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Estate Planning Ramifications of the Taxpayer Relief Act of 1997: Nobody Said Anything about Simplification

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Comment

ESTATE PLANNING RAMIFICATIONS OF THE TAXPAYER RELIEF ACT OF 1997: Nobody Said Anything About Simplification.

[T]he words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.[1]

If Justice Hand could admit that he found the income tax regulations confusing, the rest of us should have no trouble admitting that the gift and estate tax regulations are sometimes mysterious. The Taxpayer Relief Act of 1997[2] (TRA 97) is no exception. Among the hundreds of changes to the Internal Revenue Code are several that will directly impact the estate planning profession. This comment is intended as an explanation of some of the estate planning consequences of TRA 97. While nonexperts can understand this discussion, the author presupposes a familiarity with basic estate planning laws, strategies, and terminology on the part of the reader. This comment will focus on five of those changes: 1) the increased unified credit;[3] 2) the new family-owned business exclusion;[4] 3) the reduction in the interest rate for deferred estate tax;[5] 4) the expansion of exceptions to the Generation Skipping Transfer Tax;[6] and 5) changes in the rules for charitable gifts.[7]

I. UNIFIED CREDIT

One of the most important estate tax provisions of TRA 97 is the in-

1. Learned Hand, *Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947).
2. Taxpayer Relief Act of 1997, PUB. L. NO. 015-34.
3. I.R.C. § 2010(c) (1997).
4. *Id.* § 2033A.
5. *Id.* § 6601(j).
6. *Id.* § 2651(e).
7. *Id.* §§ 602, 664, 2055.

crease in the unified credit[8] in Code Section 2010, to be phased in over nine years. The unified credit exempts from transfer tax[9] a fixed amount of assets, whether transferred by gift or at death. The amount exempted was $600,000 from 1987 through the end of 1997.[10] This year the unified credit exempts the first $625,000 from transfer tax.[11] The amount will increase to $650,000 in 1999, then to $675,000 for 2000 and 2001.[12] In 2002 and 2003, it will be $700,000.[13] The biggest single year increase will come in 2004 when the credit jumps to $850,000.[14] Another big increase in 2005 will bring the credit up to $950,000, followed by the last scheduled increase to $1,000,000 in 2006.[15]

The obvious purpose of the increased unified credit is to restore some of the value which inflation has eroded since the credit was set at $600,000 in 1987.[16] While TRA 97 restores part of the value lost to inflation, an even greater increase would be needed to fully compensate for inflation since 1987. Based on the Consumer Price Index year-end figures,[17] $600,000 in 1987 dollars is equal to $847,749 in 1997 dollars. Even assuming the 1997 inflation rate of 2.7 percent[18] remains constant, by the time the unified credit exempts $1,000,000 in 2006, it will take $1,039,766 to equal the value of $600,000 in 1987 dollars. A higher rate of inflation will, obviously, produce greater disparity.

Because TRA 97 fails to index the unified credit for inflation, the real value of the credit will decline after 2006.[19] Congress could correct this problem by linking subsequent changes in the unified credit to the rate of inflation, thus keeping the value of the credit at its 2006 level.

The increased unified credit presents an opportunity for significant tax savings since it allows greater amounts of wealth to pass free of transfer tax.

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8. The term "unified credit" refers to the Code Section 2010 credit against gift and estate tax. The word "unified" dates from 1976 when the previously separate gift and estate tax structures were unified. JOHN R. PRICE, PRICE ON CONTEMPORARY ESTATE PLANNING § 2.2 (1992).

9. While virtually every transfer of property is subject to taxation at some level of government, the term "transfer tax" refers to gift and estate taxation, or generation-skipping transfer tax.

10. I.R.C. § 2010(a).

11. *Id.* § 2010(c).

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. PRICE, *supra* note 8, § 2.23.1.

17. BUREAU OF LABOR STATISTICS, DATA HOME PAGE at http://stats.bls.gov/data home.html (visited Feb. 13, 1998).

18. *Id.*

19. Another figure which TRA 97 does not tie to inflation is the point at which the unified credit begins to phase out. Therefore, the amount of wealth (in terms of purchasing power) required to trigger recapture of the unified credit will decrease over time. John J. Scroggin, *Planning Issues You Might Have Missed in Recent Legislation*, TRUSTS & ESTATES, Jan. 1998, at 54, 56.

It also calls for careful review of existing estate plans to ensure clients get the maximum benefit without jeopardizing other priorities.[20]

Wealthy married couples have regularly arranged their holdings so that each spouse had at least $600,000 in his or her estate.[21] This strategy ensures full advantage from both unified credits.[22] These couples should review their holdings, and if necessary, redistribute assets annually to use both unified credits. Similarly, taxpayers should review any existing estate plans that contain funding provisions assuming a $600,000 unified credit, and modify them if necessary.

Conversely, many estate plans provide for an amount equal to the unified credit to pass to someone other than the spouse, often children from a prior marriage.[23] While this strategy makes full use of the unified credit, it risks leaving a surviving spouse without adequate support. As the unified credit increases, this becomes an even greater risk for individuals with modest estates, since a larger portion of the estate goes to individuals other than the spouse.

For taxpayers who want to provide lifetime income to a surviving spouse yet have their wealth ultimately pass to someone else, the increased unified credit makes a Qualified Terminable Interest Property Trust (Q-TIP) a more attractive option.[24] A Q-TIP Trust is a trust in which the trustor's surviving spouse has an income interest for life, but does not control the disposition of the trust assets upon his or her death.[25] If the decedent spouse's estate elects Q-TIP treatment, the trust assets are not subject to transfer tax until the death of the surviving spouse.[26] When the surviving spouse dies, his or her unified credit will shield some of the assets from taxation.[27] A Q-TIP trust also offers the decedent's estate flexibility in deciding how much goes into the trust after death, so that the amount can be adjusted to use the full unified credit of the spouse who dies first.[28]

> Example: X and Y are married. They have no children together but each has adult children from prior marriages. X has significantly more wealth than Y. While X wants to provide for Y financially should X die first, X also wants her wealth to pass to her children

20. *Id.* at 57.
21. *Id.* at 56.
22. *Id.*
23. *Id.*
24. *Id.*
25. PRICE, *supra* note 8, § 5.23.
26. *Id.*
27. *Id.* § 5.3.2.
28. *Id.*

rather than to Y's children. X can achieve these goals with a Q-TIP trust. X can put assets into a Q-TIP trust (with no transfer tax, courtesy of the marital deduction). Y will receive the income from the trust until his death, at which time the trust assets will pass through his estate to X's children.

Wealthy taxpayers can also benefit from the increased unified credit by making lifetime gifts equal to the full amount of the credit.[29] Lifetime giving removes the asset given, all subsequent appreciation on the asset, and all subsequent income from the asset, from the donor's estate.[30] Thus the taxpayer can transfer an appreciating asset during his or her lifetime using a smaller amount of the unified credit than he or she would use to transfer the same asset at death.[31] As the unified credit increases, some taxpayers may choose to make additional gifts at each incremental increase in the credit to use their entire unified credit.[32] Even with gifts of modestly appreciating assets, this strategy can produce significant tax savings over passing the same assets at death.[33]

> Example: X has made no prior lifetime gifts. X makes taxable gifts totaling $625,000 on January 1, 1998 and makes subsequent gifts equal to the amount of the increase in the unified credit on January 1 of the year of each increase. If the gifted assets appreciate at 4 percent annually, at the end of 2006 the value of the assets X has transferred will be $1,315,988. Had X held all these assets until his death at the end of 2006 his taxable estate would have contained an extra $315,988. The additional estate tax on this amount would be at least $130,875, and as much as $173,793.[34]

Some smaller estates will reap a double benefit as the unified credit exceeds the value of the taxable estate.[35] First, the entire estate will pass free of transfer tax since its entire value falls within the credit.[36] Second, since the IRS does not require an estate tax return for estates less than the unified

29. Scroggin, *supra* note 19, at 56.

30. *Id.* at 58.

31. The decision to make lifetime gifts using the unified credit has often involved balancing the benefit of avoiding transfer tax by lifetime giving against the benefit of stepped-up basis from holding assets until death. With the increased unified credit and decreased capital gains tax rates the balance for many taxpayers is now decidedly in favor of lifetime gifts.

32. Howard M. Zaritsky, *The Year in Review: An Estate Planner's Perspective of Recent Tax Developments*, 23 TAX MGMT. EST., GIFTS & TR. J. 3, 24 (1998).

33. Scroggin, *supra* note 19, at 58.

34. The lower figure assumes X died with few or no other assets, the higher figure assumes X died with enough wealth to place him in the highest estate tax bracket. Both calculations ignore the phaseout in I.R.C. § 2001(c)(2).

35. Scroggin, *supra* note 19, at 56.

36. *Id.*

credit, smaller estates will be spared the associated attorney and accountant fees.[37]

II. FAMILY OWNED BUSINESS EXCLUSION

TRA 97 adds a new section to the Internal Revenue Code that provides relief for the family of a deceased business owner.[38] This new section allows an exclusion from a decedent's gross estate of the decedent's interest in certain family-owned businesses.[39] Code Section 2033A combines with the unified credit to provide a maximum exclusion of $1,300,000.[40] To do this, Subsection (a) sets the amount of the exclusion at the lesser of the value of the decedent's qualifying business interest[41] or $1,300,000 minus the applicable unified credit.[42] The exclusion formula is not tied to inflation, so as the unified credit increases the Section 2033A exclusion will decrease.[43]

On its face, this new section seems to offer a solution to families faced with having to sell the family business to pay the estate tax on it when the primary owner dies.[44] However, three elements of Section 2033A may limit both the number of estates using it and the benefit those estates receive: first, to qualify for the exclusion a decedent's business interest must fall within detailed requirements;[45] second, recapture provisions limit the options of the decedent's heirs;[46] third, the increasing unified credit will reduce the value of the Section 2033A exclusion.[47]

A. *Qualification*

To qualify for Section 2033A treatment, a decedent's business interests must meet very specific requirements, which comprise the bulk of the section.[48] The first requirement is that the decedent, at the date of death, must have been a citizen or resident of the United States.[49] Next, the executor of the estate must elect treatment under Section 2033A and file an agreement,

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37. *Id.*
38. I.R.C. § 2033A.
39. *Id.*
40. *Id.* § 2033A(a)(2).
41. *Id.* § 2033A(b)(2) details the requirements for a qualified business interest. Those requirements are discussed in the following section of this comment.
42. *Id.*
43. Grace Allison & David Hirschey, *Spotlighting the Taxpayer Relief Act of 1997*, PROB. & PROP., Nov.-Dec. 1997, at 56.
44. Glen White, *The Taxpayer Relief Act and Family Businesses: Few Qualify; Other Methods More Effective*, WASH. STATE BAR NEWS, Feb. 1998, at 33.
45. I.R.C. § 2033A(b).
46. *Id.* § 2033A(f).
47. Scroggin, *supra* note 19, at 57.
48. I.R.C. § 2033A(b).
49. *Id.* § 2033A(b)(1)(A).

signed by each person who will receive an interest in the family-owned business.[50] All those signing this agreement must consent to the section's recapture provision.[51]

The third requirement is a fifty percent liquidity test.[52] The sum of the value of the decedent's qualified business interests, plus the value of any such interests which the decedent gave to family members, must be greater than 50 percent of the decedent's adjusted gross estate.[53] The fifty percent liquidity requirement will prevent estates from using Section 2033A treatment when a family-owned enterprise constitutes a relatively small portion of a decedent's estate. Such a result is consistent with the purpose of affording protection to families who do not have sufficient liquid assets to pay the estate tax on a family-owned business. The inclusion of previously gifted interests will allow a parent to relinquish some ownership and control to the next generation of owners without losing the tax benefits of this section.

The new section next borrows the "material participation" requirement from the Special Use Valuation[54] provision of Section 2032A(e)(6).[55] To satisfy this condition the decedent or a family member must have owned the business interest and materially participated in its operation for periods aggregating five of the eight years immediately before the decedent's death.[56] Individuals can satisfy the material participation requirement by physically working in the business or participating in management decisions.[57] This requirement serves to exclude business interests that the decedent held as investments but he or a family member did not operate.

The decedent must give or pass the interests in the family-owned business to qualified heirs[58] in the manner described in section 2032A(e)(9).[59] Section 2032A(e)(9) states that to qualify, the business interest must pass from the decedent to the qualified heir by means of a trust, estate, or life-

50. *Id.* § 2033A(b)(1)(B).
51. *Id.*
52. *Id.* § 2033A(b)(1)(C).
53. *Id.*
54. The Section 2032A Special Use Valuation allows a decedent's estate to reduce the taxable value of real property used in a business. This section is of special importance in Wyoming and other agricultural states, and is discussed more fully later in this comment.
55. I.R.C. § 2033A(b)(1)(D).
56. *Id.*
57. CCH, INC., 1997 TAX LEGISLATION LAW, EXPLANATION AND ANALYSIS 244 (1997).
58. The definition of "qualified heir" appears in I.R.C. § 2033A(i)(1). It incorporates the "member of family" definition from I.R.C. § 2032A(e)(2), which includes ancestors of the decedent, the decedent spouse, lineal descendants of the decedent or the decedent's spouse, and the spouse of such a lineal descendant. Section 2033A also expands the definition of qualified heir to include long-term employees of the decedent's business interest. I.R.C. § 2033A(i)(1)(B).
59. *Id.* § 2033A(b)(2)(B).

time gift.

In addition to the requirements for the decedent and the heirs, there are requirements for the business interest itself. The decedent and his or her family must have owned a sufficient portion of the business.[60] They must own at least fifty percent of the business, or at least thirty percent, if two families combined to own at least seventy percent, or three families owned at least ninety percent.[61]

Four types of business interests are specifically excluded from special treatment under Section 2033A.[62] First, any business that has its principal place of business outside of the United States is excluded.[63] Second, any business is excluded whose stock has been tradable on a securities market or secondary market within three years before the decedent's death.[64] Third, any business which derived more than thirty-five percent of its adjusted ordinary gross income for the tax year in which the decedent died as personal holding company income[65] is excluded.[66] Fourth, any portion of a business interest is excluded if it is attributable to cash or marketable securities in excess of day to day working capital needs, or attributable to income producing assets not used in the conduct of the business.[67] By excluding excess cash and liquid assets, the Code guards against an influx of unnecessary cash into the business in anticipation of a business owner's death, for the purpose of taking advantage of Section 2033A treatment. This exclusion will influence the fifty percent liquidity test since it may exclude some assets of the business that are needed to reach the fifty percent requirement.[68]

The qualification requirements will make it impossible or impractical for many estates to take advantage of the Section 2033A exclusion.[69] The costs of compliance in terms of lost business flexibility, and the need to monitor closely the ratio of business value to personal net worth, may keep some business owners from including the new section in their estate plan-

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60. *Id.* § 2033A(e)(1)(B)(i).
61. *Id.*
62. *Id.* § 2033A(e)(2).
63. *Id.* § 2033A(e)(2)(A).
64. *Id.* § 2033A(e)(2)(B).
65. The definition of personal holding company income, incorporated from Code Section 543(a), includes income from certain dividends, rents, copyright royalties, produced film rents, personal service contracts, use of corporate property by shareholders, estates and trusts, and mineral, oil, or gas royalties. There are, of course, exceptions to each of these categories which are beyond the scope of this comment.
66. I.R.C. § 2033A(e)(2)(C).
67. *Id.* § 2033A(e)(2)(D).
68. White, *supra* note 44, at 33.
69. *Id.*

ning strategies.[70]

B. Recapture

For some families, Section 2033A will not be useful because of the section's recapture[71] provisions.[72] If a recapture event[73] occurs within ten years after the decedent's death, the IRS will impose an additional estate tax equal to the entire estate tax reduction attributable to Section 2033A, plus interest.[74] In other words, the estate will forfeit the entire benefit from the new section. The recapture rate declines to eighty percent of the tax savings in the seventh year after death, sixty percent in the eighth year, forty percent in the ninth year, and twenty percent in the tenth year.[75] After ten years, recapture is no longer possible.[76]

Section 2033A describes four recapture events.[77] Recapture will result if any of the following occur within ten years after the decedent's death and before the death of the qualified heir: 1) no qualified heir materially participates in the business;[78] 2) the qualified heir transfers all or part of the business interest to someone other than a family member;[79] 3) the qualified heir ceases to be a United States citizen;[80] or 4) the principal place of business ceases to be within the United States.[81]

Like the requirements for qualification, the recapture provisions may lead some business owners to forego Section 2033A in their estate plans.[82] While the provisions regarding loss of citizenship and relocation outside the United States will not affect most businesses, the need for qualified heirs to maintain ownership and participation for ten years may impose unwelcome restrictions.[83] Obviously, if there is no qualified heir willing and able to materially participate in the business for ten years, recapture is inevitable. In

70. Robin Herman, *Taxpayer Relief Act of 1997 Becomes Law*, TAX MGMT. EST. GIFTS & TR. J., Sept.-Oct. 1997, at 91, 95.

71. "Recapture" describes an action by IRS to revoke or disallow a deduction or exclusion, and thereby impose a higher tax.

72. Herman, *supra* note 70, at 95.

73. A recapture event is any of the four circumstances described in I.R.C. § 2033A(f)(1), which will trigger recapture. The next two paragraphs focus on recapture events.

74. I.R.C. § 2033A(f).

75. *Id.* § 2033A(f)(2)(B).

76. *Id.*

77. *Id.* § 2033A(f).

78. *Id.* § 2033A(f)(1)(A).

79. *Id.* § 2033A(f)(1)(B). Although long-term employees are included in the definition of qualified heirs, a subsequent transfer from a qualified heir to a long-term employee will apparently trigger recapture.

80. *Id.* § 2033A(f)(1)(C).

81. *Id.* § 2033A(f)(1)(D).

82. Herman, *supra* note 70, at 95.

83. *Id.*

such a case it may be better to sell the business during the owner's life while it still has its value.[84]

C. *Loss of the Value of Section 2033A*

The relationship between Section 2033A and the unified credit produces a tax benefit that will lose much of its value in eight years.[85] While the total exclusion available remains constant at $1,300,000, the portion attributable to the unified credit will increase from its current level of $625,000 to $1,000,000 and the portion attributable to Section 2033A will decrease from $675,000 to $300,000.[86] This change will dramatically reduce the benefit of Section 2033A since Section 2033A excludes wealth from the top of the decedent's tax bracket, while the unified credit excludes wealth from the bottom of the tax bracket.

> Example: X has an estate worth $3,000,000 that includes a qualifying business worth $1,500,000. If X dies in 1998, the unified credit will exclude $625,000 and Section 2033A will exclude $675,000, resulting in estate tax of $738,000. If X dies in 2006 or thereafter, the unified credit will exclude $1,000,000 and Section 2033A will exclude $300,000, resulting in estate tax of $831,800.[87] X can save $93,800 in estate tax by dying in 1998 rather than 2006.[88]

Viewed in context, Section 2033A is of limited use to business owners who want to retain business flexibility, or expect to live well into the next decade and continue to own their business interests.[89] This "new Estate Tax Exclusion for Family Business appears to benefit those who do not make better plans early. Greater benefit still is available for those who do develop a plan, and in doing so utilize the expertise of specialists to evaluate all of their options."[90]

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84. Scroggin, *supra* note 19, at 59. "Where there are no heirs to take over the business, the highest and best value for a business can generally be obtained during the owner's life. Therefore, if there are no family heirs in the business, the owner should review selling the business and provide transitional management after the sale." *Id.*

85. *Id.* at 57.

86. Allison, *supra* note 43, at 58.

87. These figures are computed as follows:

1998: $3,000,000 (X's estate) minus $675,000 (Section 2033A exclusion) equals $2,325,000 (taxable estate). $940,050 (tentative tax on $2,325,000) minus $202,050 (1998 unified credit) equals $738,000 (estate tax due).

2006: $3,000,000 (X's estate) minus $300,000 (Section 2033A exclusion) equals $2,700,000 (taxable estate). $1,131,800 (tentative tax on $2,700,000) minus $300,000 (2006 unified credit) equals $831,800 (estate tax due).

88. X's estate planner will likely find it a challenge to sell X on the benefits of dying sooner rather than later.

89. Herman, *supra* note 70, at 95.

90. White, *supra* note 44, at 34.

Practitioners in Wyoming and other agricultural states should pay close attention to the relationship between Section 2033A and Section 2032A.[91] Section 2032A provides a formula by which estates may reduce the taxable value of real property used in a trade or business. To qualify, the real and personal property used in the trade or business must comprise at least fifty percent of the decedent's estate.[92] The real property alone must comprise at least twenty-five percent of the decedent's estate.[93]

Rather than valuing land at its highest and best use, Section 2032A allows an estate to value land according to its actual use.[94] Where there is comparable land in the same area, and its average gross cash rental is known, the estate may value the real property by dividing 1) average annual gross cash rental on comparable land minus average annual state and local taxes on such land by 2) the average annual effective interest rate for all new Federal Land Bank Loans.[95] The Section 2032A reduction in value is currently limited to $750,000.[96] TRA 97 indexed that amount for inflation, so it will increase with inflation, rounded down to increments of $10,000.[97]

Congress has specified that estates may take advantage of both Section 2033A and Section 2032A, rather than having to choose between them.[98] While there is no official guidance yet on applying both sections, it seems logical to apply Section 2032A first. The Section 2033A exclusion would then apply to the value determined by Section 2032A. This would result in more of the business value being covered by the Section 2033A exclusion. Practitioners should be careful to ensure that the reduction in value under Section 2032A does not cause the estate to fail the Section 2033A fifty percent liquidity test.[99]

III. INTEREST RATE ON DEFERRED ESTATE TAX

In another attempt to provide relief for family-owned businesses, TRA 97 amended Code Section 6601(j) to reduce the interest rate on deferred estate tax.[100] The rate reduction applies to estate tax deferred under Code

91. I.R.C. § 2032A provides for special use valuation of certain real property used in a trade or business. This section applies most often to agricultural land. A more complete discussion of Section 2032A follows.
92. *Id.* § 2032A(b)(1)(A).
93. *Id.* § 2032A(b)(1)(B).
94. PRICE, *supra* note 8, § 12.19.
95. I.R.C. § 2032A(e)(7)(A).
96. *Id.* § 2032A(a)(2).
97. *Id.* § 2032A(a)(3).
98. H.R. CONF. REP. NO. 105-220, at 396 (1977), *reprinted in* 1997 U.S.C.C.A.N. 1129, 1208.
99. It will be interesting to see if the IRS will allow estates to take only part of the Section 2032A reduction in value, or take the special use valuation on only part of the land. If so, some estates may elect to take only as much of the reduction as they can without failing the Section 2033A liquidity test.
100. I.R.C. § 6601(j).

Section 6166[101] that is attributed to the first $1,000,000[102] in taxable value of a closely-held business (i.e., the first $1,000,000 over the amount sheltered by the decedent's unified credit). Prior to TRA 97 the interest rate on such deferred tax was four percent.[103] For the estates of decedents dying after January 1, 1998, that rate is two percent.[104]

For any deferred estate tax in excess of the amount eligible for the 2 percent rate, interest is payable at a rate equal to forty-five percent of the Section 6621 underpayment rate.[105] The interest on such amounts prior to TRA 97 was equal to the Section 6621 underpayment rate. Forty-five percent of the Section 6621 underpayment rate for the first quarter of 1998 is 3.915 percent.[106] Even families with sufficient liquid assets to pay estate tax may choose to avail themselves of what is essentially a low interest loan. The changes to this section are not all favorable to the taxpayer; the interest paid on deferred estate tax is no longer deductible for estate tax or income tax purposes.[107]

> Example: X dies in the first quarter of 1998. Her estate includes a $2,000,000 interest in a closely held business, and her executor elects to defer the estate tax attributable to X's business interest. The unified credit excludes the first $625,000 in value. The estate tax due on the next $1,000,000 is deferred at 2 percent interest, and the tax on the final $375,000 is deferred at an interest rate of 3.915 percent.

TRA 97 also provides interest rate relief for the estates of some decedents who died before 1998.[108] If such an estate deferred tax payments under

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101. Under Section 6166, where a decedent's interest in a closely-held business comprises a large enough part of the estate, the estate tax attributable to that interest may be paid over a maximum of fifteen years. *See* PRICE, *supra* note 8, § 2.46.

102. I.R.C. § 6601(j)(2)(A). Unlike many other important dollar amounts in TRA 97, this figure is subject to adjustments for inflation after 1998. Adjustments will be based on the difference between the current year Consumer Price Index (CPI) and the CPI for 1997. Increases will be calculated then rounded down to the next lowest multiple of $10,000.

103. *Id.* § 6601(j).

104. *Id.* § 6601(j)(1)(A).

105. *Id.* § 6601(j)(1)(B).

106. Determining the Section 6621 underpayment rate requires a circuitous journey through the Internal Revenue Code. The rate is established in Section 6621(a)(2) at three percentage points above the Federal short-term rate, which is defined in Section 6621(b)(3) as the Federal short-term rate determined by the Secretary of the Treasury in accordance with Section 1274(d). Section 1274(d)(1)(C)(i) directs the Secretary to set the short-term rate based on the market yield of United States obligations with less than three years remaining before maturity. For the first quarter of calendar year 1998 the applicable short-term rate is 5.7 percent. Rev. Rul. 98-4. Therefore the Section 6621 underpayment rate for the first quarter of 1998 is 8.7 percent. Forty-five percent of the Section 6621 underpayment for the first quarter of 1998, therefore, is 3.915 percent.

107. I.R.C. § 6601(a).

108. *Id.* § 503(d)(2).

Section 6166, it may elect to have the new two percent rate apply to any amount still outstanding that it previously deferred at the four percent rate.[109] The new rate will apply only to payments due after 1997, and the estate must elect treatment under the new rate before January 1, 1999.[110] Once the estate has elected to use the lower interest rate, it may no longer take the interest deduction for installments due after the election.[111]

IV. GENERATION SKIPPING TRANSFER TAX

The Generation Skipping Transfer Tax (GSTT) ensures that family wealth is subjected to transfer tax at each generation.[112] Historically, it targeted so-called "dynasty trusts." In its simplest form, a dynasty trust occurred when an individual placed great wealth into a trust paying income to a child for life, after which the trust corpus would pass to a grandchild. The trustor would pay transfer tax at the creation of the trust, but since the trustor's child never owned the property, there was no further tax imposed until the grandchild gave away the trust assets or died with the trust assets in her estate. The GSTT defeated dynasty trusts by imposing an additional tax on generation skipping transfers, which is greater than the tax such trusts sought to avoid.[113]

Three provisions of TRA 97 soften the impact of the GSTT: 1) adjustment of the $1,000,000 GSTT exemption for inflation;[114] 2) an enlarged class of donees for the predeceased parent exception;[115] and 3) an expansion of the predeceased parent exception to include more types of wealth transfers.[116] TRA 97 tied the $1,000,000 GSTT exemption to the 1997 CPI, so the exemption will increase with inflation starting in 1999.[117] IRS will round all increases down to the next lowest multiple of $10,000.[118]

Before TRA 97, an individual could transfer assets to a grandchild without paying the GSTT, or using the exemption, if the grandchild's parent, who was the transferor's child, died before the transfer took place.[119]

109. *Id.*
110. *Id.*
111. *Id.*
112. The GSTT imposes a tax on transfers of wealth to "skip persons." A skip person is either an individual who is two or more generations below the transferor, or a trust in which all interests are held by skip persons. *See* PRICE, *supra* note 8, § 2.23.1.
113. Congress's intent to target large family fortunes is evident in the Section 2631 GSTT exemption which allows up to $1,000,000 in generation skipping transfers free of the GSTT.
114. I.R.C. § 2631(c). The first $1,000,000 of generation-skipping transfers by an individual taxpayer are exempt from the GSTT. *Id.*
115. *Id.* § 2651(e)(1).
116. *Id.*
117. *Id.* § 2631(c).
118. *Id.*
119. *Id.* § 2612(c)(2).

New language added to Section 2651 greatly expands the class of donees for the so-called predeceased parent exception.[120] That class now includes descendants of a transferor's parent and descendants of a parent of the transferor's spouse or former spouse.[121] Such individuals are called collateral heirs, and transfers to them can qualify if their parent who is a descendant of the transferor's parent or parent-in-law is deceased.[122] However, no collateral heir can qualify if the transferor has any living lineal descendant.[123]

> Example: X, who has no living lineal descendants, gives property to his grandnephew, Y in 1998. Y is a collateral heir and the transfer to Y is not subject to GSTT. If X did have a living descendant, the transfer to Y would be subject to GSTT.

The third major change to the GSTT is the extension of the predeceased parent exception to taxable terminations and taxable distributions.[124] This enlarged exception applies only if the donee's parent died before the transfer was first subject to gift or estate tax.[125] The exception formerly applied only to direct skips.[126] In general, there are three types of transfers to a skip person: direct skips, taxable terminations, and taxable distributions.[127]

A direct skip is a transfer directly to a skip person, that is subject to estate or gift taxation.[128] First, the GSTT applies to the amount transferred, then the gift and estate tax is assessed on the sum of the gift and the GSTT. This double taxation effectively treats the GSTT paid by the transferor as part of the taxable gift.[129]

> Example: X is in the highest gift and estate tax bracket and has already used her entire GSTT exemption. X gives $1,000,000 to her grandchild, whose parents are living. The gift is subject to a fifty-five percent GSTT of $550,000. Gift tax on $1,550,000 (the sum of the gift amount and the GSTT) is $852,500. Thus, X must part with $2,402,500 to make a generation skipping transfer of $1,000,000.

A taxable termination is the "termination (by death, lapse of time, re-

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120. *Id.* § 2651(e)(1).
121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.* § 2651(e).
125. *Id.*
126. *Id.* § 2612.
127. PRICE, *supra* note 8, § 2.23. An extensive discussion of taxable terminations and taxable distributions is beyond the scope of this comment.
128. *Id.* § 2.23.1.
129. *Id.*

lease of power, or otherwise) of an interest in property held in trust."[130]

> Example: T left $2,000,000 in trust to pay the income to her husband H for life. Following the death of H the trust is to continue for the benefit of T's grandnephew, G. The life income interest of H is an interest in the trust that terminates upon the death of H, following which only skip persons hold interests in the trust. Thus, the death of H constitutes a taxable termination.[131] If G's parent who was related to T was dead at the time T funded the trust, the transfer to G qualifies for the expanded predeceased parent exception and is exempt from GSTT.

A taxable distribution is a distribution of property from a trust to a skip person, which is neither a direct skip nor a taxable termination.[132]

> Example: T's will established a testamentary trust that authorized the trustee to sprinkle income among T's collateral heirs. A distribution of income to a skip person, such as T's grandniece G, is a taxable distribution.[133] If G's parent who was related to T was dead at the time T funded the trust, the transfer to G qualifies for the expanded predeceased parent exception and is exempt from GSTT.

V. CHARITABLE GIFTS

Estate tax law has allowed deductions for charitable gifts since its early years.[134] Two sections of TRA 97 will affect charitable gifts in estate plans. One section extends a very favorable tax treatment for charitable gifts of appreciated stock.[135] The other imposes new rules for trusts that pay income to noncharity beneficiaries and a remainder to charity.[136]

A. Gifts of Appreciated Stock

For income tax purposes, charitable deductions are among the most important tax-saving strategies for many individuals.[137] In most cases, a taxpayer's deduction for gifts to private charities cannot be greater than the taxpayer's basis[138] in the property given.[139] An exception allowed taxpayers

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130. I.R.C. § 2612(a).
131. PRICE, *supra* note 8, § 2.23.2.
132. *Id.* § 2.23.3.
133. *Id.*
134. *Id.* § 8.1.
135. I.R.C. § 170(e)(5)(D)(ii).
136. *Id.* § 664.
137. PRICE, *supra* note 8, § 8.1.
138. A taxpayer's basis in property, in its simplest form, is the amount the taxpayer paid for the property, plus the value of any improvements made, minus any depreciation claimed as a tax deduction.

to deduct the fair market value of publicly traded stock given to private charities before June 1, 1997.[140] This deduction was available only if the donor's sale of the stock would have generated capital gain,[141] rather than ordinary income.[142]

The ability to deduct the fair market value can make a charitable gift of appreciated stock more attractive to taxpayers. The taxpayer gets to deduct the full value of stock, for which he or she might have paid much less, and avoid paying capital gains tax on the appreciation.

> Example: On September 16, 1997, X contributed 100 shares of ABC stock to a private charity. X paid $1,000 for the stock, which had a fair market value of $5,000 on the day of the gift. Without § 170(e)(5)(D)(ii), X would be allowed a deduction from income of only $1,000. However, X is allowed to deduct the full $5,000 because of § 170(e)(5)(D)(ii).

TRA 97 reinstated the special treatment for gifts of appreciated stock, retroactive to May 31, 1997.[143] This is the third time Congress has acted to ensure that such treatment will remain available.[144] This reinstatement is now scheduled to expire on June 30, 1998.[145] While this provision applies to income tax rather than estate tax, it still has estate planning importance. Taxpayers wishing to support a charitable cause and continue to own a certain stock should consider

> contributing appreciated shares of stock rather than cash to a private foundation and using the cash to buy new shares of the contributed stock. The result will be a full fair market value charitable deduction for the shares of the stock . . . with no capital gains liability. In addition, the donor effectively receives a tax-free stepped-up basis in identical property through the purchase of the new shares.[146]

Having obtained the fair market value basis, the taxpayer will be in a better position to make lifetime gifts of stock to noncharities, who will assume the

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I.R.C. §§ 1011, 1013.

139. *Id.* § 170(e)(1).

140. *Id.* § 170(e)(5)(D)(ii).

141. A detailed discussion of capital gains is beyond the scope of this comment. The definition of capital gain appears in I.R.C. § 1222.

142. *Id.* § 170(e)(5)(D)(ii).

143. *Id.*

144. Allison, *supra* note 43, at 60. Based on Congress's willingness to extend the rule three times, one might be excused for expecting further extensions.

145. *Id.*

146. KPMG, Peat Marwick, *Taxpayer Relief Act of 1997 Booklet*, http://www.us.kpmg.com/taxact/booklet/3estate.html.

taxpayer's basis in the stock.[147]

B. Charitable Remainder Trusts

Under certain circumstances, a charitable deduction is allowed for a charitable gift of a remainder interest in a trust.[148] Such a trust is known as a charitable remainder trust, and must take one of two basic forms: a charitable remainder annuity trust (CRAT), or a charitable remainder unitrust (CRUT).[149] A charitable remainder trust of either kind must make specified annual distributions to at least one noncharity beneficiary.[150]

A CRAT must distribute, at least once each year, a fixed amount of money to the noncharity beneficiary.[151] Before TRA 97, this amount had to be no less than five percent of the initial value of the trust assets.[152] Since the distribution amount is fixed, it cannot vary from year to year and no party may place additional property into the trust.[153]

A CRUT must distribute, at least once each year, a fixed percentage of the annually determined fair market value of the trust assets.[154] Therefore, the distributions from a CRUT will vary with the fair market value of its assets.[155] The fixed percentage must be at least five percent.[156]

In response to perceived abuses, TRA 97 requires that the annual payout from a CRAT cannot exceed fifty percent of the initial fair market value of the trust assets.[157] Similarly, the annual payout from a CRUT cannot exceed fifty percent of the fair market value of the trust assets for that year.[158] In addition, TRA 97 requires that the value of the charitable remainder interest in a CRAT or CRUT be at least ten percent[159] of the value of the transferred property.[160] This provision will ensure that the charitable beneficiary

147. I.R.C. § 1015(a).
148. *Id.* § 170(f)(2)(A).
149. PRICE, *supra* note 8, § 8.20.
150. *Id.* § 8.21.
151. *Id.*
152. I.R.C. § 664(d)(1).
153. PRICE, *supra* note 8, § 8.21.
154. I.R.C. § 664(d)(2).
155. PRICE, *supra* note 8, § 8.22.
156. I.R.C. § 664(a)(2)(A).
157. Allison, *supra* note 43, at 60.
158. *Id.* at 61.
159. The ten percent requirement for the remainder interest seems to effectively reduce the fifty percent annual payout limit. A trust paying out fifty percent of its value annually cannot reasonably be expected to have a ten percent remainder value unless it earns an unprecedented return, or the noncharity beneficiary is certain to die very soon.
160. Allison, *supra* note 43, at 60.

actually receives a meaningful benefit from the trust.[161]

CONCLUSION

TRA 97 will impact virtually every taxable estate, and will undoubtedly impact every estate planner. It is important for estate planners to be able to combine new strategies with the old ones, to best meet client goals while still complying with all applicable regulations. At a minimum, planners should alert their clients to the need to review existing estate plans. Although TRA 97 does not make estate planning any simpler, it does provide some new and better tools for the job.

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161. Herman, *supra* note 70, at 204.