TESTIMONY

BEFORE

THE SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

PRESERVING AND PROTECTING FAMILY BUSINESS LEGACIES

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Mr. Chairman and Members of the Subcommittee on Taxation and IRS Oversight:

My name is Stefan F. Tucker. I am a member of the District of Columbia Bar and a partner in the law firm of Venable, Baetjer, Howard & Civiletti, LLP, of Washington, D.C. and Baltimore, Maryland.

I am appearing before you today as a private practitioner, with a heavy emphasis in my practice as a lawyer for and counselor to entrepreneurs and high-wealth individuals, both as to their income, estate and gift tax planning and as to the structuring of their business and investment strategies, including the acquisition and disposition of assets.

I very much appreciate the opportunity to discuss with you the potential impact of radical changes in the present Federal estate and gift tax regime, including particularly the move from full stepped-up basis to part stepped-up and part carryover basis.

I. Overview

A. Current Law.

All U.S. citizens and residents are subject to Federal estate and gift taxation on their worldwide assets. As a result, transfers of property of any type, whether located in the U.S. or abroad, trigger either estate tax or gift tax, subject to certain exclusions and credits.

The lifetime "applicable credit" generally allows each taxpayer to make the first $675,000 of such transfers tax-free. (The applicable credit is presently scheduled to increase gradually to $1 million by 2006.) In addition, each taxpayer is permitted to make tax-free gifts of $10,000 ($20,000 for married couples who elect to split gifts) to any one person each year; and certain "qualified transfers" for educational or medical expenses are not considered gifts.

In addition to the Federal estate and gift tax, a generation-skipping transfer tax (the "GST tax") applies to transfers or distributions to persons who are treated as two or more generations below the generation of the transferor (a “skip person”). The GST tax is imposed at a flat rate of 55 percent. However, every U.S. citizen and resident has a lifetime GST tax exemption, currently $1,060,000, which permits transfers to skip persons equal to that amount free of GST tax.

B. Current Proposals.

As of the 1st of March of this year, 18 bills had been filed with respect to the reform of the Federal estate and gift tax. Of these, nine bills had been filed in the House, and nine bills had been filed in the Senate.

The bills represent a range of proposals, including particularly the following:

1) Immediate repeal of the estate and gift tax (S.82, S.100, S.275 and H.R. 86, H.R. 130, H.R. 153, H.R. 193, H.R. 246, H.R. 330).

2) Phased-in elimination of the estate and gift tax (S.31, S.35, S.83 and the proposed Dunn-Tanner bill, as well as President Bush's proposal).

3) Increase in the exclusion, in some cases combined with a decrease in the estate and gift tax rates (S.9, S.84, S.179 and H.R. 42, H.R. 88, H.R. 543).

Those categories of bills which propose to repeal the estate and gift tax, either immediately or through a phase-out mechanism, open a Pandora's box of issues. Some of these will profoundly impact the estates of those who die during the phase-out period. The proposed changes make planning for such persons and protections for their families and donees and heirs particularly difficult. Other of these changes will severely impact the backbone of our income tax system and its voluntary nature.

This testimony will emphasize (1) issues and questions regarding carryover of basis or a part stepped-up basis/part carryover basis system, (2) opportunities and incentives to "game" the Federal income tax regime if there is no Federal estate or gift tax, and (3) the effects on the states.

II. CARRYOVER BASIS ISSUES

A. Determination of Basis.

Property acquired by gift. The basis of property acquired by gift is its basis in the hands of the donor ("carryover basis"), increased by any gift tax paid, but not beyond the property's fair market value at the time of the gift. For gifts made after December 31, 1976, the increase in basis for gift tax paid is only as to the ratio of (1) the gift tax paid to (2) the net appreciation in value of the gift (that is, the excess of the fair market value of the gift over the donor's adjusted basis) as compared to the amount of the gift.

> Illustratively, if the gift is stock or securities having a value of $100,000 and a cost basis of $20,000, and if the gift tax paid is $45,000, then $36,000 (or 80% <$80,000/$100,000> times $45,000) will be the increase in the basis of the stock. Thus, the adjusted basis of the stock in the hands of the donee is $56,000 (or $20,000 plus $36,000).

Accordingly, in computing any gain or loss on a subsequent sale or other disposition of the transferred property, the donee uses the donor's basis (as so increased by the applicable gift tax paid).

The Internal Revenue Code (the "Code") contains a provision for gifts of built-in loss property to prevent a donor from transferring losses to the donee. Thus, a donee cannot use the donor's basis for purposes of determining subsequent losses where the donor’s basis exceeds the property’s fair market value (i.e., the property contains a “built-in loss”) at the time of the gift. Rather, the basis of the property for purposes of computing the donee's loss is the lesser of the property’s fair market value on the date of the gift or the donor’s basis.

If the property is sold at a price greater than the fair market value at the date of gift, but less than the donor’s basis, then neither gain nor loss is recognized on the transaction. The built-in loss is never utilized. If the property is sold at less than the property’s fair market value at the time of the gift (i.e., the property continues to decline in value after the gift), the donee can use the property’s fair market value at the time of the gift (but not the donor’s higher basis). Similarly, if the property appreciates so that its value exceeds the donor’s basis, the donee can use the donor’s basis for purposes of calculating any gain.

In effect, these rules interlock the Federal gift tax and the Federal income tax.

Property acquired from a decedent. Under current law, the basis of property acquired from a decedent is the fair market value of the property as of the date of the decedent’s death (or, if the decedent’s executor so elects, the alternate valuation date six months after the decedent’s date of death, but only if the election decreases the decedent's gross estate and the taxes imposed thereon). If property has appreciated as of the decedent’s death, that appreciation is not subject to income tax. Of course, the property, including any appreciation, is subject to estate tax.

Because property generally tends to appreciate during a decedent’s lifetime, this new basis is usually referred to as a basis “step-up”. Thus, the heir or legatee has a “fresh start”, rather than a basis that is determined by reference to the decedent’s basis in the property. (Concomitantly, if the asset decreased in value during the decedent's lifetime, there would be a basis "step-down".)

In the case of property held jointly by the decedent with another person with right of survivorship, the entire value of the property is included in the decedent’s estate, unless it is established that the portion of the property owned by the other party was not acquired from the decedent for less than full consideration. If the joint owner is the decedent’s spouse, one-half of the value of the property is included in the decedent’s estate (at least in common law states). In either case, the basis of the property so included and passing to the surviving joint owner equals its date of death fair market value (unless the alternate valuation date is elected).

B. *Liabilities in Excess of Basis.*

Assume that the decedent owns a piece of improved real property solely in his individual name. The total cost was $1,000,000; the fair market value on the date of death is $5,000,000; there is debt encumbering the property in the amount of $4,000,000; and the adjusted basis on the date of death is $400,000.

Under the current Federal estate tax laws, the $1,000,000 net fair market value of the real property [that is, $5,000,000 less $4,000,000 of debt] would be included in the decedent's estate. Assuming that the decedent's estate is in the 55 percent estate tax bracket, the estate tax attributable to this real property is $550,000, due as a consequence of the decedent's death. This estate tax may not be payable at such time due to the utilization of the marital deduction, if left to the decedent's spouse, or the charitable contribution deduction, if left to an eligible charity. Alternatively, the estate tax due may be covered by other liquid assets (if the heirs desire to continue to hold the real property), or the proceeds of the sale of the real property (which, based on the facts, would essentially produce a net $1,000,000 because there is no Federal income tax due on the sale, due to the step-up in basis to $5,000,000 on death), or through other sources of liquidity, such as loans secured by this or other assets or life insurance proceeds.

Contrast the carryover basis regime – under which the decedent's heirs would acquire the same property, but would have an adjusted basis of only $400,000 (the decedent's basis). On disposition of the real property, the heirs would realize a taxable gain of $4,600,000 (that is, the $5,000,000 of fair market value less $400,000 of adjusted basis, without taking any cognizance of the debt). The Federal income tax would range from $920,000 (if none of the gain were attributable to unrecaptured depreciation) to $950,000 (assuming that the $600,000 difference between the total cost of $1,000,000 and the adjusted basis of $400,000 were attributable to unrecaptured depreciation).

While the income taxes due in a carryover basis scenario could be covered by the same sources as above, it must be noted that, under these facts, the Federal income tax due ranges from 167 percent to 172 percent of the Federal estate tax. Incredibly, the difference in the tax payable is infinite if the real property goes to the spouse, who then sells the same, inasmuch as the combined Federal estate and income tax attributable to such scenario under current law would be -0-, whereas the Federal income tax alone in a carryover basis regime would range between $920,000 to $950,000.

C. A Focus on Add-Ons to Adjusted Basis.

Under the current Federal income tax law, the basis of property starts with its cost, whether acquired by purchase or by construction or fabrication. This cost is increased by related expenditures, such as commissions paid, title search costs, legal and related costs attributable to acquisition and certain direct and indirect costs of producing or acquiring the property. At later points in time, the basis of the property is further increased by rehabilitation and replacement costs, as well as overhaul and similar costs incurred in adapting the property to a new use or in significantly extending the useful life of the property.

There are other add-ons to the basis of property. Under the current law, for example, and as explained above, the basis of the property is increased in the hands of the donee by certain gift taxes paid with respect to such gift.

Likewise, when an estate or trust distributes an interest in a passive activity, then, under Code Section 469(j)(12), the basis of the interest is increased by the passive activity loss carryover allocable to such interest, and the losses are no longer allowable as a deduction, whether against passive income or on disposition of that property.

When considering whether to move from a combined Federal estate and gift tax/income tax regime to a solo Federal income tax regime, a number of other potential income tax basis adjustments need to be analyzed, with the decision on each being whether it is to become a basis adjustment or a continuing income tax carryforward. For under all circumstances each of these items must, in a fair and equitable solo Federal income tax regime, be one or the other. Among these items are the following:

1) Charitable contribution carryforwards, under Code Section 170(d), with the concomitant consideration as to whether the carryforward should continue to be limited to the next succeeding five taxable years, and, further, whether carrybacks should be instituted.

2) Net operating loss carryovers, under Code Section 172(b), with the concomitant consideration as to whether there should be a 20-year limitation on the carryover.

3) Amortization deductions with respect to amortizable Code Section 197 intangibles, as to which the adjusted basis is amortized over the 15-year period beginning with the month in which the intangible was acquired.

4) Investment interest carryforwards, under Code Section 163(d), which presently have an unlimited time period.

5) Capital loss carryovers, under Code Section 1212(b), which presently have an unlimited time period.

With regard to the foregoing, it would be counterintuitive to provide for carryover of basis on death without permitting the heirs to continue to utilize the carryovers and carryforwards to which the decedent was entitled. If these unused carryovers and carry-forwards were to become adjustments to basis, then the new system will impose the painstaking task of determining those assets the bases of which are to be adjusted and the allocation of such adjustment among such assets. Is this to be an elective procedure, through the executor, trustee or other personal representative or, in the absence of the same, the heirs? Whether or not elective, will there be a tiering (for example, first to capital assets, then to investments held for productive use in a trade or business, then to inventory and then to personal property), or a tracing (for example, which assets produced which carryover or carryforward), and/or a proportional application (such as in the ratio of the various assets or categories of various assets in the decedent's estate, based on a fair market value determination)? Please note that the use of any or all of these calculations requires significant record keeping, record retention and tracing, as will be noted time and again in this discussion.

Furthermore, what about the impact of the payment of state or local estate, inheritance, succession or other taxes in lieu thereof? Clearly, one can see the logic in adding these taxes to the basis of the decedent's assets for Federal income tax purposes. [In fact, to the extent that the state estate, inheritance, succession or other taxes in lieu thereof were attributable to net appreciation in value of property, this increase in basis was provided in the carryover basis provisions of (now repealed) Code Section 1023 by the Tax Reform Act of 1976.]

Again, through what mechanism(s) would state estate taxes be added to adjusted basis? On the other hand, it would be somewhat simpler to trace state inheritance taxes because that tax is generally imposed on the recipient of the property. In that event, one need only be concerned with the allocation of this tax among the assets received.

D. Determining and Tracing Historic Adjusted Basis.

It can be extraordinarily difficult to trace the historic basis of many assets, such as personal property held for generations within families for reasons of family history or affection, rather than because the property was not marketable. Recognizing such difficulty, a step-up in basis to fair market value as of March 1, 1913 was essentially sanctioned at the inception of the Code in 1913. A similar reconciliation was done as to gifts or transfers in trust before January 1, 1921.

Again, in order to prevent retroactive adverse effect from the adoption of carryover basis, a "fresh start" to December 31, 1976 was to be afforded taxpayers with the carryover basis provisions of the Tax Reform Act of 1976, based on the application of (1) the ratio of the number of days held prior to January 1, 1977 to the entire number of days held by the decedent as of the date of death to (2) an increase to the fair market value of the relevant property, subject to certain adjustments.

The current Regulations applicable to determining the basis of property in the hands of a donee clearly take into account the difficulty of ascertaining such basis in many situations. Under Treas. Reg. §1.1015-1(a)(3), if "the facts necessary to determine the basis of property in the hands of the donee or the last preceding owner by whom it was not acquired by gift are unknown to the donee", the district director of Internal Revenue is supposed to ascertain the property’s basis; and, if the district director finds it impossible to do so, then the basis is considered to be "the fair market value of such property … as of the date or approximate date at which, according to the best information the district director is able to obtain, such property was acquired by such donor or last preceding owner." With all due respect to all present and prior district directors, neither donors nor donees will, under the best or worst of cases, put themselves into such straits. This makes for a lot of educated guesstimates of fair market value, using the best information available under the circumstances.

One must perforce compound this difficulty of ascertaining historic basis generally, which has not been a real problem on a practical basis in a Federal estate and gift tax regime that provides a stepped-up basis on death, with the four horsemen of the carryover basis apocalypse -- (1) tracing the cost per asset, (2) tracing the dates of acquisition of multiple assets (e.g., dividend reinvestment plan stock acquisitions, stock splits and dividends, spin-offs of corporate subsidiaries), (3) record keeping and retention (query – notwithstanding our increasingly "paperless society", will our reforestation effort meet the pace of tree destruction for paper records?), and (4) reporting requirements.

Examining only the third of these horsemen – recordkeeping and retention, consider this simple example:

> Decedent A dies on December 31, 2004, with $10,000,000 of stock in Corporation Y, acquired on many different dates, not taking into account a number of stock dividends or splits. (This is decedent A's sole asset and under the law then in effect there is a step-up of basis on $2,800,000 of the stock and no step-up, but a carryover of basis, as to the remaining $7,200,000 of the stock.) Decedent A has five heirs, C, D, E, F and G, with all five being grandchildren of A. Each of C, D, E, F and G acquires 20 percent of A's estate, and each holds the stock in Corporation Y until his or her death, which occurs from 30 to 55 years later. Each of C, D, E, F and G has sufficient other assets for his or her own step-up of basis on $2,800,000 of assets (or whatever the magic number is then). C dies 42 years later, with 10 heirs.

How do the heirs of C trace basis? Was C required to retain the records for the 42 years from A's death to her death? Why would a taxpayer retain records so that those records could be used against that taxpayer, to prove a lower tax basis? This is counter-intuitive! What would be the penalties imposed, and on whom? Would we want the Revenue Service to be the intrusive "Big Brother" here, annually or at some other period of years requiring record production? Surely not!

Some have suggested that perhaps the burden of retaining such records – for decades and perhaps centuries – should be imposed on the Revenue Service, as the central repository. Other than perhaps as a means of filling up the thousands of empty and abandoned stores, office buildings and silos in the central cores of the cities and towns in the Rust Belt and Farm Belt, at an enormous rental cost to the Federal Government, there cannot be any justification for same. In carrying the burden of proof of proving the negative – the lower carried over basis of an asset or a fractional piece of an asset, the Revenue Service may be no better at tracing cost than the taxpayer. And then what about acts of God, such as tornadoes, floods, fires and the like?

E. The Interface between Stepped-Up and Carryover Bases.

As can be seen by the immediately preceding example, the combination of stepped-up and carryover bases on death will add incredible layers of complexity to an Internal Revenue Code already in sore need of real simplification.

The actuality and extensive and intensive reach of this combination of stepped-up and carryover bases on death will surely make the current estate and gift tax system look like a model of simplicity. And that is said by one who believes that it is considerably more difficult to understand the need for and operation of the GST tax than it is to solve the Middle East controversy, or the true meaning of Stonehenge.

Return once more to the dreaded four horsemen of the carryover basis apocalypse. Starting with the first of these -- tracing the cost per asset, imagine the intense and detailed records to be retained from generation to generation. Will each taxpayer be required to retain all purchase records on all assets -- real, personal or mixed, tangible or intangible, present or future, choate and inchoate -- for his or her lifetime? And then will each succeeding generation be required to retain its records and those of each preceding generation, so long as any asset has a carried over basis? Will each taxpayer need to keep all receipts and all VISA, MasterCard, American Express, Discover and other credit card statements?

Move to the second of the horsemen -- tracing the dates of acquisition of multiple assets. If you own mutual fund shares, where there is a mark-to-market each December 31, think about the relative complexity there. Move on to stock splits and dividends, spin-offs and split ups, mergers and consolidations, and then move over to non-recognition transactions, such as contributions to and distributions from partnerships, contributions to corporations and like kind exchanges of real and personal property.

The third horseman -- record keeping and retention -- will for many require more outside assistance, at a far greater cost, than occurs today. Again, this would be due in large part to the need potentially to produce these records to an Internal Revenue Service Agent or other authority years or decades or generations after the asset, or a fraction or portion of the asset, was acquired.

Now, onto the scene gallops the fourth horseman -- reporting requirements. In order that the Revenue Service and the states (as the partners or dependents of the Revenue Service) will have full knowledge and information, it is logical to assume that more -- yes, significantly more, not a modicum or iota less -- returns (denominated "information returns", not "tax returns") will be required to be filed.

In today's world, no Federal estate tax return need be filed for an estate (including past gifts in excess of the annual $10,000 exclusion or transfers not considered taxable gifts) of $675,000 or less, moving gradually to $1,000,000 in 2006. That is because Congress, with wisdom, decided that such amount was not to be taxable and, importantly, in a universe of stepped-up basis for all assets, that there is no need or desire to trace these assets.

However, in a world of combined stepped-up basis and carryover basis, there will be every need to trace, and those well below any magic number (whether $1,000,000 or $2,800,000 or any larger number) will still see the need to file, in order to be able to prove stepped-up bases at a much later time or times.

Following closely behind the four horsemen are the twin specters of valuation and allocations of stepped-up basis among assets. If a decedent's estate is close to the magic number of, say, $2,800,000, there is every incentive to keep it at or below that number.

> Illustratively, if the decedent has an asset with a potential fair market value of $200,000 to $400,000 but a zero adjusted basis, and the use of $200,000 would leave the estate at $2,800,000, there is simply no advantage to valuing the asset at $400,000 (or $200,000 more), because the basis is $200,000, whether or not the extra $200,000 of value is reported; and any sale at a price above $200,000 has exactly the same tax consequences.

Finally, how are stepped-up basis and carryover basis allocated among assets? Assume that the executor has the ability to elect however he, she or it wishes. Will all basis be allocated away from assets not to be sold, such as art, vacation homes, collectibles and the like? Will stepped-up basis be tiered, such as first to capital assets, then to assets held for productive use in a trade or business, then to inventory, and then to ordinary income items?

Where do IRAs, 401(k) and similar plans and the like fit into this picture? Today, these items of so-called "income in respect of a decedent" do not receive a stepped-up basis at death. For decades, taxpayers were urged to save for their retirement through such and similar vehicles. Now the taxpayer with stock in his or her own name will receive a step-up in basis, and the taxpayer with stock in his or her IRA, 401(k) or similar plan will not. That was acceptable when there was a Federal estate and gift tax regime, so that all such assets were subject to the estate and gift tax. That, however, does not seem acceptable where the taxpayer with such assets in his or her name will escape income tax due to the stepped-up basis, but the taxpayer with such assets in his IRA or 401(k) will not.

How will assets with built-in losses be treated? Will the donee or heir be permitted to carry over the basis, or will a fair market value basis apply, or will some combination be applicable?

As can be seen, the resulting complexity will take its toll on taxpayer comfort and confidence. It must be remembered that our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations and record keeping and retention requirements. Three years of record retention for the greatest number of American taxpayers is an acceptable burden; three generations of such record retention is implausible, if not impossible.

F. When Is There a "Sale or Disposition"?

A key question under the proposed carryover basis system will be what constitutes a sale or disposition triggering gain recognition.

In general, the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is relieved as a result of the sale or disposition. Thus, determining whether a "sale or other disposition" has occurred will be significant, as it will determine when the built-in gain in appreciated property (or property with liabilities in excess of basis) must be recognized.

Determining whether a sale or other disposition has occurred may be difficult. A disposition would generally be considered to have occurred when the property has been sold. This raises the question as to whether death constitutes a sale or disposition for gain recognition purposes. That is, does the death of the property holder constitute a disposition of the property by the decedent's estate?

Rather than hold property in their individual names, some taxpayers hold their assets through revocable trusts that become irrevocable upon their deaths. These revocable trusts are treated as "grantor trusts", and are disregarded for income tax purposes. Thus, transfers to a revocable trust during the grantor's lifetime are not treated as dispositions for income tax purposes, even if the property has liabilities in excess of the grantor's basis.

The grantor trust status of a revocable trust terminates on the grantor's death, whereupon the trust, now irrevocable, becomes a separate taxable entity. Upon termination of the grantor trust status, the grantor is treated as transferring the assets to the irrevocable trust for income tax purposes.

Under current law, because the property in a revocable trust is included in the grantor's estate, the property receives a step-up in basis upon the grantor's death. As a result, no gain is triggered under current law on the deemed transfer to the now-irrevocable trust. In a carryover system without any basis step-up, the "deemed transfer" to the now-irrevocable trust might require that gain be recognized, even though technically there has been no disposition.

Alternatively, a disposition might be deemed to occur only when the appreciated property is distributed to the heir or legatee (or the beneficiary of the decedent's trust), particularly where the distribution is in satisfaction of a fixed dollar amount (a "pecuniary bequest"). Under current law, a trust or an estate recognizes gain whenever appreciated property is distributed in satisfaction of a pecuniary bequest. Thus, a $5,000 bequest to the decedent's grandchild, unless satisfied with cash or another asset with a basis equal to $5,000, will trigger gain to the estate or trust. Without a basis step-up, there is a far greater possibility that such distribution will trigger gain. The same result will obtain for marital deduction bequests that are computed using a pecuniary formula and satisfied using appreciated property.

Alternatively, *any* distribution by a trust of property subject to a liability in excess of the property's basis might trigger gain. The distribution need not be in satisfaction of a pecuniary bequest in order for this result to obtain. Rather, if the distribution is treated as a “sale or other disposition”, the mere relief of the liability might be treated as consideration for the distribution, requiring the estate or trust to recognize gain. This will force the recognition of gain even though the decedent’s heirs never dispose of the property and, in certain cases, may compel that the property to be sold in order to pay the related Federal income tax. This is precisely the type of “forced sale” that the repeal of the estate tax would presumably be intended to prevent.

Neither the decedent’s death nor the distribution from the decedent’s estate or trust should constitute a disposition. Rather, a disposition should occur only when the distributed property is subsequently sold or otherwise disposed of by the heir, legatee or trust beneficiary; or, if the property is transferred in an otherwise non-recognition event, only when sold or otherwise ultimately disposed of.

What would the result be if the heir disclaimed an interest? Would that disclaimer be treated as a sale or other disposition, triggering gain? Surely, one would not expect the disclaimer to trigger gain when the disclaimer is considered only a by-pass, not a transfer.

III. GAMING THE SYSTEM

The repeal of the Federal estate and gift tax, with the substitution of a part stepped-up/part carryover basis system, presents numerous opportunities and incentives to “game” the income tax regime. One cannot blithely assume that the absence of any Federal estate or gift tax will make taxpayers happy to pay income tax on sales or dispositions of carryover basis assets.

A. Shifting Basis by Gift.

Taxpayers may be motivated to “swap” assets to produce the highest after-tax benefit. For example, assume Aunt Nelly owns high-basis real property and her high-tech nephew owns low-basis stock. Both the real property and the stock have the same fair market value. However, nephew is in the highest marginal Federal income tax bracket, while Aunt Nelly pays tax at the lowest marginal rate (in large part because most of her income comes from tax-free municipal bonds).

If nephew needs to raise cash, he can give his low-basis stock to Aunt Nelly in exchange for (but not tied to) a gift of her high-basis real estate, all without incurring any gift tax, and avoiding any immediate income tax (in the absence of a finding of a step transaction or taxable trade of assets). Nephew can then sell the real estate, thereby retaining more of the sales proceeds because the amount of his capital gain is lower. Under the right circumstances, both Aunt Nelly and her nephew may be better off as a result of these “gifts", and only the fisc suffers.

B. Tax Shelters – Entity and Individual.

Congress continues to consider whether to legislate on individual and entity income tax shelters. As we have moved from one Administration to the next, the Treasury and Revenue Service appear to remain concerned about these shelters.

In the meantime, like amoeba, the shelters seem to multiply by dividing. As one side of the tax shelter envelope is squeezed by unfavorable judicial rulings, Temporary and Proposed Regulations, I.R.S. Notices and Announcements and Revenue Rulings, new shelters transmogrify and morph at the other sides of the envelope. Thus, if the Revenue Service holds that a transaction fails because factors L, M and N exist, the next version features P,Q and R. To paraphrase Sir Walter Scott, “O what a tangled web we weave, when first we practice to tax relieve!”

If all of these tax shelters (now known, euphemistically, as "strategic planning" products) are being marketed today to corporations, business entities and wealthy individuals by accountants, lawyers, investment bankers, financial advisors and others, just imagine what will happen in a world where there is no Federal estate or gift tax, but only an income tax. Without the estate and gift tax, taxpayers will devote even more resources to acquiring and utilizing such shelters, and the demand for these schemes will increase exponentially.

Assume that a taxpayer inherits stock with a fair market value of $1,000,000 and zero adjusted basis. Will that taxpayer actively seek, and be marketed, alternatives to paying Federal income tax on a long term capital gain of $200,000? And what if that asset were instead a collectible, as to which the Federal long-term capital gain tax would be $280,000? And what if that stock were worth $10,000,000 with a zero adjusted basis, so that the capital gain tax would be $2,800,000?

C. Charitable Contributions.

Much has been written about how repealing the estate tax could impact charitable contributions. The impact may prove even more unfavorable if the repeal is coupled with the loss of a step-up in basis.

The Internal Revenue Code permits individuals who itemize deductions to deduct, with certain limitations, the value of property donated to certain “qualified” charitable entities. The amount of the deduction – both in terms of the value to be used in determining the deduction and the percent of that value that may be deducted in any given year – depends upon the type of property contributed and the nature of the donee organization.

For example, taxpayers are permitted to deduct 50 percent of their contribution base (essentially, their taxable income) for contributions of cash and ordinary income property to public charities. If the percentage limitation is exceeded, the excess generally can be carried forward five years.

On the other hand, taxpayers are only permitted a deduction of 30 percent of their contribution base for gifts of long-term capital gain property to public charities, unless they reduce the value of the property to their basis in the property contributed. In that event, the applicable percentage limitation is increased to 50 percent.

Gifts of long-term capital gain property to private foundations are further limited, in that the percentage limitation is 20 percent of the donor's contribution base. Moreover, in computing the value of the donated property, the taxpayer must reduce the deduction by the property's built-in capital gain. A limited exception is available under the Code for contributions to private foundations of so-called "qualified appreciated stock", which is, in short, publicly traded stock.

Subject to these limitations, the taxpayer may use the fair market value of such property in determining the amount of the deduction, regardless of the taxpayer's basis in the property.

The loss of the step up in basis may further aggravate the decline in charitable contributions caused by the repeal of the estate tax. Taxpayers holding low carryover basis property will be less likely to contribute such property to charity because of the reduced charitable contribution deduction. If the contribution is to a private foundation, the donor will be subject to a percentage limitation based on his or her basis in the property.

A smaller charitable contribution deduction will also result in less contributions to public charities because donors are likely to be forced to elect the 30 percent limitation (which is determined based on the property's fair market value), rather than the higher 50 percent limitation (based on the property's basis, which may be lower). Otherwise, the taxpayer would have to sell the property, recognize the capital gain and then contribute the proceeds in order to enjoy the full value of the charitable contribution deduction.

A carryover basis system will also put additional planning burdens on taxpayers, executors and trustees to reallocate gifts and bequests so that low-basis assets are transferred to charitable beneficiaries and high-basis assets to family members. This reallocation will become necessary to encourage subsequent gifts and to reduce the built-in income tax liability. To the extent such a reallocation is effective, it will reduce the utility of the carryover basis as a revenue offset for the repealed Federal estate and gift tax.

D. International Games.

<u>Expatriation</u>. The repeal of the estate tax presents new planning opportunities and incentives for persons who are neither U.S. citizens nor U.S. residents (that is, "non-resident aliens"). Because such persons generally are exempt from Federal capital gains taxes, implementing a carryover basis system to replace the repealed estate tax may lose its intended effect.

Whereas the Federal income tax applies to a U.S. citizen’s or resident’s worldwide income, non-resident aliens generally are subject to U.S. income tax only on their U.S. sourced income. For non-resident aliens engaged in a U.S. trade or business, any income effectively connected with the conduct of that business is taxed in the same manner as a U.S. citizen. Investment income, on the other hand, is taxed at a flat 30 percent rate, subject to certain exceptions (and subject to any lower treaty rates).

Non-resident aliens who are not engaged in a U.S. trade or business are not subject to tax on capital gains, whether or not the gains are U.S. sourced, unless the gains relate to the sale of a U.S. real property interest. Thus, sales of appreciated stock or other non-real property assets, if made by a non-resident alien who is not engaged in a U.S. trade or business and who has no connection to the U.S. other than the fact that he or she holds such stock or property, generally are not taxed.

If the estate tax is repealed, property transferred to a non-resident alien will forever escape taxation. This presents a significant planning opportunity for U.S. persons who anticipate a significant inheritance. Such persons could decide to expatriate before receiving the inheritance. If the estate and gift tax is repealed, appreciated property could then be transferred tax-free to such persons, who could then sell the appreciated property without incurring any Federal income tax.

Congress did enact provisions that continue to tax tax-motivated expatriates for ten years on certain U.S. sourced income as though they remained U.S. citizens or residents. However, in order for this ten-year “look back” to apply, there must be evidence that the expatriation was tax motivated. A former U.S. citizen or resident is presumed to have expatriated with a principal purpose to avoid U.S. taxes if the individual's average annual income tax liability (the "tax liability test") or the individual's net worth (the "net worth test") on the date of expatriation exceeds certain thresholds. The thresholds are indexed for inflation. The tax liability and net worth test thresholds for 2001 are approximately $115,000 and $580,000, respectively.

However, if the U.S. citizen or resident expatriated before receiving the inheritance, and therefore before exceeding the statutory thresholds, tax-motivated expatriation would certainly be more difficult to establish. As a result, the U.S. citizen or resident could expatriate before receiving the inheritance without being subject to the ten-year “look back” rule.

<u>Non-citizen spouses</u>. Similar planning opportunities are available for transfers to non-citizen spouses. Generally, a donor who is a U.S. citizen is allowed an unlimited marital deduction for gifts and bequests to the donor’s spouse. This “deduction” is, in fact, only a “deferral” because the transferred property is includable in the recipient spouse’s estate at death (unless the property is consumed or given away during the surviving spouse’s lifetime). Thus, the assumption that the property transferred by the first spouse tax free to the surviving spouse would eventually be subject to transfer tax justified the unlimited marital deduction. However, where the donee spouse is not a U.S.

citizen, it is possible that the transferred property would escape taxation because of the limited application of the tax rules to non-resident aliens. Thus, the same property might escape taxation entirely because of the combination of both the unlimited marital deduction and the limited reach of the Federal estate and gift tax rules to non-resident aliens.

To prevent this result, Congress enacted a statutory provision that denies the Federal estate tax marital deduction for bequests to non-citizen spouses unless the property passes to the spouse through (or is placed by that spouse in) a "qualified domestic trust" ("QDOT"). Once the property is placed in the QDOT, a transfer tax is imposed whenever property (other than income) is distributed from the trust (with certain exceptions for "hardship" distributions). Thus, the QDOT serves as an "escrow arrangement", ensuring that if property is distributed to the spouse (and therefore moves beyond the reach of the transfer tax system), the appropriate amount of transfer tax will be collected.

If the Federal estate and gift tax regime is repealed and transfers can be made tax free, the non-citizen spouse can, subject to the expatriation rules noted above, move abroad and later sell the property without incurring any U.S. tax. Thus, the expectation that a carryover basis system will recapture a substantial portion of the revenue lost by the repeal of the Federal estate and gift tax regime will not be realized.

IV. IMPACT ON STATES

A. Cost of Elimination of Estate Tax; Alternatives.

Under the present structure, 41 states and the District of Columbia have an estate tax, and the other 9 states have inheritance, succession or other taxes in lieu thereof.

It has been estimated that state tax revenues from all sources average about $1 trillion per year. With the estate tax raising about $5 billion annually in state tax revenues, the states would lose about ½ percent of their revenues if the estate tax were repealed. Although this represents only ½ percent of total tax revenues, think of the raw cost to the states of losing $5 billion of revenue.

Where would the states replace such revenue? Through increased income taxes, sales and use taxes, intangible taxes, tangible personal property taxes and/or user fees? In any such case, the real cost is imposed on a broader spectrum of persons, the overwhelming majority of which are persons with lower incomes and much smaller asset bases, who are most likely to feel the pain of non-progressive taxes, rather than those who benefit from the repeal of the estate tax.

B. Changes in Domicile or Trust Situs.

Today, many individuals change domicile to eliminate or substantially reduce state income taxes. However, there is generally no focus on changing such domicile from one state to another to escape state estate taxes, inasmuch as, with a few notable exceptions, the state estate tax is generally absorbed into the Federal estate tax.

The repeal of the Federal estate tax in favor of a carryover basis system will increase the pressure on individuals to relocate to jurisdictions without an estate tax, resulting in a loss of revenue for states that fail to adapt.

Likewise, there would be a major migration of trusts, both new and (to the extent feasible) existing, into states without a state income tax, irrespective of where the settlors or beneficiaries reside.

V. CONCLUSION

In light of a deep-seated desire on the part of all sides of the debate to achieve fairness and equity for all, while effectively eliminating the Federal estate and gift tax for about 99 percent of the American population, the following seven-point plan is proffered:

1. Increase the per-taxpayer amount not subject to Federal estate or gift tax immediately to $5,000,000.
    a. Do so in 1 step, without any phase-in.
    b. On January 1 of each year, increase such amount by 5 percent, on a compounded basis.
    c. Eliminate the qualified family-owned business interest deduction (Code Section 2057).

2. Make such $5,000,000 a true exemption from Federal estate and gift tax.
    a. The 18 percent rate would begin to apply at $5,000,001 in the first year, at $5,250,001 in the second year, and so forth.
    b. Move the top rate bracket down to 40 percent.

3. Retain full step-up of basis on death and permit step-up of basis on gifts, other than those subject to the annual exclusion or otherwise not deemed gifts.
    a. This would encourage unlocking assets prior to death.
    b. Recipients might be more likely to dispose of assets than the transferors.

4. Increase the annual gift tax exclusion per donee immediately to $30,000.
    a. Do so in 1 step, without any phase-in.
    b. On January 1 of each year increase such amount by 5 percent, on a compounded basis.
    c. Apply the exclusion to all gifts, whether present or future interests.

5. Equalize residents of non-community property states with those of community property states.

a. Provide stepped-up basis on death for all property held with a spouse as tenants by the entirety or joint tenants with rights of survivorship.
b. In order to do so, the Federal estate and gift tax law will need to supersede the state common or civil law, but only for Federal tax basis purposes.

6. Expand the availability of Code Section 6166 – currently providing for a deferral of Federal estate taxes at a favorable interest rate, but only for a qualifying "interest in a closely held business" -- to all estates.
   a. This will put all taxpayers on the same level playing field.
   b. Currently, older taxpayers, who move to an inactive status in connection with such assets as rental real estate, are severely disadvantaged.

7. Eliminate (and bury forever without ceremony) the generation-skipping transfer tax.
   a. The GST tax complexity far outweighs any usefulness.
   b. Too much time and energy is provided, and too many incomprehensible clauses in Wills and trust agreements, are drafted in order to avoid, defeat or outsmart the GST tax.
   c. While its actual applicability is very limited, its potential reach and cause for angst are unlimited.

Thank you again for the opportunity to testify at this historic hearing. I can only wish you, and, through you, your multifarious constituents, the very best of success in the outcome of your endeavors.