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A History of Federal Estate, Gift, and Generation-Skipping Taxes

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Abstract. Three primary categories of legislation pertaining to transfer taxes have been introduced in the 110th Congress. As noted above, the repeal of the estate and generation-skipping taxes is not permanent. One category would make the repeal permanent. (See, H.R. 411 and H.R. 2380). Another category would accelerate the repeal of these transfer taxes. (See, H.R. 25, H.R. 1040, H.R. 1586, H.R. 4042, S. 1025, S. 1040, and S. 1081). The third would reinstate these taxes at lower rates and/or in a manner more considerate of family-owned business. (See, H.R. 1928, H.R. 3170, H.R. 3475, H.R. 4172, H.R. 4235, H.R. 4242, and S. 1994). In this report, the history of the federal transfer taxes has been divided into four parts: (1) the federal death and gift taxes used between 1789 and 1915; (2) the development, from 1916 through 1975, of the modern estate and gift taxes; (3) the creation and refinement of a unified estate and gift tax system, supplemented by a generation-skipping transfer tax; and (4) the phaseout and repeal of the estate and generation-skipping taxes, with the gift tax being retained as a device to protect the integrity of the income tax.

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Summary

Since 1976, the federal transfer tax system has included an estate tax, gift tax, and generation-skipping tax. The estate and gift transfer taxes have been part of the federal revenue system, off and on, since the earliest days of the United States. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) provided for a phaseout of the estate and generation-skipping taxes over a 10-year period, leaving the gift tax as the only federal transfer tax. It is important to note that, as structured in this act, the repeal of the estate and generation-skipping taxes is not permanent. Unless revised, these taxes are to be reinstated at 2001 levels in 2011.

Two primary categories of legislation pertaining to transfer taxes may be expected to be introduced in the 111th Congress. As noted above, the repeal of the estate and generation-skipping taxes is not permanent. One category would make the repeal permanent. The second would reinstate these taxes at lower rates and/or in a manner more considerate of family-owned business.

In this report, the history of the federal transfer taxes has been divided into four parts: (1) the federal death and gift taxes used between 1789 and 1915; (2) the development, from 1916 through 1975, of the modern estate and gift taxes; (3) the creation and refinement of a unified estate and gift tax system, supplemented by a generation-skipping transfer tax; and (4) the phaseout and repeal of the estate and generation-skipping taxes, with the gift tax being retained as a device to protect the integrity of the income tax.

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Introduction

The concept of a death tax and the controversies surrounding such taxes have ancient roots. There is evidence of a 10 percent tax on transfers of property at death in ancient Egypt, as early as 700 B.C.[1] Later, the Greeks and Romans adopted death taxes. Critics of such taxes may trace their grievances at least to Pliny the Younger, who charged that a death tax was "an unnatural tax augmenting the grief and sorrow of the bereaved."[2]

The gift tax has developed as a necessary concomitant to the death tax because the easiest way to escape a tax on the gratuitous transfer of property at death is to divest oneself of the property during life. The impact of either tax alone would be diminished by the escape offered by the alternate transfer.[3]

Starting in 1976, Congress almost completely restructured the federal transfer tax system. The estate and gift taxes were unified. The scope of these taxes was changed in terms of size of estates affected. Perceived loopholes of major importance were closed or narrowed. Certain groups, previously thought to have suffered excessive tax burdens, were afforded relief. A new tax, the generation-skipping transfer tax, was added to supplement these two other transfer taxes.

The enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001,[4] begins a movement away from the use of transfer taxes. This act phases out the estate and generation-skipping taxes over a ten year period, leaving the gift tax as the only federal transfer tax. The repeal of the estate tax would leave the United States without a federal estate tax for the first time since 1916.

This report details the history of the three federal transfer taxes, tracing their development from their eighteenth century roots to the present.[5]

[1] Randolph E. Paul, *Federal Estate and Gift Taxation*, p. 3 (Boston 1942), William J. Schultz, *The Taxation of Inheritance*, p. 3 (New York, 1926); and Max West, *The Inheritance Tax*, p. 11 (New York, 1908). *See also, Knowlton v. Moore*, 178 U.S. 41, 49 (1900).

[2] William J. Schultz, *The Taxation of Inheritance*, p. 6 (New York 1926). The Roman death taxes were adopted by Emperor Augustus in 6 A.D. *See also, Max West, The Inheritance Tax*, p. 11 (New York, 1908); and 3 Adam Smith, *The Wealth of Nations*, p. 311 (London, 1811). For a discussion of the complexities of estate planning in ancient Greece, *see, Anton-Herman Chroust, Estate Planning in Hellenic Antiquity: Aristotle's Last Will and Testament,* 45 Notre Dame Lawyer 629 (1969).

[3] The history of using inter vivos transfers to evade death taxes may be traced to Egypt in the seventh century, B.C.. As noted by one author:

> "Another inscription [Egyptian hieroglyphics] records a sale of property by an old man to his sons at a nominal price, apparently for the purpose of avoiding the inheritance tax."

Max West, The Inheritance Tax, pp. 11-12 (New York, 1908).

[4] P.L. 107-16, 107th Cong., 1st Sess. (2001).

[5] For a summary and description of current law in this area, please *see*, CRS Report 95-416, *Federal Estate, Gift, and Generation-Skipping Taxes: A Description of Current Law*, by John R. Luckey.

Death and Gift Taxes in the United States: 1789-1915

Prior to 1916, the United States did not make regular use of death and gift taxes. The federal government turned to them only in time of extraordinary revenue demands, such as wartime, although individual states used them extensively.

The Death Stamp Tax: 1789-1802

The federal experience with death taxes began in the eighteenth century, when strained trade relations with France necessitated development of a strong naval force. In 1794, a special revenue committee of the House of Representatives recommended that a system of stamp duties be adopted to meet the resultant revenue needs. The recommended duties included a tax:

> On inventories of the effects of deceased persons, ten cents.
>
> On receipts for legacies, or shares of personal estate, where the sum is above $50 and not exceeding $100, twenty-five cents; more than $100 and not exceeding $500, fifty cents; for every further sum above $500, a dollar. Not to extend to wives, children or grandchildren.
>
> On probates of wills, and letters of administration, fifty cents.[6]

In 1796, the House Committee on Ways and means reported to Congress a bill to adopt such a tax[7] and the tax was enacted in 1797.

The Stamp Act of July 6, 1797,[8] required the use of federal stamps on receipts and discharges from legacies and intestate shares, and levied a charge for the purchase of the required stamps. The rate structure recommended by the special revenue committee in 1794 was adopted, along with exemptions for distributions to a wife (but not a husband), or a child or grandchild.[9] The stamp tax continued in force until 1802, when it was repealed.[10] For the next 60 years, the federal tax structure endured without any form of death tax.

The Civil War Inheritance Taxes: 1862-1870

The Civil War period was important in the development of the federal estate and gift tax system. The Revenue Act of 1862 introduced the first federal gift tax and included a number of features which have become important parts of the present federal estate, gift, and generation-skipping tax laws, including taxation of certain lifetime transfers of a testamentary character and exemption of

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[6] 1 *American State Papers in Finance* 277.

[7] *Annals of Congress*, 4th Cong., 1st Sess. 993 (1796). The tax proposed by the Ways and means Committee, however, was not graduated, unlike the 1794 recommendation. The Ways and Means proposal called for a flat 2 percent levy and exempted property passing to parents, husbands, and lineal descendants.

[8] Act of July 6, 1797, 1 Stat. 527.

[9] The policy of favorable tax treatment of transfers to a spouse has continued into present law, which affords special estate and gift tax deductions for certain interspousal transfers. 26 U.S.C. §§ 2056, and 2523.

[10] Act of April 6, 1802, 2 Stat. 148.

small estates. During the debate on the act, Congress considered for the first time special treatment of charitable transfers.[11]

The use of a federal death tax was revived in 1862 to meet the revenue demands of the Civil War.[12] The 1862 levy, like its predecessor, taxed legacies and distributive shares of personal property but, unlike its predecessor, it was not a documentary stamp tax but an inheritance tax (a tax imposed upon individuals who receive property from a decedent upon the privilege of inheriting the property).[13]

The amount of the 1862 tax was, as is typical of inheritance taxes, graduated according to the closeness of the familial relationship between the decedent and the beneficiary. The rates ranged from 0.75 percent, for distributions to ancestors, lineal descendants, and siblings, to 5 percent, for distributions to distant relations and unrelated persons. The tax was imposed only on personal estates in excess of $1,000. Bequests to surviving spouses were entirely exempt from tax. Gifts intended to take effect at the donor's death or thereafter were included in the donor's estate for tax purposes.

War revenue needs prompted Congress to increase the rates of tax on inheritances in 1864 and to impose a succession tax on the receipt of real property by devise. The succession tax applied both to devises of real property and to transfers for inadequate consideration, though transfers in consideration of marriage were regarded as transfers for adequate consideration. Widows (though not widowers) were exempt from the succession tax, and charitable transfers of real estate were expressly taxed at the highest rate.[14]

In 1866, Congress responded to pleas of the Special Commissioner of the Revenue and tightened enforcement of the legacy and succession taxes. A penalty of up to $1,000 was imposed on executors and administrators who failed to furnish the required statements or filed false statements.[15]

The legacy and succession taxes were repealed in 1870, when the need for their additional revenues had ceased.[16] Four years later, the United States Supreme Court held, in *Scholey v. Rew*,[17] that the legacy and succession taxes had been constitutionally imposed.

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[11] During consideration of the 1862 tax, Representative William Payne Sheffield of Rhode Island argued unsuccessfully for special treatment of charitable bequests. In debates on the floor of the House of Representatives, Congressman Sheffield stated:

> It seems to me proper for the national Legislature to give encouragement to making of this class of devises for charitable and literary purposes. There are a great many of them made—made to poor churches and made for the purpose of building schools and colleges. The Government has frequently aided such institutions by grants of land; and it seems to me to be in harmony with the previous policy of our legislature to adopt a provision of this character. *Cong. Globe,* 37th Cong., 2nd Sess. 1534 (1862).

[12] Act of July 1, 1862, 12 Stat. 432, 483.

[13] An inheritance tax may be distinguished from an estate tax, such as the tax presently imposed by the federal government. An estate tax is imposed upon a decedent's estate for the privilege of passing the property to designated beneficiaries, whereas an inheritance tax is imposed upon the beneficiaries themselves for the privilege of receiving legacies, bequests and devises from the deceased.

[14] Act of July 30, 1864, 13 Stat. 285, 480.

[15] Act of July 13, 1866, 14 Stat. 140.

[16] Act of July 15, 1870, 16 Stat. 256.

In *Scholey*, the taxpayer contended that the Civil War death taxes were direct taxes which, under the United States Constitution, must be apportioned according to the census.[18] The Court disagreed, stating that:

> Taxes on lands, houses, and other permanent real estate have always been deemed to be direct taxes, and capitation taxes, by the express words of the Constitution, are within the same category, but it never has been decided that any other legal exactions for the support of the federal government fall within the condition that unless laid in proportion to the numbers that the assessment is invalid.... Whether direct taxes in the sense of the Constitution comprehends any other tax than a capitation tax and a tax on land is a question not absolutely decided, nor is it necessary to determine it in the present case, as it is expressly decided that the term does not include the tax on income, which cannot be distinguished in principle from a succession tax such as the one in the present controversy.[19]

An Income Tax on Gifts and Inheritance: 1894

The Income Tax Act of 1894 was not, in a technical sense, a death or gift tax, but it did treat gifts and inheritances as income and tax them as such.[20] The tax was short-lived, as the United States Supreme Court ruled it unconstitutional in 1895, in *Pollock* v. *Farmers' Loan and Trust Company*.[21] The Court found that, to the extent the 1894 income tax was imposed on the gains from real estate, it so burdened the real estate as to constitute a direct tax, which had to be apportioned among the states according to the census. The Court struck down the entire statute because it found that elimination of only the tax on real estate income would unduly burden the other classes of income taxpayers, contrary to congressional intent.

Modified Estate Tax: 1898-1902

The War Revenue Act of 1898[22] imposed another death tax in order to raise revenues to finance the Spanish-American War. The 1898 death tax was a form of estate tax, levied upon the value of all personal property included in a decedent's gross estate. Property passing to a surviving spouse was excluded from the tax, and a $10,000 specific exemption excluded small estates. The tax rates were graduated from 0.74 percent to 15 percent, taking into consideration both the size of the estate and the degree of kinship of the decedent and the beneficiaries.

The United States Supreme Court upheld the 1898 estate tax in *Knowlton v. Moore*.[23] The Court reaffirmed its earlier decision in *Scholey v. Rew, supra*, and said that the estate tax, like the inheritance tax, was an indirect tax subject to the rule of uniformity and not the rule of

(...continued)

[17] 23 Wall. (90 U.S.) 331 (1874).

[18] U.S. Const., Art. I, § 9, cl. 4.

[19] 23 Wall. (90 U.S.) 331, 347.

[20] Act of August 27, 1894, 28 Stat. 509, 553.

[21] 158 U.S. 429 (1895). This case is often correctly viewed as setting the stage for the passage of the Sixteenth Amendment to the United States Constitution, which expressly authorizes the imposition of an income tax without apportionment by census.

[22] Act of June 4, 1898, 30 Stat. 448, 464.

[23] 178 U.S. 41 (1900).

apportionment. The Court rejected the contention that death taxes were the exclusive prerogative of the states and held that, although wills and distribution of estates were matters for state law, taxation of these transfers could rest with the federal government as well as the states.

The 1898 estates tax was amended in 1901 to exempt bequests to charitable, religious, literary and educational organizations and to organizations for the encouragement of the arts or the prevention of cruelty to children.[24] In 1902, the estate tax was repealed.[25]

Reasons for Federal Death Taxes: 1789-1915

Federal death taxes in the United States between 1797 and 1915 appear to have served as supplementary revenue sources adopted only during war times. There is little support for the theory that these taxes were levied in an attempt to prevent the transfer of vast estates or to redistribute wealth.

Attitudes began to change with respect to the perpetuation of large estates, however, and in a speech in 1906 President Theodore Roosevelt called for:

> a progressive tax on all fortunes beyond a certain amount, either given in life or devised or bequested upon death to any individual—a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual.[26]

Development of the Modern Federal Estate and Gift Taxes: 1916-1975

A history of the modern federal estate and gift taxes must begin in 1916. Though since extensively reexamined and revised numerous times, legislation enacted that year is the direct ancestor of current law.

The Revenue Act of 1916

In 1916, Congress reacted to a mixture of changing attitudes and revenue shortages, the latter caused by a reduction in United States trade tariff receipts in the early years of World War I. It became apparent that greater reliance would have to be placed on internal taxes and that dependence on tariffs would have to be reduced. One internal tax was a federal estate tax.

The estate tax adopted in the Revenue Act of 1916[27] had many features of the current taxes. It was measured by the value of the property owned by a decedent at the date of death and the value of a decedent's estate was increased for tax purposes by certain lifetime transfers, including transfers

[24] Act of March 2, 1901, 31 Stat. 946.

[25] Act of April 12, 1902, 32 Stat. 96.

[26] *See*, quotation in Randolph E. Paul, *Taxation in the United States* p. 88 (Boston, 1954).

[27] Act of September 8, 1916, 39 Stat. 756; on rationale for the tax as a revenue measure, *see*, H.Rept. 64-922, 64th Cong., 1st Sess. 1-5 (1916).

for inadequate consideration, transfers not intended to take effect until death, and transfers in contemplation of death.[28] The full value of property owned concurrently by a decedent and another person would be included in the decedent's gross estate, unless it could be established that the surviving joint owner had contributed part of the property's acquisition cost.

The 1916 estate tax allowed the executor to reduce a decedent's estate for tax purposes by a $50,000 exemption and the amount of any funeral expenses, administration expenses, debts, losses, and claims against the estate. The tax rates ranged from 1 percent on net estates of up to $50,000, to 10 percent on net estates over $5,000,000.

The Supreme Court upheld the 1916 estate tax in *New York Trust Company v. Eisner*.[29] Writing for the Court, Justice Oliver Wendell Holmes stated:

> The statement of the constitutional objections urged imports on its face a distinction that, if correct, evidently hitherto has escaped this Court. *See, United States v. Field*, 255 U.S. 257. It is admitted, as since *Knowlton v. Moore*, 178 U.S. 41, it has to be, that the United States has power to tax legacies, but it is said that this tax is cast upon a transfer while it is being effectuated by the State itself and therefore, is an intrusion upon its processes, whereas a legacy tax is not imposed until the process is complete. An analogy is sought in the difference between the attempt of a State to tax commerce among the States and its right after the goods have become mingled with the general stock in the State. A consideration of the parallel is enough to detect the fallacy. A tax that was directed solely against goods imported into the State and that was determined by the fact of importation would be no better after the goods were at rest in the State than before. It would be as much an interference with commerce in one case as in the other . . . . Conversely, if a tax on the property distributed by the laws of a State, determined by the fact that distribution has been accomplished, is valid, a tax determined by the fact that distribution is about to begin is no greater interference and is equally good.[30]

Rate Increases: 1917

The revenue demands of defense preparations prompted increases of one-half in the estate tax rates, as part of the Revenue Act of 1917.[31] Later in that same year, two new rate brackets were added at the upper end of the rate scale.[32] By the end of 1917, the estate tax rates progressed from 2 percent on net estates below $50,000, to 22 percent on net estates between $8,000,000 and $10,000,000, and 25 percent on net estates above $10,000,000. Estates of individuals whose death resulted from military service were not taxed.

[28] A gift was presumed to have been made in contemplation of death if it was made within two years of death. The executor could rebut this presumption by showing that the gift was motivated by lifetime considerations, rather than death tax avoidance.

[29] 256 U.S. 345 (1920).

[30] 256 U.S. at 348.

[31] Act of March 3, 1917, 39 Stat. 1000; for statements regarding its necessity to provide war revenues, *see*, H.Rept. 64-1366, 64th Cong., 2nd Sess. 1-3 (1917).

[32] Act of October 3, 1917, 40 Stat. 300.

Estate Tax Fluctuations and a Brief Gift Tax: 1918-1926

The conclusion of World War I prompted debates over the continued existence of the estate tax. The House of Representatives approved a rate in 1918[33] but the Senate sought instead to replace the estate tax with an inheritance tax. The Revenue Act of 1918[34] reflected a compromise between the views of the House and Senate, retaining the estate tax but cutting the rates on estates of less than $1,000,000.

The 1918 law also expanded the estate tax base by including the value of a surviving spouse's dower or curtesy right in the decedent's estate and the proceeds, over $40,000, of life insurance policies on the decedent's life, if they were receivable by the executor or the estate. The 1918 Act also included in the gross estate the value of any property subject to a general power of appointment held by the decedent, whether exercised in the decedent's will or exercised during the decedent's life in contemplation of death.[35] Charitable contributions were deductible in computing the taxable estate.

The estate tax remained unchanged until 1924, when Congress again increased the estate tax rates to a top rate of 40 percent on net estates over $10,000,000; made certain adjustments to the estate tax base; and added a gift tax.[36] The estate tax base was increased by adding the value of property which a decedent transferred during life but over which the decedent retained the power to "alter, amend, or revoke" the beneficial enjoyment. Provision was also made for allocating to the estate a portion of the value of concurrently owned property acquired by a decedent and a surviving joint owner by gift or inheritance, in which case there would be no relative contributions. Also, a credit against the federal estate tax was allowed for state death taxes, up to a total of 25 percent of the federal tax liability.

The Revenue Act of 1924 also added a gift tax with the same rate schedule as the estate tax. A lifetime exclusion of $50,000 and an annual exclusion of $500 per donee were both allowed. Neither charitable contributions nor gifts of property which the donor had received by gift or inheritance within the past five years were subject to gift tax.

Stiff opposition to the estate and gift taxes increased during the mid-1920s, and in 1926 the gift tax and many of the estate tax rate increases were repealed.[37] The 1926 Act created an estate tax rate range from 1 percent on net estates under $50,000, to 20 percent on net estates above $10,000,000. The estate tax exemption was increased from $50,000 to $100,000, and the maximum credit for state death taxes was increased from 25 percent to 80 percent of the federal estate tax liability.

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[33] *See*, H.Rept. 65-767, 65th Cong., 2nd Sess. (1918); and the debates on H.R. 12863, 65th Cong., 2nd Sess., 56 *Cong. Rec*. (1918).

[34] Act of February 24, 1919, 40 Stat. 1057.

[35] A power of appointment is a right held by someone other than the owner of property, to designate the person or persons who will enjoy the benefits of the property. For example, a power to designate who will receive the income from certain stocks would be a general power of appointment over the income from stocks. The power to designate who would receive the stocks at the owner's death would be a general power of appointment over the stocks themselves.

[36] Revenue Act of 1924, Act of June 2, 1924, 43 Stat. 253.

[37] Revenue Act of 1926, Act of February 26, 1926, 44 Stat. 9; on the necessity of the estate tax rate increases to provide revenues to finance new Federal projects, *see*, H.Rept. 72-708, 72nd Cong., 1st Sess. 1-4 (1932).

Although the 1924 gift tax was repealed by the Revenue Act of 1926, it did stimulate a decision of the United States Supreme Court upholding its constitutionality. In *Bromley v. McCaughn*,[38] the Court held that the gift tax was an excise tax of the constitutional class of indirect taxes, requiring only intrinsic uniformity, rather than apportionment.

Estate Tax Rate Increases and a Permanent Gift Tax: 1932-1941

The depression of the 1930s reduced income tax revenues and increased the demand for revenues to finance various new Government projects. Again, Congress turned to the estate and gift taxes.

The Revenue Act of 1932[39] increased the estate tax rates at virtually every level, added two new rate brackets, and reduced the estate tax exemption to its 1924 level of $50,000. The resultant estate tax had rates graduated from 1 percent on net estates up to $100,000, to 45 percent on net estates above $10,000,000.

The 1932 Act also reintroduced a federal gift tax, but with rates set at three-quarters of the estate tax rates, a level maintained until 1976. The lifetime gift tax exclusion was set at $50,000, and the annual exclusion at $5,000 per donee. No tax was imposed on charitable gifts.

The gift tax was, and continues to be, cumulative. That is, the rate of tax on each successive taxable gift over the donor's lifetime is computed on the basis of the total amount of all such gifts. If two donors each made identical gifts of $50,000 in a specific year, the donor with the greater amount of lifetime taxable gifts (after 1932) would pay the higher tax on the present transfer.

Between 1934 and 1942, social policies and wartime demands led to a series of estate and gift tax rate increases, though the gift tax rates continued to be maintained at three-quarters of the estate tax rates. The Revenue Act of 1934 raised the maximum estate tax rate to 60 percent, on a net estate over $10,000,000,[40] and the Revenue Act of 1935 further raised it to 70 percent, on net estates over $50,000,000.[41] The 1935 Act also reduced the estate and gift tax lifetime exemptions to $40,000 each.

The outbreak of World War II in Europe raised congressional concern over the state of American military preparedness and prompted an increase in the estate and gift taxes to provide additional revenue. The Revenue Act of 1940 added a 10 percent surtax to the income, estate, and gift taxes.[42] The Revenue Act of 1941 increased the estate and gift tax rates even further, producing an estate tax rate graduation from 3 percent, on net estates not over $5,000, to 77 percent, on net estates over $50,000,000.[43] The gift tax rates were maintained at three-quarters of the estate tax rates.

[38] 280 U.S. 124 (1929).

[39] Act of June 6, 1932, 47 Stat. 169.

[40] Act of May 10, 1934, 48 Stat. 680.

[41] Act of August 30, 1935, 49 Stat. 1014.

[42] Act of June 25, 1940, 54 Stat. 516; on the reason for the increased rates, *see*, H.Rept. 76-2491, 76th Cong., 3rd Sess. 1 (1940).

[43] Act of September 20, 1941, 55 Stat. 687.

Further Rate Adjustments and the Marital Deduction: 1942-1948

The basic estate and gift tax exemptions were altered again by the Revenue Act of 1942,[44] which created a $60,000 estate tax exemption, a $30,000 lifetime gift tax exclusion, and a $3,000 annual per donee gift tax exclusion. The 1942 Act also increased the estate tax base by including in a decedent's gross estate the proceeds of any life insurance policy on the decedent's life if either the proceeds were payable to or for the benefit of the estate or the decedent had paid the premiums on the policy.

The 1942 Act also attempted to correct the perceived inequity in estate and gift taxation between residents of community property states and non-community property states.[45] Property owned concurrently by a decedent and a surviving spouse in a non-community property state was excluded from the decedent's gross estate only to the extent it could be shown that the surviving spouse contributed to the acquisition cost. In a community property state, however, one-half of all property acquired by either spouse during their marriage belonged to each spouse, by operation of law. On the death of either spouse, only one-half of the community property would be subject to estate taxes.[46] This resulted in the automatic equalization of the estates of spouses residing in community property states and a lower total estate tax burden.

Congress attempted to resolve this problem by treating community property like it treated concurrently owned property in a non-community property state. Community property was included in a decedent's gross estate except to the extent that the surviving spouse could be shown to have contributed to the acquisition cost.

This solution, deemed complex and unsuccessful, was replaced in the Revenue Act of 1948[47] by the estate and gift tax marital deductions and the rules on split-gifts. The estate tax marital deduction permitted a decedent's estate to deduct the value of all property passing to a surviving spouse, whether passing under the will or otherwise. Under the 1948 Act, the maximum deduction was one-half of the decedent's adjusted gross estate (the gross estate less debts, taxes and administration expenses). Community property, however, was ineligible for the estate tax marital deduction, thereby equalizing the tax treatment of estates of residents of community property states and non-community property states.

The gift tax marital deduction allowed a donor to deduct one-half of an interspousal gift, other than community property, to a third person. Concomitantly, the split gift rule allowed the non-donor spouse to elect to be treated as having made a gift of one-half the total transfer. This election was to be made on the gift tax return, and use of two annual exclusions on gifts by a spouse to a third person was permitted.

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[44] Act of October 21, 1942, 56 Stat. 798.

[45] Under community property laws, the property acquired by either spouse during their marriage belongs half to each spouse.

[46] *See Estate of Eisner v. Comm'r*, B.T.A. Memo. Op. (October 31, 1939); and *Hernandez v. Becker*, 54 F.2d 542 (10th Cir. 1931).

[47] Act of April 2, 1948, 62 Stat. 110.

Changes in the Estate Taxation of Life Insurance: 1954

The estate taxation of life insurance proceeds was changed during the recodification of the tax laws in 1954. The Internal Revenue Code of 1954 includes the proceeds of a life insurance policy on the decedent's life in the gross estate if the proceeds were payable to, or for the benefit of, the estate, if the decedent retained any incidents of ownership in the policy on the date of death, or if the decedent gave away any of the incidents of ownership in the policy within three years of death and in contemplation of death.[48]

Restructuring of the Federal Transfer Tax System: 1976-1998

Starting in 1976, Congress enacted major revisions to the federal transfer tax system. The estate and gift tax laws were significantly altered. A new tax on generation-skipping transfers was added.[49] The greatest structural change was the unification of the estate and gift taxes.

The Tax Reform Act of 1976

The Tax Reform Act of 1976[50] created a unified estate and gift tax framework, consisting of a single graduated rate of tax imposed on both lifetime gifts and testamentary dispositions. The gift tax remained cumulative, so that the rate of tax on each successive taxable gift was higher throughout the donor's entire lifetime. Transfers made at death are treated as the last taxable gift of the deceased donor. Therefore, the amount of lifetime taxable gifts affects the rate of tax imposed on the donor's taxable estate, though it does not affect the actual size of the taxable estate. The estate and gift tax rates were graduated to a maximum tax rate of 70 percent on cumulative gifts or taxable estates of more than $5,000,000.[51]

The Tax Reform Act of 1976 also merged the estate tax exclusion and the lifetime gift tax exclusion into a single, unified estate and gift tax credit,[52] which may be used to offset gift tax liability during the donor's lifetime but which, if unused at death, is available to offset the deceased donor's estate tax liability. The credit was $42,500 for transfers made in 1980 and $47,000 for transfers made after 1980. This was equivalent to an estate and gift tax exemption of $161,000 for transfers made during 1980 and $175,625 for transfers made after 1980.[53] The $3,000 per donee annual gift tax exclusion was retained unchanged.

[48] 26 U.S.C. § 2042. An "incident of ownership" is any economic benefit from the policy, such as the right to change the beneficiary, to borrow against the cash surrender value, or to cancel the policy.

[49] P.L. 94-455 §§ 2001-2009; *See also*, Staff on the Joint Committee on Taxation, 94th Cong., 2nd Sess., *General Explanation of the Tax Reform Act of 1976*, 525-597 (1976).

[50] P.L. 94-455, 94th Cong., 2nd Sess. (1976).

[51] P.L. 94-455 § 2001.

[52] P.L. 94-455 § 2001.

[53] The credit was a dollar-for-dollar offset against tax, rather than a deduction from the amount of taxable gifts or taxable estate. Therefore, the $47,000 credit was equivalent to an exemption of $175,625 because it would cover the gift or estate tax on a transfer of $175,625.

The Tax Reform Act of 1976 also changed the income tax consequences of a sale of property received from a decedent. The gain on a sale is the difference between the amount realized by the seller and the seller's basis. An heir's basis in inherited property, prior to the 1976 Act, was its fair market value for federal estate tax purposes. Therefore, if inherited property were sold soon after the date of death, there would be no gain and no income tax liability. The appreciation accruing prior to the date of death would be forever eliminated from the income tax base. The 1976 Act provided a rule under which the basis of property received from a decedent was "carried over" from the decedent. This so-called "carryover basis" rule gave heirs a basis in inherited property equal to the decedent's basis on the date of death, with adjustments for a share of the appreciation accruing before 1977, a share of the estate taxes paid on the property, and a share of the state death taxes imposed on the property. The heir could also increase the basis in all of the decedent's property to a minimum basis of $60,000.[54]

The 1976 Act also increased the limitation on the estate tax marital deductions for moderate-sized estates, allowing the deduction for the greater of one-half of the adjusted gross estate (the former limitation) or $250,000.[55] In conjunction with the unified transfer tax credit, the increased estate tax marital deduction permitted the tax-free passage of an estate of up to $425,625 in 1981, if at least $250,000 passed to the surviving spouse.

The limitation on the gift tax marital deduction was also increased in certain cases, allowing a donor spouse to deduct the full amount of the first $100,000 of lifetime interspousal taxable gifts after 1976, but allowing no deduction on the next $100,000 of interspousal taxable gifts. A deduction was allowed for one-half of the value of all subsequent interspousal taxable gifts.[56]

The inclusion of property transferred by gift in contemplation of death was also revised by the 1976 Act, eliminating the rebuttable presumption that all gifts made within three years of death were made in contemplation of death. Now, the 1976 Act required automatic inclusion in the gross estate of the value of all gifts made within three years of death, unless they were less than $3,000.[57]

The 1976 Act also provided a method by which spouses could assure the exclusion of one-half of the value of concurrently owned property by electing to treat the creation of the joint interest as a taxable gift.[58] Previously, a gift to a spouse of one-half of the value of concurrently owned property did not remove any portion of the value of the property from the donor's gross estate, if the donor predeceased. Under the "fractional interest" rule, however, if the creation of the concurrently owned property was a taxable gift, and if certain other requirements were met, the estate of the first spouse to die included only one-half of the value of the concurrently owned property. Therefore, the executor did not have to establish relative contributions of the deceased and the surviving spouse.

[54] P.L. 94-455 § 2005. This rule never went into effect. Its effective date was suspended and later the rule was repealed retroactively to its date of enactment. See, discussion of the Revenue Act of 1978 and the Crude Oil Windfall Profits Tax Act of 1980, *infra*.

[55] P.L. 94-455 § 2002.

[56] To further integrate the estate and gift taxes there was an offset in the estate tax marital deduction for gifts which qualify for more than a one-half gift tax marital deduction. To the extent that a decedent's life time taxable interspousal gifts were less than $250,000, the estate tax maximum marital deduction was reduced by the difference between the actual gift tax marital deduction on these transfers and one-half of the value of the gifts. P.L. 94-455 § 2002(a) and (b).

[57] P.L. 94-455 § 2001(a)(5).

[58] P.L. 94-455 § 2002(C).

The 1976 Act provided special rules for estates composed principally of interests in a closely held business or family farm. If the business (or farm) interest was a sufficiently large share of the estate, and if it satisfied certain other requirements, any real estate used in the farm or business will be valued at its present use, rather than its "highest and best use."[59] This provision could reduce the size of the decedent's gross estate by up to $500,000, but any estate tax savings were recaptured if the business or farm was not continued by the decedent's family for the next 15 years.

The 1976 Act also permitted estates composed primarily of an interest in a closely-held business or family farm to defer payment of the estate taxes attributable to the business interest.[60] If certain rules were met regarding the size of the business interest in proportion to the estate, no portion of the estate taxes attributable to the business interest would have to be paid for the first five years, with only interest required. The estate taxes on this share of the estate were allowed to be paid in up to ten equal annual installments thereafter.

The 1976 Act also created an estate tax deduction for certain bequests to minor children of the decedent if the children had no other living parents after the decedent's death. This "orphan's deduction" was limited to $5,000 for each year each child is under 21 years of age.[61]

One of the major changes in the 1976 Act was the adoption of a new tax on certain generation-skipping transfers. A generation-skipping transfer was defined as one which split the enjoyment and ownership of property between two individuals. The first level of beneficiaries, usually the donor's children, received the right to use and benefit from property during their lifetime. The second level of beneficiaries, usually the settlor's grandchildren, received the out-right ownership of the property at the termination of the interests of the first level of beneficiaries. Prior to the 1976 Act, the character of the interests held by the different beneficiaries had resulted in estate or gift taxation of the property to the donor and the ultimate, second level of beneficiaries, but not the intervening, first level of beneficiaries. The Tax Reform Act of 1976 added a complex series of rules designed to treat the termination of the interest of the intervening beneficiaries as a taxable event, taxed at a rate equal to the estate and gift tax rates which would have been applicable had the property been transferred outright by the donor and then by the first beneficiary.[62]

The Revenue Act of 1978

The Revenue Act of 1978[63] made a number of technical changes in the estate and gift tax rules added in 1976, and two substantive changes. First, it suspended the effective date of the carryover basis rules until 1980. Second, it provided a set of rules by which a surviving spouse who "materially participated" in the operation of a family firm or closely held business owned concurrently with a deceased spouse, could treat a portion of appreciation in the value of the business that accrued during the period of such participation, as cash consideration contributed by

[59] P.L. 94-555, §2003(a).

[60] P.L. 94-455, § 2004(a).

[61] P.L. 94-455 § 2007.

[62] P.L. 94-455 § 2006. This tax never went into effect. Its effective date was suspended, and later it was repealed retroactively to its date of enactment and replaced with a new tax. *See*, P.L. 99-514, §§ 1431-1433.

[63] P.L. 95-600, 95th Cong., 2d Sess. (1978).

that surviving spouse. Therefore, a share of the value of the concurrently owned business assets would not be taxable in the estate of the deceased spouse because it would be treated as having come from the surviving spouse's contributions.[64]

The Crude Oil Windfall Profits Tax Act of 1980

The Crude Oil Windfall Profits Tax Act of 1980[65] is, perhaps, an odd vehicle for an important death tax provision. However, it was as an amendment to this bill that the carryover basis rules of the Tax Reform Act of 1976 were repealed, retroactive to the effective date of the 1976 Act.[66]

The Economic Recovery Tax Act of 1981

The Economic Recovery Act of 1981 (ERTA)[67] made substantial changes in the estate tax apparently designed to reduce the number of taxable estates and to prevent the imposition of an estate or gift tax on interspousal transfers. With only minor exceptions, these changes applied to estates of decedents dying after December 31, 1981, and to gifts made after December 31, 1981.

ERTA increased the unified transfer tax credit from $47,000 to $192,800, phased-in over six years, effectively increasing the exemption equivalent from $175,625 to $600,000 over that period.[68] Also phased-in over a three year period was a reduction, from 70 percent to 50 percent, in the top estate, gift, and generation-skipping transfer tax rates applicable to transfers above $2,500,000.[69]

ERTA made substantial changes in the marital deduction. The quantitative limits on the estate and gift tax marital deductions were eliminated, thereby allowing unlimited interspousal tax-free transfers after December 31, 1981. The marital deduction was permitted for transfers of certain lifetime income interests in trust or otherwise, if the donor or executor elects to include the full value of the transferred property in the estate of the donee or surviving spouse. Transfers of

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[64] P.L. 95-600, § 511(a).

[65] P.L. 96-223, 96th Cong., 2d Sess. (1980).

[66] Executors could elect to use the carryover basis rules on certain estates of decedents who died after December 31, 1976, and before November 7, 1980.

[67] P.L. 97-34, 97th Cong., 1st Sess. (1981); *see also*, H.Rept. 97-201, 97th Cong., 1st Sess. 154-196 (1981); S.Rept. 97-144, 97th Cong., 1st Sess. 124-142 (1981); and H.Rept. 97-215, 97th Cong., 1st Sess. 247-257 (1981).

[68] P.L. 97-34, § 401. The credit was phased-in as follows:

Year	Credit	Exemption Equivalent
1981	$47,000	$175,625
1982	$62,800	$225,000
1983	$79,300	$275,000
1984	$96,300	$325,000
1985	$121,800	$400,000
1986	$155,800	$500,000
1987+	$192,800	$600,000

[69] P.L. 97-34, § 402.

income interests in charitable remainder trusts after December 31, 1981, were allowed to qualify for the marital deduction.[70]

A new rule was enacted regarding the estate taxation of property owned jointly by spouses with a right of survivorship. This rule required including in the gross estate of a decedent dying after December 31, 1981, only one-half of the value of property owned jointly with a right of survivorship by the decedent and the surviving spouse and no other persons, regardless of the relative contributions of the decedent and the surviving spouse. The 1981 Act also repeals the special rules that formerly applied with respect to elective fractional interests of a husband and wife in a jointly owned property and to jointly owned farm or business property.[71]

ERTA liberalized and simplified the rules by which an estate qualifies to have family farm or closely held business real estate valued at its present use, rather than its highest and best use. Included was a special rule to enable individuals more easily to retire on Social Security without losing the ability to specially value their farm or business real estate. The “material participation” standard was reduced in certain cases, and the amount by which a decedent’s gross estate can be reduced by special use valuation was increased from $500,000 to $750,000. These rules apply generally with respect to estates of decedents dying after December 31, 1981.[72]

ERTA also liberalized and simplified the rules by which the estate taxes attributable to an interest in a closely held business can be paid in installments over a 15-year period. A special 4 percent interest rate on the deferred tax attributable to the first $1,000,000 in value was provided, with respect to estates of decedents dying after December 31, 1981.[73] The new law also eliminates the former 10-year installment payment rule.

After 1981, the rule by which property given away within three years of the date of death is automatically included in the gross estate of the donor was eliminated for most types of gifts. The automatic inclusion rule was retained in certain special instances, such as gifts of life insurance policies.[74]

ERTA increased the annual gift tax per donee exclusion from $3,000 to $10,000, with respect to taxable gifts after December 31, 1981. The act also permitted an unlimited annual exclusion for the payment of a donee’s tuition or medical expenses.[75]

Only an annual gift tax return was required to be filed after 1981. The filing date for this return was set on the same date as the donor’s income tax return, including time for extensions.[76]

A qualified disclaimer for estate and gift tax purposes was permitted even if the disclaimer was invalid under applicable State law, if the disclaimant actually transferred the property to the person who would have taken it if the disclaimer had been valid.[77]

[70] P.L. 97-34, § 403.
[71] P.L. 97-34, § 403(c).
[72] P.L. 97-34, § 421.
[73] P.L. 97-34, § 422.
[74] P.L. 97-34, § 424(a).
[75] P.L. 97-34, § 441.
[76] P.L. 97-34, § 401(a)(2)(B).
[77] P.L. 97-34, § 426(a).

ERTA repealed the orphan's deduction allowed first under the Tax Reform Act of 1976.[78] It also delayed for an additional year the effective date of the generation skipping transfer tax rules with regard to transfers under wills and revocable trusts in existence on June 11, 1976.[79]

The Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984 (DFRA)[80] contained a number of changes involving gift and estate taxes, though the essential thrust of the Economic Recovery Tax Act was unaffected.[81] DFRA froze the maximum gift and estate tax rate at 1984 levels (55 percent) until 1988. Under ERTA the top rate was scheduled to fall to the 50 percent level in 1985.[82]

DFRA modified the gift and estate tax law to liberalize provisions for gift tax free transfers to former spouses pursuant to a written agreement. It increased to three years, two years before and one year after a divorce, the period for making an agreement for such transfers. It also allowed an estate tax deduction for such transfers.[83]

DFRA made three changes that affected estates containing closely held businesses. First, it modified the installment payment provisions applicable to a closely held business interest to permit their use in a modified form where non-readily tradeable stock is indirectly owned. This was accomplished by permitting a look through a passive holding company to determine if the decedent owned 20 percent or more of the voting stock and the value of such closely held business interest exceeded 35 percent of the adjusted value of the estate.[84] Second, the alternate valuation rules were amended to permit an election on late returns, those filed within one year of the due date, and to prevent use of alternate valuation except where it resulted in a decrease in both the total value of the estate and estate taxes.[85] Third, a provision to permit perfection of a current use valuation election notice or agreement, where there was substantial compliance with IRS regulations in the original notice or agreement, was enacted.[86]

In DFRA, Congress, for the first time, adopted statutory provisions governing gift loans (certain below market interest rate loans) which treat foregone interest as a gift. An exception was provided where loans do not exceed $100,000. The act also provided for income tax treatment of the imputed interest.[87]

[78] P.L. 97-34, § 427(a).

[79] P.L. 97-34 § 428.

[80] P.L. 98-369, 98th Cong., 2nd Sess. (1984); *see also*, H.Rept. 98-432, part II, 98th Cong., 2nd Sess. 1504-1522 (1984); S.Rept. 98-169, 98th Cong., 2nd Sess. 711-725 (1984); and H.Rept. 98-861, 98th Cong., 2nd Sess. 774, 1120, and 1235-1243 (1984).

[81] P.L. 97-448 § 104, 97th Cong., 2nd Sess. (1982), Technical Corrections Act of 1982, included several provisions to clarify the 1981 ERTA Gift and Estate Tax provisions.

[82] P.L. 98-369 § 21.

[83] P.L. 98-369 § 425.

[84] P.L. 98-369 § 1021. Where the stock is indirectly owned and the quantitative requirements are met, an installment payment election may be made, but the 4 percent interest rate and five-year deferral of principal payments of certain amounts of deferred tax payments, available for directly owned interests, are not applicable.

[85] P.L. 98-369 §§ 1023, 1024.

[86] P.L. 98-369 § 1025.

[87] P.L. 98-369 § 172.

DFRA also provided for the addition of permanent rules for permitting reformation of a charitable, split-interest trust, to comply with the 1969 Tax Reform Act requirements for income, estate, or gift tax deductibility as a charitable contribution (Congress had in the past enacted temporary provisions permitting reformation);[88] elimination of the $100,000 estate tax exclusion for certain retirement benefits payable at death from individual retirement accounts, qualified plans, military retirement, and tax sheltered annuities;[89] and clarification of congressional intent to apply transfer taxes (gift, estate, and generation-skipping) to certain bonds exempt from income tax by virtue of law outside the Internal Revenue Code.[90]

The Tax Reform Act of 1986

The Tax Reform Act of 1986[91] contained four generally applicable changes to the estate, gift, and generation-skipping taxes. The most extensive of these changes was the repeal of the existing generation-skipping transfer tax retroactive to June 11, 1976, and enactment of a new system to tax such transfers.[92] This new tax replaced the graduated tax, based on the estate tax rates, with a flat rate tax set at the highest estate tax rate, currently 55 percent. The tax was applicable to all generation-skipping transfers, including transfers which directly skipped a generation without the intervening generation enjoying any beneficial interest in the transferred property.[93]

The Tax Reform Act also included a 50 percent exclusion from estate taxation of qualified proceeds from qualified sales of employer securities to an employee stock option plan;[94] modification of the definition of the qualified conservation contribution rules to allow a deduction without regard to whether contributions met the “conservation purpose” requirement of the income tax;[95] and repeal of the gift tax exclusion for an employee’s exercise or non-exercise of an election under which an annuity, pension from a qualified plan, tax-deferred annuity, IRA, or military pension would be paid to a beneficiary after the employee’s death.[96]

The Omnibus Budget Reconciliation Act of 1987

The Omnibus Budget Reconciliation Act of 1987 (OBRA)[97] contained four amendments to the estate, gift and generation-skipping taxes. The first of these amendments froze the generation-skipping tax rate and the top gift and estate tax rates at 55 percent, delaying the drop to a 50 percent rate until after December 31, 1992.[98]

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[88] P.L. 98-369 § 1022.

[89] P.L. 98-369 § 525.

[90] P.L. 98-369 § 641.

[91] P.L. 99-514, 99th Cong., 2nd Sess. (1986). *See also*, H.R. Rep. 841, 99th Cong., 2nd Sess. 770-776 (1986).

[92] P.L. 99-514 §§ 1431-1433.

[93] These “direct skips” were not taxed under the 1976 generation-skipping transfer tax.

[94] P.L. 99-514 § 1172.

[95] P.L. 99-514 § 1422.

[96] P.L. 99-514 § 1852(e). This section also makes technical corrections to 26 U.S.C. § 2039 by repealing subsection (c).

[97] P.L. 100-203, 100th Cong., 1st Sess. (1987). *See also*, H.Rept. 100-495, 100th Cong., 1st Sess. 992-998 (1987).

[98] P.L. 100-203, § 10401(a).

OBRA provided for a phase-out of the unified credit for estate and gift transfers exceeding $10,000,000. This phase-out is accomplished by adding a 5 percent tax to the tax on taxable transfers over this amount until the benefit of the unified credit has been recaptured. Thus between 1988 and the end of 1992, transfers between $10,000,000 and $21,040,000 would be taxed at 60 percent. Once the recapture is complete, 55 percent would again become the tax rate. After 1992, when the top rate was scheduled to drop to 50 percent, the recapture was to apply to transfers between $10,000,000 and $18,340,000.[99] This provision did not affect the tax rate for computing the generation-skipping transfer tax.[100]

OBRA closed a perceived loop hole which had been created by the provision of the Tax Reform Act of 1986 which established the estate tax deduction for sales of employer securities to an ESOP. This provision had left open the possibility that an estate could, through a series of purchases and sales to an ESOP, totally wipe out its estate tax liability. The act clarifies and restricts the availability of this deduction by limiting the deduction to sales of nonpublicly traded securities; limiting the deduction to 50 percent of the taxable estate; limiting the maximum reduction in estate taxes to $750,000; imposing holding requirements on the decedent and the ESOP; prohibiting the deduction in the case of securities acquired with assets transferred from another plan of the employer; and imposing an excise tax on the ESOP for failure to satisfy the allocation and holding period requirements.[101]

Finally, OBRA provided that "valuation" or "estate freeze" transactions will cause the total value of the property transferred in the transaction to be included in the decedent's gross estate as property in which the decedent had a retained interest.[102]

The Technical and Miscellaneous Revenue Act of 1988

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA)[103] contained a number of amendments to the estate, gift, and generation-skipping taxes. Many of these, as the name of the act implies, were technical in nature. Among these were a number of clarifying amendments to the generation-skipping transfer tax, which affected such areas as the overlapping definitions of

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[99] This drop in rates was retroactively repealed by P.L. 103-66, § 13208, 103rd Cong., 1st Sess. (1993).

[100] P.L. 100-203, § 10401(b).

[101] P.L. 100-203, § 10411-10413. The retroactive effect of this provision was upheld by the Supreme Court in *U.S. v. Carlton*, 114 S.Ct. 2018 (1994).

[102] P.L. 100-203, § 10402. In general, a freeze transaction involves the division of ownership of a business into two parts, a growth interest and an interest in the current value of the business, which is the interest which is frozen. By selling, at a nominal price, or giving away the growth interest, a taxpayer could maintain control of the business and continue to enjoy the income from the business while excluding any future appreciation in its value from his gross estate. The classic freeze transaction is a recapitalization of a closely held business. The transferor exchanges his common stock for voting preferred stock, which represents the current value of the business entity. New common stock is given to the transferor's children. This stock, at the time of the gift, has practically no value, but as the value of the business appreciates, the appreciation in value is represented in this common stock. If not for this provision, this transaction would "freeze" the transferor's interest in the business at the value it had at the time of the transaction and any appreciation value would pass to his children free of estate taxation because it had been given away. This estate tax benefit is eliminated by treating a retained frozen interest as the equivalent of a retained life estate in the gifted growth interest.

This provision was repealed retroactively to the date of its enactment by the Omnibus Reconciliation Act of 1990, P.L. 101-508, § 11601, *supra*.

[103] P.L. 100-647, 100th Cong., 2nd Sess. (1988).

"direct skips," "taxable terminations," and "taxable distributions"; the inclusion ratio for charitable lead trusts and nontaxable gifts; generation assignment; taxation rules for multiple skips; and the grandchild exemption.[104]

TAMRA made several changes expanding and clarifying the situations to which the estate freeze rules apply.[105] The act also removed the marital deduction for both the estate and the gift tax when a spouse is not a citizen of the United States unless the transfer is made utilizing a "qualified domestic trust."[106]

TAMRA amended the alternate valuation rules for family farms. Under the amendment, a surviving spouse may rent the farm to a family member on a net cash basis without incurring recapture liability. The amendment applied to rentals occurring after December 31, 1976. The statute of limitations for refunds for closed years was waived for claims made within one year of TAMRA's enactment.[107]

Under prior law, art loaned to a tax-exempt organization was a transfer taxable under the gift tax. Such a transfer did not qualify for the gift tax charitable deduction because only a partial interest was transferred. TAMRA allowed such loans to qualify for the charitable deduction if the charities use of the art is related to the organizations tax-exempt purpose.[108]

The Revenue Reconciliation Act of 1989

The Revenue Reconciliation Act of 1989 (RRA)[109] contained a small number of amendments to the transfer taxes. The amendments to the generation-skipping tax were of a technical nature.[110] The gift tax was amended to allow the $100,000 exclusion for transfers to a noncitizen spouse only if the transfer would qualify for the marital deduction if the spouse were a citizen of the United States.[111]

The estate tax changes in RRA modified the new rules enacted in TAMRA concerning transfers to a spouse who is not a citizen of the United States. Under TAMRA the estate tax marital deduction had been eliminated for transfers to a noncitizen spouse unless a qualified domestic trust was utilized. The RRA allowed the use of the marital deduction for transfers to a resident spouse if the spouse became a citizen before the filing estate tax return.[112]

The RRA also modified the requirements of a qualified domestic trust. As modified, a qualified domestic trust needed only to have one trustee who is a citizen of the United States as opposed to the previous requirement that all trustees be citizens. The lone citizen trustee was required to have veto power over the distributions from the trust. Under the RRA, the noncitizen spouse no longer

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[104] P.L. 100-647, § 1014.

[105] P.L. 100-647, § 3031.

[106] P.L. 100-647, § 5033.

[107] P.L. 100-647, § 6151.

[108] P.L. 100-647, § 1018.

[109] P.L. 101-239, 101st Cong., 1st Sess. (1989).

[110] See, P.L. 101-239, § 7811.

[111] P.L. 101-239, § 7815(d)(1).

[112] P.L. 101-239, § 7515(d)(5).

needed an income interest in the trust for the trust to be qualified, unless the trust was a terminable interest.[113]

The RRA went a long way toward taxing qualified domestic trusts in the same manner as the estates of citizen spouses by permitting certain estate tax benefits against the estate tax required of a qualified domestic trust upon the death of the noncitizen spouse. These benefits included alternate valuation, charitable deductions, special use valuation, and certain capital gains provisions.[114]

The RRA provided that the denial of the marital deduction to a noncitizen spouse will not be effective, during a three-year period from the effective date of the RRA, against a noncitizen spouse who is domiciled in a country which has a treaty with the United States which would provide a different result.[115] The RRA set rules and time tables for reforming trusts to qualify as qualified domestic trusts.[116]

The Omnibus Reconciliation Act of 1990

The Omnibus Budget Reconciliation Act of 1990 (OBRA90)[117] contained one modification of the estate and gift tax provisions. OBRA90 completely altered the transfer tax approach to the estate tax freeze which had been enacted in 1987 and amended in 1988. The previous approach to tax avoidance through freeze transactions was to include the at death value of property transferred in this manner in the estate of the transferor as a retained interest.[118] OBRA90 repealed section 2036(c) retroactively to 1987, thus removing the freeze transaction from the estate tax retained interest rules.[119]

Under OBRA90 the focus changed from the estate tax to the gift tax. The act added new rules for determining if the transfer constituted a gift and, if so, valuating the transferred interest at the time of the freeze transaction for gift tax purposes. These new rules were premised upon the general principal that the value of a residual interest is determined by subtracting the value of any retained interests from the value of the entire business entity, adjusted to reflect percentage of ownership or control. OBRA90 changed the gift tax consequences of the freeze transaction by establishing the value of the rights retained in the transaction at zero or a much lower value than that which would have been found under prior law, thus greatly increasing the value of the transferred (gifted) interest.[120]

[113] P.L. 101-239, § 7815(d)(7)(A).

[114] P.L. 101-239, § 7815(d)(7)(B).

[115] P.L. 101-239, § 7815(d)(14).

[116] P.L. 101-239, § 7815(d)(8).

[117] P.L. 101-508, 101st Cong., 2nd Sess. (1990).

[118] See, 26 U.S.C. § 2036.

[119] P.L. 101-508, § 11601.

[120] P.L. 101-508, § 11602.

The Omnibus Reconciliation Act of 1993

The Omnibus Budget Reconciliation Act of 1993[121] amended the transfer taxes by restoring[122] the top two tax rates to 53 percent and 55 percent, effective retroactively to December 31, 1992.[123]

The Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 (TRA)[124] amended all three of the transfer taxes. The unified credit was increased for the first time since 1981. The terminology was changed from unified credit to applicable exclusion amount. TRA phased in an increase in this applicable exclusion amount from $600,000 in 1997 to $1,000,000 in 2006 (*See*, column 2 in chart below).[125] While this amount was not indexed for inflation, TRA did bring indexation to the estate and gift taxes for the first time. The following amounts were indexed for inflation beginning in 1998: the $10,000 annual exclusion for gifts; the $750,000 ceiling on special use valuation; the $1,000,000 generation-skipping tax exemption; and the $1,000,000 ceiling on the value of a closely-held business eligible for special low interest rates.[126]

TRA created a new exclusion from the estate tax for qualified family-owned businesses. Under this exclusion the executor of a qualified estate was empowered to elect special estate tax treatment for qualified "family-owned business interests." This exclusion was limited to a total of $1,300,000 when combined with the applicable exclusion amount of the unified credit.[127] Thus the family-owned business exclusion was scheduled to decrease as the applicable exclusion amount increased.

Table 1. Applicable Exclusion amount and Family-Owned Business Exclusion

Year	Applicable Exclusion amount	Business Exclusion	Total Exclusion
1998	$625,000	$675,000	$1,300,000
1999	$650,000	$650,000	$1,300,000
2000-1	$675,000	$625,000	$1,300,000
2002-3	$700,000	$600,000	$1,300,000
2004	$850,000	$450,000	$1,300,000
2005	$950,000	$350,000	$1,300,000
2006+	$1,000,000	$300,000	$1,300,000

[121] P.L. 103-66, 103rd Cong., 1st Sess. (1993).

[122] The top rate had dropped to 50 percent on December 31, 1992.

[123] P.L. 103-66, § 13208.

[124] P.L. 105-34, 105th Cong., 1st Sess. (1997).

[125] P.L. 105-34, § 501. Instead of the code referring to an amount of credit and one having to compute the size of taxable estate which would be covered by that size of credit, the code now sets out the amount of the taxable estate which the unified credit will cover.

[126] *Id.*

[127] P.L. 105-34, § 502.

The TRA defined "qualified estate" to be the estate of a U.S. citizen or resident of which the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50 percent of the decedent's adjusted gross estate.[128] "Qualified heir" was defined to include any individual who has been employed in the business for at least 10 years prior to the date of the decedent's death, and members of the decedent's family.[129] A "qualified family-owned business interest" was defined as any interest in a business with principal place of business in the U.S. if ownership of the business is held at least 50 percent by one family, 70 percent by two families, or 90 percent by three families, as long as the decedent's family owns at least 30 percent of the business.[130]

To qualify for the beneficial treatment afforded family-owned businesses under TRA, the decedent (or a member of his family) was required to have owned and materially participated in the business for at least five of the eight years preceding the death of the decedent. Also, each qualified heir was required to materially participate in the business for at least five years of any eight year period within ten years following the decedent's death.[131]

Other changes in the transfer taxes found in TRA included a reduction in the interest rate on installment payments of estate taxes attributable to closely held businesses;[132] denial of revaluation of gifts for estate tax purposes after the expiration of the statute of limitations;[133] repeal of the throwback rules applicable to domestic trusts;[134] reduction in the estate tax for certain land subject to permanent conservation easements;[135] and modification of the generation-skipping transfer tax for transfers to individuals with deceased parents.[136]

The Internal Revenue Service Restructuring and Reform Act of 1998

In addition to clarifying and making several technical amendments to changes enacted in 1997, the Internal Revenue Service Restructuring and Reform Act of 1998[137] contained one more substantive amendment to the estate tax. This amendment converted the family-owned business exclusion into a deduction.[138] The act also coordinated this new deduction with the unified credit to increase benefits to the estates with qualified family-owned business interests as the unified credit increases. The act provided that if an executor elected to use the family-owned business deduction, the estate tax liability would be calculated as if the estate were allowed a maximum qualified business deduction of $675,000 and an applicable exclusion amount of $625,000,

[128] P.L. 105-34, § 502. The formula for calculating this percentage was included in the section.

[129] P.L. 105-34, § 502. TRA incorporated by reference the definition of "family member" from I.R.C. § 2032A(e)(1), which included the individual's spouse, the individual's ancestors, and the lineal descendants of the individual or his spouse or parent (and the spouses of such lineal descendants).

[130] P.L. 105-34, § 502. Again, TRA utilized the definition of "family member" from I.R.C. § 2032A(e)(1).

[131] P.L. 105-34, § 502. Recapture rules were included if the heirs failed to meet these participation rules.

[132] P.L. 105-34, § 503.

[133] P.L. 105-34, § 506.

[134] P.L. 105-34, § 507.

[135] P.L. 105-34, § 508.

[136] P.L. 105-34, § 511.

[137] P.L. 105-206.

[138] P.L. 105-206 § 6007(b)(1)(A).

regardless of the year in which the decedent died. If the estate included less than the $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar for dollar basis, limited to the applicable exclusion amount generally available for the year of death.[139]

Phaseout and Repeal of the Federal Estate and Generation-Skipping Taxes

The Economic Growth and Tax Relief Reconciliation Act of 2001[140] generally repealed the federal estate and generation-skipping transfer taxes at the end of the year 2009, provided for the phasing out of these taxes over the period 2002 to 2009, lowered and modified the gift tax, provided new income tax carry-over basis rules for property received from a decedent, and made other general amendments applicable in the phaseout period.

Repeal of the Estate and Generation-Skipping Transfer Taxes

The federal estate tax and the generation-skipping transfer tax shall not be applied to decedents dying or generation-skipping transfers made after December 31, 2009.[141]

Phaseout of the Estate and Generation-Skipping Transfer Taxes

The phaseout of the estate tax is being accomplished primarily by adjusting three features of the tax. The top rate is being gradually lowered.[142] The applicable exclusion amount is being gradually raised.[143] The credit for death taxes (estate or inheritance taxes) paid to a State was gradually lowered and replaced by a deduction for such taxes.[144] Also, the 5% surtax used to recapture the benefits of the graduated tax rates on taxable estates of over $10,000,000 was repealed,[145] and, after the applicable exclusion amount had surpassed the $1,300,000 level used to protect family owned businesses, the family owned business deduction was repealed.[146]

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[139] P.L. 105-206 § 6007(b)(1)(B).

[140] P.L. 107-16, 107th Cong., 1st Sess. (2001).

[141] P.L. 107-16, § 501. It should be noted that for purposes of compliance with the Congressional Budget Act, P.L. 107-16, § 901 provides for sunset of its provisions at the end of the year 2010. Therefore, absent Congressional action in the interim, the law governing the estate, gift and generation-skipping transfer taxes would revert to the law which was in place on June 7, 2001.

[142] P.L. 107-16, § 511. The 50% rate in 2002 was to be the maximum rate on taxable estates on the portion in excess of $2,500,000. The top rates in succeeding years are to be the maximum rates on taxable estates on the portion in excess of $2,000,000.

[143] P.L. 107-16, § 521. The applicable exclusion amount is a unified amount which can be exempted from the gift and/or estate tax. After the applicable exclusion amount surpassed $1,000,000 in the year 2004, the amount which may be exempted from gifts was limited to $1,000,000, with the remainder of the exempt amount reserved to the taxable estate.

[144] P.L. 107-16, § 531 and § 532. Generally the maximum allowable credit was the lesser of the net tax paid to the State or the statutory ceiling of 26 U.S.C. § 2011(b) (a percentage of the taxable estate minus $60,000). Many States used the maximum credit allowed under § 2001(b) to constitute the State's estate tax.

[145] P.L. 107-16, § 511(b).

[146] P.L. 107-16, § 521. The family owned business deduction allowed $625,000 in value of qualified family owned (continued...)

Table 2. Schedule of Changes

Year	Top Rate	Applicable Exclusion Amount	Credit for State Death Tax	Other Scheduled Changes
2002	50%	$1,000,000	75% of current allowable credit.	Repeal of 5% surtax.
2003	49%	$1,000,000	50% of current allowable credit.	—
2004	48%	$1,500,000	25% of current allowable credit.	Repeal of family owned business deduction.
2005	47%	$1,500,000	Credit repealed. Deduction for tax paid to State.	—
2006	46%	$2,000,000	Deduction for tax paid to State.	—
2007	45%	$2,000,000	Deduction for tax paid to State.	—
2008	45%	$2,000,000	Deduction for tax paid to State.	—
2009	45%	$3,500,000	Deduction for tax paid to State.	—

The phaseout of the generation-skipping tax is being accomplished primarily through lowering the rates and increasing the lifetime exemption. The generation-skipping transfer tax is imposed at the top rate of the estate tax.[147] Therefore, when the top rate of the estate tax is lowered under the act, it has the affect of lowering the generation-skipping tax as well. The lifetime exemption is increased by making the exemption equal to the estate tax applicable exclusion amount.[148]

Modification of The Gift Tax

The gift tax was not repealed as originally proposed in order to protect the integrity of the income tax. It was felt that, absent a gift tax, income producing property could be gifted to taxpayers in lower brackets, sold, the taxes paid, and the proceeds gifted back to the higher bracket taxpayer, thus avoiding great amounts of income tax on the sale of capital assets.

The gift tax was modified by lowering the rates and increasing the applicable exclusion amount. The top rate of the gift tax declines with the top rate of the estate tax.[149] After the repeal of the estate tax, the top gift tax rate is lowered to 35% of the excess over $500,000.[150] The applicable exclusion amount was raised to $1,000,000 in the year 2002. This amount remains constant through the phaseout period of the estate tax and after the repeal of the estate tax.[151] Thus, when the unified applicable exclusion amount increases for the estate tax in the phaseout period, only $1,000,000 may be used to cover lifetime transfers (i.e., gifts).

(...continued)

business to be deducted from the estate. If an estate opted to use this deduction, the estate was limited to a $675,000 applicable exclusion amount, giving a total of $1,300,000 which was deducted from the estate. Therefore, when the applicable exclusion amount exceeded the $1,300,000 level, it was no longer useful and therefore was repealed.

[147] 26 U.S.C. § 2641.

[148] P.L. 107-16, § 521(c).

[149] P.L. 107-16, § 511(c), see discussion above.

[150] P.L. 107-16, § 511(d).

[151] P.L. 107-16, § 521.

Basis Rules for Property Received from a Decedent

Technically the new basis rules are income tax rules, not estate tax rules. Basis is used to determine gain on the sale of capital assets for income tax purposes. Often basis and cost are equivalent. Generally, to determine taxable income from sale of a capital asset, the basis in that asset is subtracted from the sale price. Currently, the basis in property received from a decedent is a "stepped-up" basis.[152] The inheritor of property, instead of having the basis of the one from which he received the property (a carry-over basis), has a basis in the property of the fair market value of the property at the date of death of the decedent. The purpose of the stepped-up basis rule was to avoid double taxation. The property had been subject to the estate tax. If the property had a carry-over basis and was sold after inheritance, there would be a capital gain subject to the income tax. The use of the stepped-up basis eliminates this capital gain and thus the income tax on the sale. With the repeal of the estate tax, this need for the stepped-up basis rules will be removed.

The act repeals the stepped-up basis rule at the end of the year 2009 (when the estate tax is repealed).[153] The new basis rule will be that the basis in property received from a decedent is the lesser of carry-over basis or the fair market value of the property on the date of death of the decedent.[154]

Under the estate tax and the income tax stepped-up basis rules, an amount of the gross estate was not subject to either tax.[155] To compensate for the loss of the exempt property with the repeal of the estate tax and the change to carry-over basis, the act provides for two amounts of property which may still receive stepped-up basis. Every estate may allocate $1,300,000 basis increase to property in the taxable estate.[156] In addition to this general step-up, property passing to the spouse of the decedent may be allocated up to $3,000,000 basis increase.[157] Each of these amounts is to be indexed for inflation.

Other Amendments

The act required certain new returns to be filed to provide information for administration of the new basis rules.[158]

The act removed the mileage restrictions for the estate tax rule for creation of conservation easements. This amendment applied to the estates of decedents dying after December 31, 2000.[159]

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[152] 26 U.S.C. § 1014.

[153] P.L. 107-16, § 541.

[154] P.L. 107-16, § 542.

[155] The applicable exclusion amount and all property passing to the spouse under the unlimited marital deduction would be not subject to the estate tax while still receiving the stepped-up basis and thus avoiding the income tax on the subsequent sale of the property.

[156] P.L. 107-16, § 542. A decedent who is a nonresident not a citizen is limited to a $60,000 step-up.

[157] P.L. 107-16, § 542.

[158] P.L. 107-16, § 542, amending 26 U.S.C. §§ 6018 & 6019.

[159] P.L. 107-16, § 551.

The act modified the generation-skipping transfer tax allocation rules for certain lifetime transfers to a trust.[160]

The 111th Congress Legislation

The Economic Growth and Tax Relief Reconciliation Act of 2001[161] generally repealed the federal estate and generation-skipping transfer taxes at the end of the year 2009, provided for the phase out of these taxes over the period 2002 to 2009, lowered and modified the gift tax, and provided new income tax carry-over basis rules for property received from a decedent. The phase out of the estate tax was accomplished primarily by adjustment to two features of the tax. The top rate was gradually lowered. The applicable exclusion amount was gradually raised to $3,500,000. Absent Congressional action, the estate and generation-skipping taxes will be repealed for the year 2010, but all three transfer taxes will revert to 2001 levels in 2011 under the sunset provision of the 2001 act.[162]

Two primary categories of legislation pertaining to transfer taxes may be expected to be introduced in the 111th Congress. As noted above, the repeal of the estate and generation-skipping taxes is not permanent. One category would make the repeal permanent. The second would reinstate these taxes at lower rates and/or in a manner more considerate of family-owned business.

Conclusion

The federal system of transfer taxes has represented an important part of the federal tax structure for the past 85 years, not so much in terms of revenue produced, but in terms of impact on individual taxpayers and their personal and business decisions. The history of the estate, gift, and generation-skipping taxes shows a mixed desire to raise revenue and to promote certain social goals. These goals include (1) reducing large estates and inheritances; while (2) alleviating the burden on small and moderate sized estates and facilitating the continued operation of family businesses. The phaseout and repeal of the estate and generation-skipping transfer taxes meets the second of these goals, but leaves the first unaddressed, at least from perspective of tax policy.

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[160] P.L. 107-16, §§ 561 to 563.

[161] P.L. 107-16

[162] P.L. 107016 at § 901.