TECHNICAL EXPLANATION OF H.R. 5638, THE "PERMANENT ESTATE TAX RELIEF ACT OF 2006" AS INTRODUCED IN THE HOUSE ON JUNE 19, 2006

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 5638, the "Permanent Estate Tax Relief Act of 2006," as introduced in the House on June 19, 2006.

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A. Extension of Estate Tax after 2009; Reform of Estate, Gift, and Generation Skipping Transfer Taxes After 2009 (secs. 2 and 3 of the bill)

Present Law

In general

A gift tax is imposed on certain lifetime transfers and an estate tax is imposed on certain transfers at death. A generation skipping transfer tax generally is imposed on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Exemption equivalent amounts and applicable tax rates

In general

Under present law in effect through 2009 and after 2010, a unified credit is available with respect to taxable transfers by gift and at death. The unified credit offsets tax computed at the lowest estate and gift tax rates.

Prior to 2004, the estate and gift taxes were fully unified, such that a single graduated rate schedule and a single effective exemption amount of the unified credit applied for purposes of determining the tax on cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. For years 2004 through 2009, the gift tax and the estate tax continue to be determined using a single graduated rate schedule, but the effective exemption amount allowed for estate tax purposes is increased above the effective exemption amount allowed for gift tax purposes, as described below.

Under present law in effect through 2009 and after 2010, the generation skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate on cumulative generation skipping transfers in excess of the exemption amount in effect at the time of the transfer. The generation skipping transfer tax exemption for a given year (prior to repeal, discussed below) is equal to the unified credit effective exemption amount for estate tax purposes.

Increase in unified credit effective exemption amount and reduction in estate and gift tax rates under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the estate, gift, and generation skipping transfer taxes are gradually reduced between 2002 and 2009. In 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) increased to $1 million, and the highest estate and gift tax rate was 50 percent. In 2003, the highest estate and gift tax rate was 49 percent. In 2004, the highest estate and gift tax rate was 48 percent, and the unified credit effective exemption amount for estate tax purposes increased to $1.5 million. (The unified credit effective exemption amount for gift tax purposes remained at $1 million in 2004 and later years, as increased in 2002.) In 2005, the highest estate and gift tax rate was 47 percent. For 2006, the highest estate and gift tax rate is 46 percent, and the unified credit effective exemption amount for estate tax purposes is increased to $2 million. In 2007, the highest estate and gift tax rate is 45 percent. In 2009, the unified credit effective exemption amount is increased to $3.5 million.

Repeal of estate and generation skipping transfer taxes in 2010; modifications to gift tax

Under EGTRRA, the estate and generation skipping transfer taxes are repealed for decedents dying and generation skipping transfers made during 2010. The gift tax remains in effect during 2010, with a $1 million exemption amount and a gift tax rate equal to the top individual income tax rate of 35 percent. Also in 2010, except as provided in regulations, certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.[2]

The following table summarizes the estate and gift tax rates and unified credit effective exemption amount for estate tax purposes from 2002 through 2010.

[2] EGTRRA sec. 511(e). EGTRRA's Conference Report (H.R. Rep. 107-84) stated that a transfer in trust will be treated as a taxable gift. Section 411 of the "Job Creation and Worker Assistance Act of 2002" includes a technical correction to clarify that the effect of section 511(e) of EGTRRA (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, and the remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treasury Regulation section 25.2511-2(c). Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life, and makes no transfer of a remainder interest, the entire value of the property will be treated as being transferred by gift under the provision.

Unified Credit Exemption Equivalent Amount and Estate and Gift Tax Rates for 2002-2009

Calendar year	Estate and GST tax exemption	Highest estate and gift tax rates
2002	$1 million	50%
2003	$1 million	49%
2004	$1.5 million	48%
2005	$1.5 million	47%
2006	$2 million	46%
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%
2010	N/A (taxes repealed)	top individual income tax rate (gift tax only)

Reinstatement of the estate and generation skipping transfer taxes for decedents dying and generation skipping transfers made after December 31, 2010

The estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions (including repeal of the estate and generation skipping transfer taxes) will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, in general, the estate, gift, and generation skipping transfer tax rates and exemption amounts as in effect prior to 2002 will apply for estates of decedents dying, gifts made, or generation skipping transfers made in 2011 or later years. A single graduated rate schedule with a top rate of 55 percent and a single effective exemption amount of $1 million will apply for purposes of determining the tax on cumulative taxable transfers made by a taxpayer by lifetime gift or bequest.

In addition, as a result of the EGTRRA sunset, the modification to the gift tax rules for certain transfers in trust, described above, will not apply for gifts made after December 31, 2010.

Basis in property received

In general

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in property received by lifetime gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of the gift.

Basis in property received from a decedent who dies before 2010

Under present law in effect through 2009, property passing from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death is less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis and eliminates the tax benefit from any unrealized loss.

There is an exception to the rule that assets subject to the Federal estate tax receive stepped-up basis in the case of "income in respect of a decedent." The basis of assets that are "income in respect of a decedent" is a carryover basis (i.e., the basis of such assets to the estate or heir is the same as it had to the decedent) increased by estate tax paid on that asset. Income in respect of a decedent includes rights to income that have been earned, but not recognized, by the date of death (e.g., wages that were earned, but not paid, before death), individual retirement accounts (IRAs), and assets held in accounts governed by section 401(k).

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Under present law in effect through 2009, this rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Under present law in effect through 2009, stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock or securities in a foreign personal holding company take a carryover basis, and stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of the company's accumulated earnings and profits, and stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Basis in property received from a decedent who dies during 2010

In 2010, upon repeal of the estate tax, the rules providing for stepped-up basis in property acquired from a decedent are repealed, and a modified carryover basis regime is to take effect.[3] Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent.[4] Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

An executor generally may increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death, subject to certain special rules and exceptions. Under these rules, each decedent's estate generally is permitted to increase the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse may be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses may be increased by a total of $4.3 million. Nonresidents who are not U.S. citizens may be allowed to increase the basis of property by up to $60,000. The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2010.

Repeal of modified carryover basis regime for determining basis in property received from a decedent who dies after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the modified carryover basis regime in effect for determining basis in property passing from a decedent who dies during 2010 does not apply for purposes of determining basis in property received from a decedent who dies after December 31, 2010. After that time, the law

[3] Sec. 1022.

[4] Secs. 1014(b)(2) and (3).

in effect prior to 2010, which generally provides for stepped-up basis in property passing from a decedent, will apply.

State death tax credit; deduction for State death taxes paid

State death tax credit under prior law

Prior to 2005, a credit was allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes ("death taxes") actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes was determined under a graduated rate table, the top rate of which was 16 percent, based on the size of the decedent's adjusted taxable estate. Most States imposed a "pick-up" or "soak-up" estate tax, which serves to impose a State tax equal to the maximum Federal credit allowed.

Phase-out of State death tax credit; deduction for State death taxes paid

Under EGTRRA, the amount of allowable State death tax credit was reduced from 2002 through 2004. For decedents dying after 2004, the State death tax credit was repealed and replaced with a deduction for death taxes actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

Reinstatement of State death tax credit for decedents dying after December 31, 2010

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, neither the EGTRRA modifications to the State death tax credit nor the replacement of the credit with a deduction applies for decedents dying after December 31, 2010. Instead, the State death tax credit as in effect for decedents who died prior to 2002 will apply.

Exclusions and deductions

Gift tax annual exclusion

Under present law, donors of lifetime gifts are provided an annual exclusion of $12,000 (for 2006) on transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $24,000 for 2006. Unlimited transfers between spouses are permitted without imposition of a gift tax. The dollar amounts are indexed for inflation.

Transfers to a surviving spouse

In general.−A 100-percent marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of "qualified terminable interest property" also are eligible for the marital deduction. "Qualified terminable interest property" is property: (1) that passes from the decedent, (2) in which the surviving spouse has a "qualifying income interest for life," and (3) to which an election under these rules applies. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens.−A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

There is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Conservation easements

Under present law, an executor generally may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter).[5] The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

Prior to 2001, a qualified conservation easement generally was one that met the following requirements: (1) the land was located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land had been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a

[5] Sec. 2031(c).

member of his or her family. Preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

Effective for estates of decedents dying after December 31, 2000, EGTRRA expanded the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. A qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. EGTRRA also clarifies that the date for determining easement compliance is the date on which the donation is made.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modification to expand the availability of qualified conservation contributions does not apply for decedents dying after December 31, 2010.

Provisions affecting small and family-owned businesses and farms

Special-use valuation

An executor may elect to value for estate tax purposes certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $900,000 for 2006. Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction

Prior to 2004, an estate was permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to $675,000.[6] A qualified family-owned business

[6] The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount of $625,000 is increased by the difference between $675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above $675,000. Because of the coordination between the qualified family-owned business deduction and the unified credit

interest generally is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death. The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death within which a disqualifying event occurred.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

EGTRRA repealed the qualified family-owned business deduction for estates of decedents dying after December 31, 2003. As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the qualified family-owned business deduction will apply to estates of decedents dying after December 31, 2010.

Installment payment of estate tax for closely held businesses

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2006 is $1,200,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (i.e., 45

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effective exemption amount, the qualified family-owned business deduction would not provide a benefit in any year in which the applicable exclusion amount exceeds $1.3 million.

percent of the Federal short-term rate plus two percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

Under pre-EGTRRA law, for purposes of these rules an interest in a closely held business was: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership was included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation was included in the decedent's gross estate or such corporation had 15 or fewer shareholders.

Under present and pre-EGTRRA law, the decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the five-year deferral for principal and the two-percent interest rate do not apply. The value of any interest in a closely held business does not include the value of that portion of such interest attributable to passive assets held by such business.

Effective for estates of decedents dying after December 31, 2001, EGTRRA expands the definition of a closely held business for purposes of installment payment of estate tax. EGTRRA increases from 15 to 45 the maximum number of partners in a partnership and shareholders in a corporation that may be treated as a closely held business in which a decedent held an interest, and thus will qualify the estate for installment payment of estate tax.

EGTRRA also expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. EGTRRA provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

EGTRRA clarifies that the installment payment provisions require that only the stock of holding companies, not the stock of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. EGTRRA provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modifications to the estate tax installment payment rules described above do not apply for estates of decedents dying after December 31, 2010.

Generation-skipping transfer tax rules

In general

A generation skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption generally equal to the estate tax effective exemption amount is provided for each person making generation skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. Natural person or certain trusts may be skip persons. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person. A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation skipping transfer tax exemption to a trust prior to the taxable distribution, generation skipping transfer tax may be avoided.

The tax rate on generation skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation skipping transfer indicates the amount of "generation skipping transfer tax exemption" allocated to a trust. The allocation of generation skipping transfer tax exemption effectually reduces the tax rate on a generation skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

Under pre-EGTRRA law, for lifetime transfers made to a trust that were not direct skips, the transferor had to make an affirmative allocation of generation skipping transfer tax exemption; the allocation was not automatic. If generation skipping transfer tax exemption was allocated on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time of the transfer. If, however, the allocation was not made on a timely filed gift tax return, then the portion of the trust that was exempt from generation skipping transfer tax was based on the value of the property at the time the allocation of generation skipping transfer tax exemption was made.

An election to allocate generation skipping transfer tax to a specific transfer generally may be made at any time up to the time for filing the transferor's estate tax return.

Modifications to the generation skipping transfer tax rules under EGTRRA

Generally effective after 2000, EGTRRA modifies and adds certain mechanical rules related to the generation skipping transfer tax. First, EGTRRA generally provides that generation skipping transfer tax exemption will be allocated automatically to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation skipping transfer trust, as defined in the Code. If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

Second, EGTRRA provides that, under certain circumstances, generation skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. In general, if a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis.

Third, EGTRRA provides that a trust that is only partially subject to generation skipping transfer tax because its inclusion ratio is less than one can be severed in a "qualified severance." A qualified severance generally is defined as the division of a single trust and the creation of two or more trusts, one of which would be exempt from generation skipping transfer tax and another of which would be fully subject to generation skipping transfer tax, if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust.

Fourth, EGTRRA provides that in connection with timely and automatic allocations of generation skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

Fifth, under EGTRRA, the Secretary of the Treasury generally is authorized and directed to grant extensions of time to make the election to allocate generation skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation skipping transfer tax exemption allocation.

Sixth, EGTRRA provides that substantial compliance with the statutory and regulatory requirements for allocating generation skipping transfer tax exemption will suffice to establish that generation skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation skipping transfer tax exemption will be allocated as produces the lowest possible inclusion ratio.

Sunset of EGTRRA modifications to the generation skipping transfer tax rules

As described above, the estate, gift, and generation skipping transfer tax provisions of EGTRRA are scheduled to sunset after 2010, such that those provisions will not apply to estates of decedents dying, gifts made, or generation skipping transfers made after December 31, 2010. As a result, the EGTRRA modifications to the generation skipping transfer tax rules described above do not apply for generation skipping transfers made after December 31, 2010. Instead, in general, the rules as in effect prior to 2001 will apply.

Explanation of Provision

Reunification of the estate and gift taxes; increase in the unified credit effective exemption amount; modification of the estate and gift tax rates

Under the provision, the estate and gift taxes are reunified, such that both a common unified credit effective exemption amount and a common rate schedule apply to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. Under the provision, the unified credit effective exemption amount for gift tax and estate tax purposes generally is $5 million for decedents dying and gifts made after December 31, 2009. A rate equal to the Federal long-term capital gains rate specified in Code section 1(h)(1)(C) (currently 15 percent in 2010 and 20 percent thereafter) in effect on the date of the decedent's death (or, in the case of a lifetime gift, in effect on the last day of the calendar year in which the gift was made) applies to the first $25 million of cumulative taxable transfers, and a rate equal to twice the Federal long-term capital gains rate specified in Code section 1(h)(1)(C) (in effect at the times described above in this sentence) applies to cumulative taxable transfers in excess of $25 million. As under present law, the generation skipping transfer tax exemption for a given year is equal to the unified credit effective exemption amount for estate tax purposes (i.e., $5 million), and the generation skipping transfer tax rate for a given year will be determined using the highest estate and gift tax rate in effect for such year.

As under present law, the tax on taxable transfers for a year is determined by computing a tentative tax on the cumulative value of current year transfers and all gifts made by a decedent after December 31, 1976, and subtracting from the tentative tax the amount of gift tax that would have been paid by the decedent on taxable gifts after December 31, 1976, if the estate tax rate schedule in effect on the date of the decedent's death had been in effect on the date of the prior-year gifts. This computation generally operates to place present-year transfers on top of prior year transfers for purposes of applying the marginal tax rates. To account for differences between the revised rate schedule effective in 2010 and certain prior year rates, the provision generally provides that the rates in effect at the decedent's death are to be used in determining the tax on prior transfers and the credit available to offset such tax for purposes of performing the computation described in this paragraph.

Example.−Assume in 1987 an individual makes taxable gifts of $1 million and dies in 2010 with a taxable estate of $9 million. Under the bill, the estate tax (before credit) is

$1,440,000. This is the excess of $1,500,000 (15 percent of $10 million) over $60,000. $60,000 is the gift tax that would have been payable on the 1987 gifts, assuming the 2010 estate tax rates had applied in computing the gift tax payable in 1987, using the 15 percent rate in computing both the 1987 gift tax and gift tax credit amounts. If the 15 percent rate had applied to the gifts made in 1987, the gift tax would have been $150,000 (15 percent of $1 million) and a gift tax credit of $90,000 would have been allowed ($150,000 - $90,000 = $60,000). $90,000 is the applicable credit amount computed at a 15 percent rate on $600,000 (the dollar amount under section 6018(a)(1) for 1987). The estate is allowed a credit of $750,000 (15 percent of $5 million). The net tax due is $690,000 ($1,440,000 less $750,000).

Portability between spouses of unused unified credit effective exemption amount

Under the provision, for gift and estate tax purposes, any unified credit effective exemption amount that remains unused as of the death of a spouse who dies after December 31, 2009 (the "deceased spousal unused exclusion amount"), generally is available for use by such spouse's surviving spouse, in addition to such surviving spouse's own $5 million unified credit effective exemption amount (the "basic exclusion amount").[7]

The aggregate amount of unused exemption equivalent (the "aggregate deceased spousal unused exclusion amount") that is available for use by a surviving spouse from all predeceased spouses in no event is permitted to exceed $5 million. As with the $5 million basic exclusion amount, a surviving spouse may use the aggregate predeceased spousal carryover amount for taxable transfers made during life or at death.

A deceased spousal unused exclusion amount is available to a surviving spouse only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse on which such amount is computed, regardless of whether the predeceased spouse otherwise is required to file an estate tax return. In addition, notwithstanding the statute of limitations for assessing estate or gift tax with respect to a predeceased spouse, the bill provides that the Secretary of the Treasury may examine the return of a predeceased spouse for purposes of determining the deceased spousal unused exclusion amount available for use by the surviving spouse. Under the provision, the Secretary of the Treasury shall prescribe regulations as may be necessary or appropriate to carry out the rules described in this paragraph.

<u>Example 1</u>.−Assume that Husband 1 dies in 2010, having made taxable gifts of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.

<u>Example 2</u>.−Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made no taxable gifts and having

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[7] It is intended that unused exemption not be available for generation skipping transfer tax purposes.

no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the deceased spousal unused exclusion amount from Husband 2 is $5 million (the amount of his unused exclusion), only $3 million of this amount is available for use by Wife, because she previously received the benefit of $2 million of deceased spousal unused exclusion amount from Husband 1, and the provision places a limit of $5 million on the aggregate deceased spousal unused exclusion amount available to a surviving spouse from all predeceased spouses.

Example 3.−Assume the same facts as in Example 2, except that Wife predeceases Husband 2. Husband 2 had no prior spouses. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount. Wife made no taxable gifts and has a taxable estate of $3 million. Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of the deceased spousal unused exclusion amount from Wife (computed as Wife's $7 million applicable exclusion amount less her $3 million taxable estate).

Other provisions

The provision makes permanent the repeal of the State death tax credit and does not allow a deduction for death taxes paid to any State or the District of Columbia. In addition, the provision makes permanent the repeal of the qualified family-owned business deduction.

The provision also repeals the modified carryover basis rules that, under EGTRRA, would apply for purposes of determining basis in property acquired from a decedent who dies in 2010. Under the provision, a recipient of property acquired from a decedent who dies after December 31, 2009, generally will receive date-of-death fair market value basis under the basis rules in effect under present law with respect to decedents dying prior to 2010.

Under the provision, the sunset of the EGTRRA estate, gift, and generation skipping transfer tax provisions scheduled to occur for decedents dying, gifts made, and generation skipping transfers made after December 31, 2010, is repealed. As a result, the provision makes permanent the above-described EGTRRA modifications to the rules regarding (1) qualified conservation easements, (2) installment payment of estate taxes, and (3) various technical aspects of the generation skipping transfer tax. The provision also makes permanent the EGTRRA provision (as modified by section 411 of the Job Creation and Worker Assistance Act of 2002) under which certain transfers in trust are treated as transfers of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Effective Date

The provision is effective for estates of decedents dying, generation skipping transfers made, and gifts made after December 31, 2009.

B. Deduction for Qualified Timber Gain
(sec. 4 of the bill)

Present Law

Under present law, if a taxpayer cuts standing timber, the taxpayer may elect to treat the cutting as a sale or exchange eligible for capital gains treatment (sec. 631(a)). Also, if a taxpayer disposes of the timber with a retained economic interest or makes an outright sale of the timber, the gain is eligible for capital gain treatment (sec. 631(b)).

Under present law, for taxable years beginning before January 1, 2011, the maximum rate of tax on the adjusted net capital gain of an individual, estate, or trust is 15 percent. Any adjusted net capital gain which otherwise would be taxed at a 10- or 15-percent rate is taxed at a 5-percent rate (zero for taxable years beginning after 2007). These rates apply for purposes of both the regular tax and the alternative minimum tax.[8]

For taxable years beginning after December 31, 2010, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. Any adjusted net capital gain which otherwise would otherwise be taxed at a 10- or 15-percent rate is taxed at a 10-percent rate. In addition, any gain from the sale or exchange of property held more than five years that would otherwise have been taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which began after December 31, 2000, which would otherwise have been taxed at a 20-percent rate is taxed at an 18-percent rate.

The net capital gain of a corporation is taxed at the same rates as ordinary income, up to a maximum rate of 35 percent.

Explanation of Provision

The provision allows a taxpayer to elect to deduct an amount equal to 60 percent of the taxpayer's qualified timber gain (or, if less, the net capital gain) for a taxable year. In the case of an individual, the deduction reduces adjusted gross income. Qualified timber gain means the net gain described in section 631(a) and (b) for the taxable year.

The deduction is allowed in computing the regular tax and the alternative minimum tax (including the adjusted current earnings of a corporation).

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[8] Because the entire amount of the capital gain is included in alternative minimum taxable income ("AMTI"), for taxpayers subject to the alternative minimum tax with AMTI in excess of $112,500 ($150,000 in the case of a joint return), the gain may cause a reduction in the minimum tax exemption amount and thus effectively tax the gain at rates of 21.5 or 22 percent. Also the gain may cause the phase-out of certain benefits in computing the regular tax.

If a taxpayer elects the deduction, the 40 percent of the gain subject to tax is taxed at ordinary income tax rates.[9]

In the case of a pass-thru entity, the election may be made separately by each taxpayer subject to tax on the gain. The Treasury Department may prescribe rules appropriate to apply this provision to gain taken into account by a pass-thru entity.

Effective Date

The provision applies to dispositions of timber after the date of enactment of the provision and before January 1, 2009.

[9] Under the provision, because only 40 percent of the gain is included in adjusted gross income and AMTI, only that amount of gain may result in the phase-out of tax benefits.