TOWARD A MORE RATIONAL TAX POLICY

Submitted by:

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1. **Recognition of Income on Disposition of Property.**

Under IRC Section 1014 all property included in a decedent's gross estate for estate tax purposes generally receives a new basis for income tax purposes equal to its fair market value at the time of the decedent's death (or the alternate valuation date under IRC Section 2032), and the decedent's net unrealized gain or loss is never recognized by anyone. Although that anomaly used to be somewhat justified because the decedent's estate is subject to the estate tax, it has now become a gaping loophole in the law. More specifically, as a result of the current $3,500,000 estate tax "applicable exclusion amount" under IRC Section 2010(c), very few estates will actually be subject to any net estate tax liability. What's even more egregious is that under our current tax law, a very wealthy individual who owns highly appreciated stock or other property (such as Bill Gates) could die and leave all of his highly appreciated (e.g., Microsoft) stock to his wife, who would (a) get an income tax-free step up in the basis of the stock to its fair market value and (b) also receive it free of any estate tax because of the unlimited estate tax marital deduction. His wife could then sell the stock free of any income tax on (Bill's) unrealized capital gain.

I propose that we adopt a system similar to what Canada successfully adopted about 30 years ago and generally provide that the net unrealized gain or loss with respect to property included in a decedent's gross estate for estate tax purposes, including qualified and non-qualified retirement benefits and other forms of deferred compensation and unrecognized income (collectively "untaxed income"), be included in the decedent's gross income as of the moment before his or her death. That otherwise untaxed income might be averageable over the decedent's last, e.g., three, taxable years in order to avoid a "bunching" problem; and an extension of time to pay the tax attributable to appreciated business interests might be allowed, similar to the extension of time to pay the estate tax attributable to such assets under IRC Section 6166. In addition, unrealized gain or loss generally should be included in a donor's gross income with respect to a completed lifetime gift of property. However, property transferred to the transferor's spouse or a qualified charitable organization generally should take a carryover basis, and no untaxed income with respect to such property should be recognized by the transferor.

This proposal would eliminate the complex "income in respect of a decedent" concept under IRC Section 691, and it would end the economically detrimental "lock-in" effect, that now encourages people to retain substantially appreciated assets until death, whether they want to retain those assets or not, in order to take advantage of the tax-free step up in the basis of those assets under IRC Section 1014. It also would eliminate the disparity between IRC Sections 1014 and 1015 (which generally provides for a carryover basis for property acquired by gift). Furthermore, including qualified retirement benefits (as well as other untaxed income) in the final income tax return of the participant would not only be better tax policy (by taxing the income to the individual who earned it (or to his or her surviving spouse)), it also would eliminate the very complicated and confusing rules applicable to the way in which those benefits are currently taxed to the participant's beneficiaries other than his or her surviving spouse. Finally, closing this loophole should raise a substantial amount of revenue without actually raising taxes.

2. **Recipient's Basis for Property Acquired by Gift or Inheritance.**

As a corollary to this recommendation, a person (other than the spouse or charitable organization) who receives a gift or inheritance should take a basis for the property received equal to its fair market value at that time. Similarly, all property belonging to a non-US person who becomes a US person should have a basis for income tax purposes equal to the fair market value of the property at the time he or she becomes a resident.

3. **Property Transferred in Trust.**

a. Property transferred to a trust for the lifetime benefit of the transferor, and/or his or her spouse should take a carryover basis, as should any property distributed from such a trust to either or both of them. However, upon the death of the last to die of the transferor and his or her spouse, untaxed income with respect to the property remaining in the trust should be included in the trust's gross income at that time. If such a trust has other beneficiaries during the lifetime of the transferor or his or her spouse, such as a typical "bypass," "family" or "credit shelter" trust established by the first spouse to die, untaxed income with respect to any trust property distributed to any such other beneficiary before the death of the last to die of the transferor and his or her spouse should be included in the trust's gross income as of the date of distribution.

b. Property transferred to a tax-exempt charitable trust or a qualified charitable remainder trust or a charitable lead trust also should take a carryover basis, as should any property distributed from such a trust to a qualified charitable organization or to the transferor or his or her spouse. However, the untaxed income with respect to any trust property distributed to any other person should be included in the trust's gross income as of the date of distribution; and the untaxed income with respect to property remaining in a charitable lead trust at the end of the lead interest should be included in the trust's gross income at that time.

c. In general, property transferred to all other trusts should take a basis equal to its fair market value at that time; and property distributed from such a trust to a beneficiary should not be a gain or loss recognition event. However, "taxable terminations" and "taxable distributions" for generation-skipping transfer (GST) tax purposes under IRC Section 2612 should be deemed sales of the property for its fair market value; and property held by or distributed from a GST-exempt trust probably should be subject to the same deemed sale rules for income tax purposes as property distributed from a non-GST exempt trust.

d. The income tax "grantor trust" rules (IRC Sections 671 – 679) should be harmonized with the similar estate tax rules under IRC Sections 2036 – 2038 and 2041. This would greatly simplify the tax law and make it more rational; and it would eliminate the unintended tax benefits of so-called "intentionally defective grantor trusts" which have become very popular. Somewhat similar recommendations were made in The President's Proposals to the Congress for Fairness, Growth and Simplicity, dated May 1985.

4. **Harmonization of the Gift Tax and GST Tax Annual Exclusions.**

The gift tax annual exclusion should be subject to the same requirements as the GST tax annual exclusion in IRC Section 2642(c). This would eliminate the abusive "Crummy" trust concept, which makes a mockery of the present-interest requirement in IRC Section 2503(b).

5. **Minority-Interest Discounts.**

Minority-interest discounts should only be allowed in appropriate situations, such as where the transferor and his or her spouse initially own less than a controlling interest in an entity. Thus, such a discount generally would only be allowed where the interest being transferred, plus interests retained by the transferor and his or her spouse and interests previously or simultaneously transferred by them, aggregate no more than 50% of the total interests.

6. **Ten Percent Remainder Interest for GRATs and GRUTs.**

At least a 10% remainder interest should be required for grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs) under IRC Section 2702, similar to the requirement for charitable remainder trusts under IRC Sections 664(d)(1)(D) and (2)(D). There is no economic justification for the concept of "zeroed-out" GRATs and GRUTs because no prudent investor would purchase such an annuity from an entity whose assets were worth no more than the actuarial present value of the annuity payments.

7. **Extension of the Benefit of IRC Section 6166 to Certain Promissory Notes.**

IRC Section 6166 should be amended to generally treat a promissory note issued by a closely held business in exchange for its stock as an interest in the business for purposes of the extension of time to pay the estate tax attributable to that interest. This would enable closely held businesses to buy out shareholders over a reasonable period of time without causing them to lose the benefit of the deferred payment of the estate tax attributable to their interests in the business.

8. **Allow Estates and Certain Trusts to be Taxed Like Partnerships.**

The personal representative of an estate and the trustee of an administrative or terminating trust should be allowed to elect to have the estate or trust taxed like a partnership, with the consent of all the residuary beneficiaries of the estate or trust. Those "entities" are more like partnerships than regular trusts and should be able to be taxed accordingly.

9. **Credit for State Death Taxes.**

The credit for state death taxes under repealed IRC Section 2011 should be re-enacted. It enabled California and a number of other states to repeal their burdensome separate estate and inheritance tax laws without losing much revenue. It also resulted in substantial savings in those states' tax collection costs as well as considerably less costs to decedent's estates in having to pay lawyers, accountants, and other advisors to comply with a separate set of complicated rules that were often substantially different from the federal estate tax rules.

10. **Credit for State Income Taxes.**

Considerably more beneficial to the states and taxpayers than the state death tax credit referred to in Paragraph 4, above, would be the enactment of a credit for state income taxes. Although the states would have to give up autonomy with respect to their own separate determinations of income tax revenues, they could eventually save substantial costs with respect to tax collection efforts; and taxpayers would greatly benefit from not having to file separate state income tax returns.

11. **Enactment of a National Sales and Use Tax and Credit for State Sales and Use Taxes.**

The enactment of a national retail sales and use tax with a credit for state (and local) sales and use taxes could not only raise much needed additional federal revenue, but it could result in the same kind of savings in the states' sales and use tax collection costs and efforts as referred to in Paragraphs 9 and 10, above, with respect to credits for state death and income taxes.

12. **Provide Equal Tax Treatment for Same-Sex Couples.**

The federal tax laws should extend the same benefits (and burdens) to same-sex couples, who have entered into domestic relationships that have substantially the same legal force and effect under state law as marital relationships, as they provide to married heterosexual couples. This would not only be fairer to those taxpayers, but it would alleviate to a great extent the divisive struggle over whether the term "marriage" should apply only to heterosexual couples.

13. **Carryover of a Deceased Spouse's Unused Estate Tax Applicable Exclusion Amount and GST Exemption to His or Her Surviving Spouse.**

A surviving spouse should be able to increase his or her estate tax applicable exclusion amount (as determined under IRC Section 2010(c)) and GST exemption (as determined under IRC Section 2631(c)) by the amount of the decreased spouse's adjusted gross estate that passes outright, free of trust, to the surviving spouse, up to the maximum exclusion and exemption amounts available to the deceased spouse at the time of his or her death. This would greatly simplify estate planning for many married taxpayers and avoid the need to create a bypass or credit shelter trust for the benefit of the surviving spouse on the death of the first spouse to die in order to preserve those benefits. It also would be fairer to those couples who do not want to create such a trust for whatever reasons. There should be no limit on the number of deceased spouses who can pass their unused exclusions and exemptions to the same surviving spouse, since the surviving spouse would actually be receiving property worth those amounts.

Thus, for example, a person dying in 2009 with an adjusted gross estate of $2,000,000 could leave all of his or her estate to a surviving spouse who would thereafter have an increased applicable exclusion amount and GST exemption of $5,500,000 ($3,500,000 plus $2,000,000), assuming that neither spouse had previously used any of his or her $3,500,000 applicable exclusion amount or GST exemption. However, if the deceased spouse's adjusted gross estate were $4,000,000, the surviving spouse's applicable exclusion amount and GST exemption would only be increased to $7,000,000 ($3,500,000 plus $3,500,000).

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