% rate under Section 6601(j) for balances not in excess of $345,000).

In order to qualify for the Section 6166 deferral, the estate must hold an "interest in a closely-held business". This is defined to include stock in a corporation carrying on a trade or business if: (i) 20% or more in value of the voting stock of the corporation is included in determining the gross estate of the decedent; or (ii) the corporation has 15 or fewer shareholders. For purposes of this definition, Section 6166(b)(2)(C) (hereinafter referred to as "Subparagraph (C)") provides: "Property owned, directly or indirectly, by or for a corporation . . . shall be considered as being owned proportionately by or for its shareholders. . . ."

A situation frequently arises in which a decedent owned the requisite interest in a closely-held operating company but, for any of a number of reasons, did not own the interest directly but rather through a holding company. This can be illustrated by two simple examples.

In the first example, decedent A owned 25% of the voting stock of Exco, a corporation which operates a steel mill, whose stock is held by 10 shareholders in total. A's stock is worth $10 million, and his adjusted gross estate is $20 million. Under these circumstances, the executor of A's estate may elect to defer payment of estate taxes under Section 6166. The Exco stock would qualify as an "interest in a closely-held business" because A owned in excess of 20% of the voting stock of Exco and Exco is an operating company.

The deferral of the estate tax liability in this case clearly effectuates the purpose of the statute: Since A owned a large block of Exco stock, this constituted a substantial part of his estate and Exco is closely held, a hardship or forced sale to outside interests might result if the deferral of estate tax were not permitted.

For comparison, consider a second example: Decedent A owned 25% of the stock of Wyco, which is a holding company. Wyco's only asset is 100% of the stock of Exco, which has all of the characteristics referred to in the first example.

Under these circumstances, one would expect that A's executor would also be entitled to defer estate tax payments under Section 6166. By reason of the indirect ownership rule of Subparagraph (C), A's estate, as a shareholder of Wyco, should be deemed to own its pro rata share of the Exco stock owned by Wyco, since stock "owned, directly or indirectly, by or for a corporation . . . shall be considered as being owned proportionately by or for its shareholders. . . ." The Internal Revenue Service, however, takes the position that the Section 6166 election is not available in this case.

Such a position elevates form over substance, for no evident purpose. In the second example given above, A's estate is no more liquid than it was in the first example; a forced sale of the stock of Wyco (or a sale of Exco stock by Wyco, followed by a redemption of Wyco stock from A's estate) would produce the same hardship as a forced sale of Exco stock in the first example. In policy terms, the two situations seem identical, and a literal reading of Subparagraph (C) leads to the same result in the second case as in the first - availability of the deferral under Section 6166. The IRS, however, has imputed a contrary Congressional intention, apparently relying on a sentence in the legislative history which it reads to limit the application of

Subparagraph (C) to cases where this results in disqualification under the 15-shareholder rule.*

It is difficult to believe that the Congress intended thus to elevate form over substance and to deny the relief of Section 6166 to cases of the kind described. Accordingly, this IRS position should be overruled.

Under the circumstances, it is essential for the Congress to effect this reversal of IRS policy through a clarifying statutory amendment or statement of Congressional intent. Even though they believe the IRS to be clearly mistaken, prudent advisors cannot safely plan on the assumption that, some time after the taxpayer's death, a court will correct the IRS' error; and there is no procedure for contesting the matter before that time.

The proportional attribution rule of Subparagraph (C) can be applied in accordance with its terms without introducing undesirable side effects or avoidance opportunities; and that application is appropriate not only to

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* The sentence is: "Also, in order to prevent avoidance of the shareholder or partner limitations by the use of partnerships, trusts, or tiers of corporations, the Act provides [the proportional attribution rule] . . ." Staff of Joint Comm. on Taxation, <u>General Explanation of the Tax Reform Act of 1976</u>, 94th Cong., 2d Sess. 548 (1976). The fact that the Joint Committee Staff, after enactment, chose to highlight this undoubted function of the rule does not imply that the rule should not operate in accordance with its terms for all purposes relevant to defining an "interest in a closely held business".

corporate holding companies but also to partnerships, trusts and estates. The reason for this is that the rule does not by itself turn the decedent's interest in the intervening entity into a qualified "interest in a closely held business".* Rather, it continues to focus the definition on the underlying business interest and disregards any other assets or characteristics of the intervening entity (except where the intervening entity is widely held). Moreover, since the ownership of the underlying business asset is attributed to the decedent only on a proportionate basis, the existence of the intervening entity does not distort the qualification tests.

Thus application of the Subparagraph (C) rule to qualify an interest held through a holding company would not permit evasion of the basic requirement that the closely held interest constitute 35% of the adjusted gross estate. For example, if the decedent's only asset were the stock of a holding company and if the holding company's assets consisted two-thirds of portfolio securities and one-third of an interest in an operating business, the decedent's estate

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* The IRS has ruled that a holding company does not meet the requirement of "carrying on a trade or business" under the former Section 6166A(c), a provision analogous to the one discussed here, by reason of the fact that its subsidiaries carry on business. PLR 8134012. Whether or not this holding is correct, the argument which the ruling rejects is not relevant to this presentation.

would not qualify for Section 6166 relief, since the decedent's deemed ownership of the operating business would constitute only 33% of his gross estate (ignoring adjustments for simplicity). This is the same result which would occur if the portfolio securities and the interest in the operating business had been separately and directly owned by the decedent. On the other hand, if the stock of the operating company held by the holding company constituted 50% of the holding company's assets, the requisite 35% would be exceeded. Again, this is the same result as in the case where the securities and the business interest were separately held. Moreover, in this case, the proportional attribution rule would carry through the correct limitation on the amount of tax to be deferred under Section 6166(a)(2), since only 50% of the tax would qualify for deferral under that provision.

The proportional attribution rule would also prevent distortion of the minimum 20% ownership requirement. If, for example, the decedent held 25% of the stock of a holding company and the holding company held only 60% of the voting stock of an operating company, the "interest in a closely held business" definition would not be satisfied; on a proportional attribution basis, the decedent would be deemed to own only 15% of the operating corporation's voting stock.

The same considerations would prevent evasion, avoidance or distortion in cases where operating corporations are held through partnerships, trusts or estates, since proportional attribution operates similarly in those cases.

I would be pleased to discuss any aspects of this issue with the Subcommittee, the Staff of the Committee on Finance or the Staff of the Joint Committee on Taxation.

While the views expressed herein are my own, this Firm has clients who are directly affected by the IRS position referred to above.

Respectfully submitted

David R. Tillinghast
Hughes Hubbard & Reed
One Wall Street
New York, New York 10005