2044, 2056, 2207A, 2515, 2515A, 2519, 2523, and 6019 of the Code)

Present Law

Marital deduction

Present law allows a limited deduction for gifts and bequests between spouses. Under present law, an unlimited gift tax marital deduction is allowed for transfers between spouses for the first $100,000 of gifts. Thereafter, a deduction is allowed for 50 percent of interspousal lifetime transfers in excess of $200,000. In addition, an estate tax marital deduction equal to the greater of $250,000 or one-half of the decedent's adjusted gross estate generally is allowed for the value of property passing from a decedent to the surviving spouse. This amount is adjusted by the excess of the amount of the unlimited marital gift tax deduction over one-half of the lifetime gifts to the surviving spouse.

Under these provisions, transfers of community property or terminable interest do not qualify for either the gift or estate tax marital deductions. Terminable interests generally are created where an interest in property passes to the spouse and another interest in the same property passes from the donor or decedent to some other person for less than adequate consideration.[1]

Jointly held property

The present estate tax provisions contain several special rules governing the treatment of jointly held property for estate tax purposes. These rules apply to forms of ownership where there is a right of survivorship upon the death of one of the joint tenants. They do not apply to community property or property owned as tenants in common.

In general, under these rules, the gross estate includes the entire value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship, except that portion of the property that was acquired by the other joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party (sec. 2040(a)). The decedent's estate has the burden of proving that the other joint owner, or owners, acquired their interest for consideration, or by bequest or gift. Consideration furnished by the surviving joint owner, or owners, does not include money or property shown to have been acquired from the decedent for less than full and adequate consideration in money or money's worth.

[159] In addition, special rules are provided for (1) certain qualified joint interests held by a decedent and his spouse (secs. 2040(b), (d) and (e)) and (2) certain jointly held property used in a farm or other trade or business in which both spouses materially participated (sec. 2040(c)).

The present gift tax provisions contain two special rules governing the treatment of jointly held property. Under section 2515, where a husband and wife take ownership of real property as joint tenants, there is not a gift between spouses until the tenancy is terminated, unless the spouses elect otherwise. Under section 2515A, where a joint interest is created by a husband and wife after December 31, 1976, any gift is computed assuming each spouse owned one-half of the value of the joint interest.

Reasons for Change

Marital deduction

Because the maximum estate tax marital deduction generally is limited, under present law, to one-half of a decedent's adjusted gross estate, the estate of a decedent who bequeathes his entire estate to his surviving spouse may be subject to estate taxes even though the property remains within the marital unit. When the surviving spouse later transfers the property (often to their children), the entire amount is subject to transfer taxes. The cumulative effect is to subject their property to tax one and one-half times, i.e., one-half upon the death of the first spouse and again fully upon the death of the second spouse. This effect typically occurs in the case of jointly held property. Because this additional tax falls most heavily on widows, it is often referred to as the "widow's tax."

Although the committee recognizes that this additional tax can be minimized through proper estate planning,[2] it believes that an individual should be free to pass his entire estate to a surviving spouse without the imposition of any additional tax. For similar reasons, the committee believes it appropriate to permit unlimited lifetime transfers between spouses without the imposition of any transfer taxes.

In addition, the committee believes that substantial simplification of the estate and gift taxes can be achieved by allowing an unlimited deduction for transfers between spouses. Under present law, it is often extremely difficult to determine the ownership of property held by the marital unit and to determine whose funds were used to acquire that property. These problems generally will not arise with an unlimited marital deduction.

In addition, the committee believes that the present limitations on the nature of interests qualifying for the marital deduction should be liberalized to permit certain transfers of terminable interests to qualify for the marital deduction. Under present law, the marital [160] deduction is available only with respect to property passing outright to the spouse or in specified forms which give the spouse control over the transferred property. Because the surviving spouse must be given control over the property, the decedent cannot insure that the spouse will subsequently pass the property to his children. Because the maximum marital deduction is limited under present law to one-half of the decedent's adjusted gross estate, a decedent may at least control disposition of one-

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[1] For example, the gift of an income interest by a donor to his spouse would not qualify for the marital deduction where the remainder interest is transferred by the donor to a third party.

[2] For example, most estate planners divide the estate into two equal portions leaving one-half of the estate to the surviving spouse in a form that qualifies for the marital deduction and the other half to the surviving spouse and or the descendants in a form which does not qualify for a marital deduction. Under such an arrangement, the nonqualifying half is taxed at the death of the decedent and the qualifying half is subsequently taxed at the death of the surviving spouse and, consequently, the entire amount of the property is taxed only once.

half of his estate and still maximize current tax benefits. However, unless certain interests which do not grant the spouse total control are eligible for the unlimited marital deduction, a decedent would be forced to choose between surrendering control of the entire estate to avoid imposition of estate tax at his death or reducing his tax benefits at his death to insure inheritance by the children. The committee believes that the tax laws should be neutral and that tax consequences should not control an individual's disposition of property. Accordingly, the committee believes that a deduction should be permitted for certain terminable interests.

Nevertheless, the committee believes that property subject to terminable interests qualifying for the marital deduction should be taxable, as under present law, upon the death of the second spouse (or, if earlier, when the spouse disposes of the terminable interest in such property). Though the committee believes that property subject to the qualifying income interests should be aggregated with the spouse's cumulative gifts to determine the amount of the transfer tax, it does not believe that the spouse's heirs should bear the burden of this tax. Accordingly, the committee believes it appropriate to provide an apportionment rule to avoid imposition of any additional taxes on the property subject to qualifying terminable interests the spouse's heirs and to insure that the transfer taxes imposed on property subject to certain terminable interests are borne by that property.

Jointly held property

The committee believes that present rules governing the taxation of jointly held property between spouses are unnecessarily complex. In particular, the tracing requirements are burdensome to estates and survivors because jointly held assets are frequently purchased with joint funds. Further, because few taxpayers understand the gift tax consequences of joint ownership, there is wide spread noncompliance.

In view of the unlimited marital deduction adopted by the committee bill, the taxation of jointly held property between spouses is only relevant for determining the basis of property to the survivor (under sec. 1014) and the qualification for certain provisions (such as current use valuation under sec. 2034A, deferred payment of estate taxes under secs. 6166 or 6166A,[3] and for income taxation of redemptions to pay death taxes and administration expenses under sec. 303). Accordingly, the committee believes it appropriate to adopt an easily administered rule under which each spouse would be considered to own one-half of jointly held property, regardless of which spouse furnished the original consideration.

[161] ***Explanation of Provision***

Marital deduction

The committee bill removes the quantitative limits on the marital deductions for both estate and gift tax purposes. Thus, unlimited amounts of property (other than certain terminable interests) can be transferred between spouses without estate or gift tax. The bill removes the provisions of present law which disallow the marital deduction for transfer between spouses of community property. In addition, certain transfers of qualified terminable interests would qualify for the deduction.

Under the bill, if certain conditions are met, a life interest granted to a surviving spouse will not be treated as a terminable interest. The entire property subject to such interest will be treated as passing to such spouse and no interest in such property will be considered to pass to any person other than the spouse. Accordingly, the entire interest will qualify for marital deduction.

In general, transfers of terminable interests may be considered qualified terminable interests if the decedent's executor (or donor) so elects and the spouse receives a qualifying income interest for life. A qualifying income interest must meet several conditions. First, the spouse must be entitled for a period measured solely by the spouse's life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals. Thus, income interests granted for a term of years or life estates subject to termination upon remarriage or the occurrence of a specified event will not qualify under the committee bill. The bill does not limit qualifying income interests to those placed in trust. However, a qualifying life income interest in any other property must provide the spouse with rights to income which are sufficient to satisfy the rules applicable to marital deduction trusts under present law (Treas. Reg. §20.2056(b)-(f)).

Second, there must be no power in any person (including the spouse) to appoint any part of the property subject to the qualifying income interest to any person other than the spouse during the spouse's life. This rule will permit the existence of powers in the trustee to invade corpus for the benefit of the spouse but will insure that the value of the property not consumed by the spouse is subject to tax upon the spouse's death (or earlier disposition). However, the bill permits the creation or retention of any powers over all or a portion of the corpus, provided all such powers are exercisable only at or after the death of the spouse.

The bill provides that property subject to an election to be treated as a qualified terminable interest will be subject to transfer taxes at the earlier of (1) the date on which the spouse disposes (either by gift, sale, or otherwise) of all or part of the qualifying income interest, or (2) upon the spouse's death.

If the property is subject to tax as a result of the spouse's lifetime transfer of the qualifying income interest, the entire value of the property, less amounts received by the spouse upon disposition, will be treated as a taxable gift by the spouse under new Code sec. 2519. In general, no annual gift tax exclusion will be permitted with respect to the imputed transfer of the remainder interest (to a person other [162] than the income beneficiary) because the remainder is a future interest. However, if the spouse makes a gift of the qualifying income interest,

[3] Sections 6166 and 6166A of present law are combined and liberalized into a new section 6166 by section 422 of the bill.

the gift of the income interest will be considered a gift to the donee, eligible for the annual exclusion and marital deduction, if applicable.

If the property subject to the qualifying income interest is not disposed of prior to the death of the surviving spouse, the fair market value of the property subject to the qualifying income interest determined as of the date of the spouse's death (or the alternate valuation date, if so elected) will be included in the spouse's gross estate pursuant to a new Code section 2044.

The bill also provides apportionment provisions under which the additional estate taxes attributable to the taxation of the qualified terminable interest property (other than the spouse's life estate) are borne by the property. Unless the spouse directs otherwise, the spouse (or the spouse's estate) is granted a right to recover the gift tax paid on the remainder interest as a result of a lifetime transfer of the qualifying income interest, or the estate tax paid as a result of including such property in the spouse's estate. Under the bill, the spouse is also entitled to recover any penalties or interest paid which are attributable to the additional gift or estate tax. If, however, as a result of a lifetime disposition of the qualifying income interest, the inclusion of the entire property as a taxable transfer uses up some or all of the spouse's unified credit, the bill does not permit the spouse to recover the credit amount from the remaindermen.

Similar rules may apply with respect to lifetime transfers to a spouse which are qualifying terminable interests if the donor makes a irrevocable election at the time of gift.

Charitable gifts

If any individual transfers property outright to charity, no transfer taxes generally are imposed. Similarly, under the unlimited marital deduction provided in the committee bill, no tax generally will be imposed on an outright gift to the decedent's spouse. As a result, the committee funds no justification for imposing transfer taxes on a transfer split between a spouse and a qualifying charity. Accordingly, the bill provides a special rule for transfers of interests in the same property to a spouse and a qualifying charity.

Under the bill, if an individual creates a charitable remainder annuity trust or a charitable remainder unitrust, and the only noncharitable beneficiaries are the donor and his spouse, the disallowance rule for terminable interests does not apply. Therefore, the individual will receive a charitable deduction (under sec. 2055 or 2522) for the amount of the remainder interest and a marital deduction (under sec. 2056 or 2523) for the value of the annuity or unitrust interest; no transfer tax will be imposed.[4]

[163] ***Gift tax requirements***

Because an unlimited marital deduction is permitted for interspousal transfers, the bill generally exempts all such transfers from the gift tax filing requirements. Nevertheless, such transfers will be brought back into the decedent's estate to the extent the rules on inclusion in a decendent's estate of gifts made within three years of death (under sec. 2035) still apply under the committee bill.[5] Where the rules of section 2035 apply, gifts made within three years of death for which a gift tax return is not required generally are not includible in the gross estate. However, the bill provides that if section 2035 still applies, this rule does not apply to interspousal gifts for which a return is not required because of the marital deduction. Thus, all interspousal transfers made within three years of death (other than transfer which are less than the annual exclusion (under sec. 2503(b)) will be included in a decedent's gross estate pursuant to section 2035 (without reduction for the amount of the annual exclusion). This rule insures that the exemption for filing a gift tax return on interspousal transfers does not permit decedents to make deathbed transfers to insure that their estates qualify for certain provisions depending on the size and composition of the gross estate (e.g., secs. 303, 2032A, and 6166).

Jointly held property

The bill provides special rules for determining the amount to be included in the gross estate in the case of property held by spouses in joint tenancy with a right of survivorship. Under the bill, the estate of the first spouse to die will include one-half of the value of the property regardless of which spouse furnished the consideration for the acquisition of the property. The bill also repeals a certain of the special present law rules applicable to treatment of jointly held property between spouses (secs. 2040(c) to 2040(e), 2515, and 2515A).

Effective Date

In general, the changes with respect to the marital deduction apply with respect to gifts made, or decedents dying, after December 31, 1981.

The committee understands that many existing wills and trusts include a maximum marital deduction formula clause under which the amount of property transferred to the surviving spouse is determined by reference to the maximum allowable marital deduction. Because the maximum estate tax marital deduction under present law is limited to the greater of $250,000 or one-half of the decedent's adjusted gross estate, the committee is concerned that many testators, although using the formula clause, may not have wanted to pass more than the greater of $250,000 or one-half of the adjusted gross estate (recognizing the prior law limitation) to the spouse which might otherwise occur under the committee's adoption of an unlimited marital deduction. For this reason, a transitional rule provides that the increased estate tax marital deduction, as provided by the bill, will not apply to transfers resulting from a will executed or trust created before the [164] date which is 30 days after

[4] The general rules applicable to qualifying income interests may provide similar treatment where a decedent provides an income interest in the spouse for her life and a remainder interest to charity. If the life estate is a qualifying income interest, the entire property will, pursuant to the executor's election, be considered as passing to the spouse. Therefore, the entire value of the property will be eligible for the marital deduction and no transfer tax will be imposed. Upon the spouse's death, the property will be included in the spouse's estate but, because the spouse's life estate terminates at death, any property passing outright to charity may qualify for a charitable deduction.

[5] (See part G. "Estate Tax Treatment of Transfers Made Within 3 Years of Decedent's Death," below.)

the date of the bill's enactment, which contains a maximum marital deduction clause provided that (1) the formula clause is not amended before the death of the decedent to refer specifically to an unlimited marital deduction, and (2) there is not enacted a State law, applicable to the estate, which would construe the formula clause as referring to the increased marital deduction as amended by the bill.

Revenue Effect

This provision will reduce fiscal year receipts by less than $5 million in 1982, $303 million in 1983, $304 million in 1984, $311 million in 1985, $300 million in 1986.

[165] D. Current Use Valuation of Certain Property (Sec. 421 of the bill and secs. 1040, 2032A, and 7479 of the Code

Present Law

In general

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain requirements are met, however, present law allows family farms and real property used in a closely held business to be included in a decedent's estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $500,00 (sec. 2032A).[1]

Qualification requirements

An estate may qualify for current use valuation if (1) the decedent was a citizen or resident of the United States at his death; (2) the adjusted value [2] of the farm or closely held business assets in the decedent's estate, including both real and personal property, is at least 50 percent of the adjusted value of the decedent's gross estate; (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely held business real property;[3] (4) the real property qualifying for current use valuation passes to a qualified heir;[4] (5) such real property has been owned by the decedent or a member of his family and used or held for use as a farm or closely held business ("a qualified use") for five of the last eight years prior to the dece- [166] dent's death and on the date of the death;[5] (6) there has been material participation in the operation of the farm or closely held business by the decedent or a member of his family for periods aggregating at least five years out of the eight years immediately preceding the decedent's death;[6] (7) the executor makes an election within the time prescribed for filing the decedent's estate tax return; and (8) all parties with any interest in the property to be specially valued enter into an agreement consenting to the election.[7]

Property is considered to be acquired from a decedent only if the qualified heir receives the property by bequest, devise, or inheritance. Property which is purchased from the decedent's estate by a qualified heir (or is subject to an option in a qualified heir to purchase it from the estate) passes by purchase rather than bequest, devise, or inheritance and may not, therefore, be specially valued.

Property owned indirectly through ownership of an interest in a partnership, a corporation, or a trust qualifies current use valuation to the extent that it would qualify if it were owned directly.[8]

Valuation methods

Under present law, the current use value of qualified real property [9] can be determined under either of two methods: (1) the multiple factor methods or (2) the formula method.

Multiple factor method

The current use value of all qualified real property may be determined under the multiple factor method (sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property without regard to any use other than its current use.

[167] *Formula method*

[1] The fair market value of specially valued property, as well as the property's use value, must be determined for purposes of this limitation and other requirements under the provision. In most cases, however, the fair market value of specially valued property is significant only for determining the maximum potential amount of the recapture tax, which is not assessed unless certain post-death events occur. (The recapture tax is more fully discussed elsewhere in this section). Under present law, judicial review of tax issues is available only where there is a dispute over the correctness of a tax assessment except in a few limited instances in which the Code contains provisions for declaratory judgments. Since the issue of fair market value of specially valued property may not affect any presently assessable amount of tax where it is the only unresolved issue in an estate, there is no opportunity for judicial review of the issue under present law unless the entire use valuation election is disallowed by the Treasury Department.

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

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

[4] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, grandparents, and aunts or uncles of the decedent and their descendants. The term does not include members of a spouse's family.

[5] Property which is acquired pursuant to an exchange under section 1031 (relating to nonrecognition of gain or loss on a like-kind exchange) or section 1033 (relating to nonrecognition of gain or loss on an involuntary conversion) is considered to be owned only from the date on which the replacement property is acquired.

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

[7] The required agreement must be binding under the law of the State in which each party resides. In many States, this requires that a *guardian ad litem* be appointed for minor heirs solely for the purpose of signing the agreement.

[8] Under present law, trust property qualifies for current use valuation only to the extent that an hair receives a "present interest" in the trust property. Treasury regulations define the term "present interest" by reference to the gift tax law (sec. 2503). This definition precludes current use valuation of any property passing from the decedent to a trust in which the interest of the life tenant (or any other beneficiary whose interest becomes a present interest before expiration of the recapture period) is subject to discretion on the part of the trustee. This result is the same even if all potential beneficiaries of the trust are qualified heirs. (Treas. Reg. §20.2032A-3(b)(1)).

[9] Under present law, growing crops, including standing timber in the case of timber farms, are not treated as part of the qualified real property.