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*REPORT TO THE JOINT COMMITTEE
ON INTERNAL REVENUE TAXATION
CONGRESS OF THE UNITED STATES*



*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

Proposed Changes In
Estate Taxation

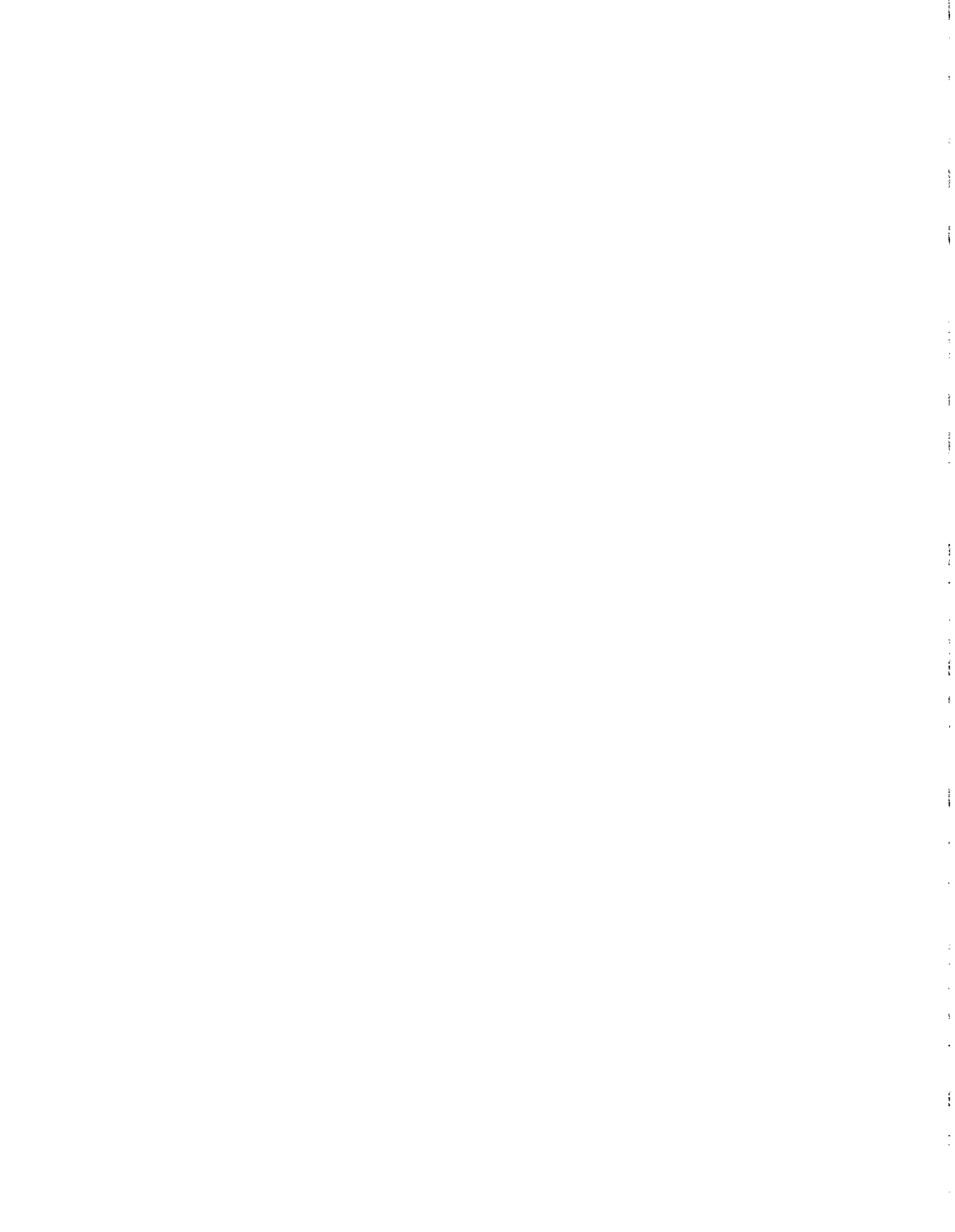
Internal Revenue Service

Department of the Treasury

GAO is recommending changes in the Internal Revenue Code to preclude

- unintended tax benefits or burdens resulting from gifts determined to be in contemplation of death and
- other unintended benefits resulting from executors' use of the alternate valuation method to value decedents' estates.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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Chairman and Vice Chairman
Joint Committee on Internal Revenue Taxation *TNT 900*
Congress of the United States

This is one of a series of reports in response to a request of the Joint Committee on Internal Revenue Taxation.

During our study of the audit of estate tax returns, we noted that, under the law, the treatment of gifts in contemplation of death resulted in unintended tax benefits in some cases and tax burdens in others. We also noted that use of the alternate valuation method resulted in unintended tax benefits in some cases. This report discusses our findings and contains recommendations for corrective amendments to the Internal Revenue Code of 1954, which we believe will enable the Internal Revenue Service to more fairly administer estate taxes.

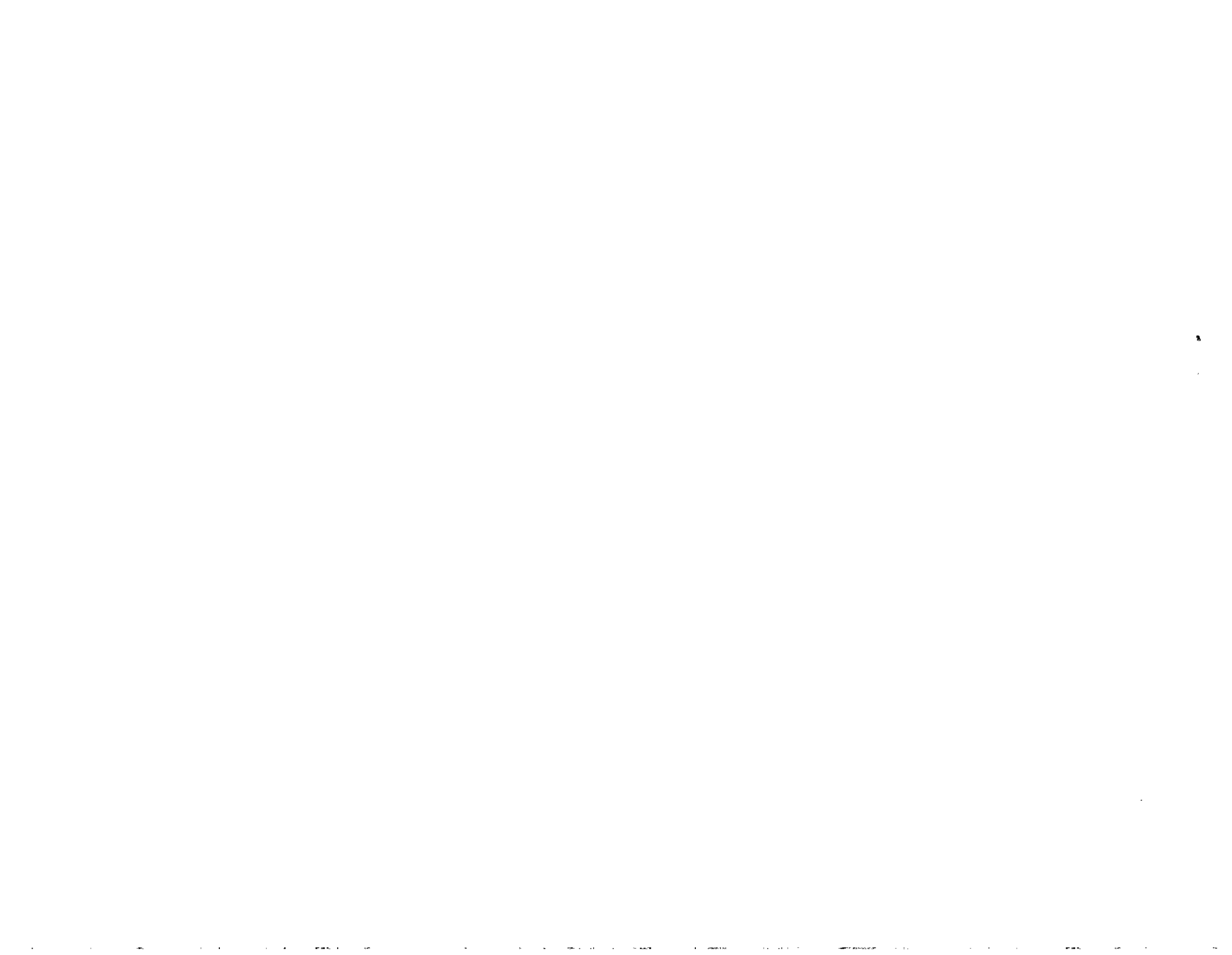
We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of the Treasury; and the Commissioner of Internal Revenue.

As authorized by the Committee, we are distributing the report without restriction.

James B. Atchaf

Comptroller General
of the United States

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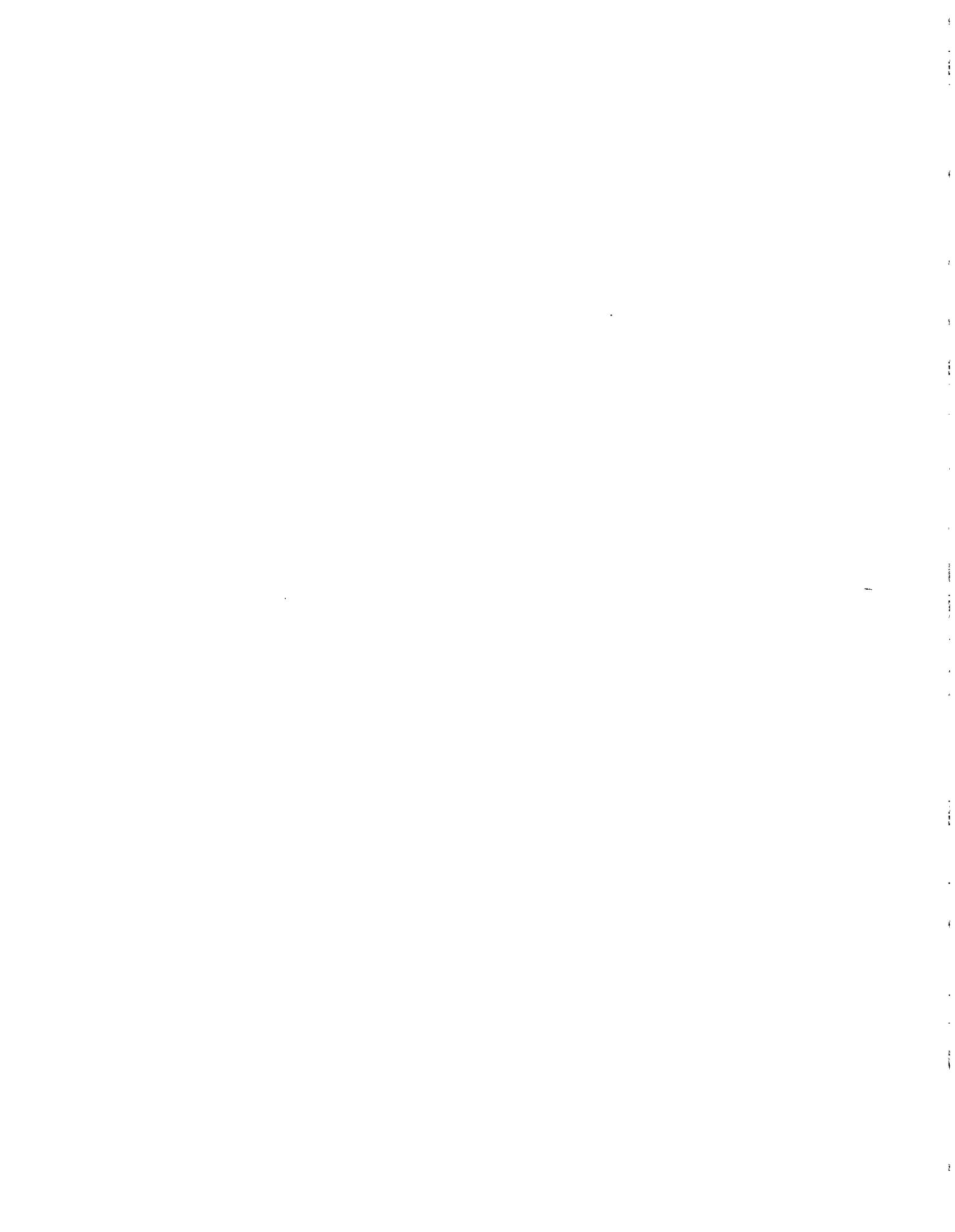


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ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service



COMPTROLLER GENERAL'S REPORT
TO THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION
CONGRESS OF THE UNITED STATES

PROPOSED CHANGES IN ESTATE TAXATION
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D I G E S T

Gifts made before a person's death and thereafter determined by the Internal Revenue Service to have been made to avoid estate taxes result, in some cases, in tax benefits unintended by the law and in others, in tax burdens. (For case studies, see p. 4.)

Accordingly, GAO recommends that the Congress amend the Internal Revenue Code dealing with gifts made by decedents.

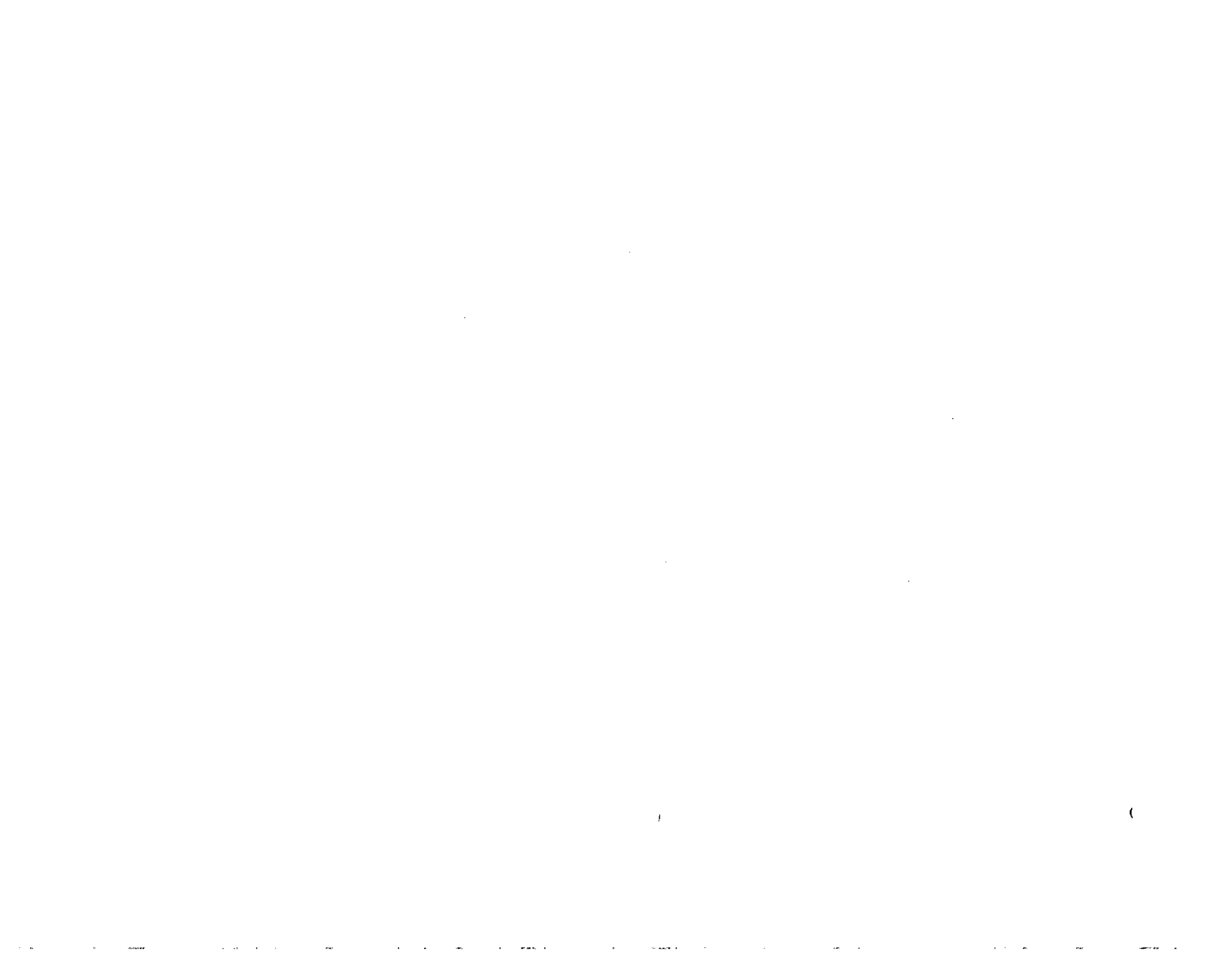
GAO also recommends that the Commissioner of Internal Revenue issue instructions to estate tax return examiners emphasizing that present law requires gift tax returns to be filed for all gifts made in contemplation of a person's death. (See p. 8.)

The Code also permits an executor to value, for tax purposes, an estate as of the date of death or as of 6 months thereafter. Use of the latter date is called the alternate valuation method. When estate property increases in value after death, use of this method can produce tax benefits unintended by law. (For case studies, see p. 15.)

Therefore, GAO recommends that the Congress amend the Code to provide estate tax relief to beneficiaries only when there is a decline in the value of estate property.

The Commissioner stated that the Service concurs with GAO's legislative recommendations. He also stated that field examining personnel will be alerted to the need to secure required gift tax returns from estate executors. (See pp. 13 and 17.)

GGD-76-1



CHAPTER 1

INTRODUCTION

In a June 18, 1973, letter, the Joint Committee on Internal Revenue Taxation asked us to study Internal Revenue Service (IRS) policies and procedures in connection with its taxpayer service program and its audit of tax returns. This report is one of a series in response to that request.

During our study of the audit of estate tax returns, we noted that under the law the treatment of gifts in contemplation of death resulted in unintended tax benefits in some cases and unintended tax burdens in others. We also noted that use of the alternative valuation method resulted in unintended tax benefits in some cases.

This report comments on these subjects and illustrates the resulting tax effects.

ESTATE TAX

The Federal estate tax is imposed on the gross estate value minus a \$60,000 exemption and allowable deductions and is subject to a progressive tax rate ranging from 3 percent of the first \$5,000 of taxable estate to \$6,088,200 plus 77 percent of the amount of taxable estates in excess of \$10 million.

The estate tax is subject to credits for (1) death taxes paid to States and foreign countries and their political subdivisions, (2) Federal gift taxes on property transfers included in the gross estate, and (3) Federal estate taxes paid on certain properties in another decedent's estate.

GIFT TAX

The Federal gift tax is imposed on every property transfer by an individual to the extent that such transfer is not supported by adequate consideration or compensation and is not specifically exempt or excludable.

The tax due is determined by the value of the property transferred less an annual exclusion of \$3,000 for each donee and certain allowable exemptions, including a lifetime exemption of \$30,000 for resident donors. The gift is subject to a progressive tax rate ranging from 2-1/4 percent on the taxable value not exceeding \$5,000 to \$4,566,150 plus 57-3/4 percent on the taxable value exceeding \$10 million.

SCOPE OF REVIEW

We reviewed pertinent sections of the Internal Revenue Code, their legislative histories, and related IRS regulations, policies, and procedures.

We analyzed about 3,400 randomly selected estate tax returns accepted as filed or closed by audit during fiscal year 1973 at IRS' Jacksonville, Los Angeles, and Manhattan District Offices. We also did related work at IRS service centers in Chamblee, Georgia, and Holtsville, New York.

CHAPTER 2

GIFTS IN CONTEMPLATION OF DEATH

Gifts in contemplation of death are completed lifetime gifts made within 3 years before the decedent's death. Unless shown to the contrary, such gifts are treated as though made at death and are subject to estate tax. This treatment precludes taxpayers transferring property by gift before death to avoid the higher estate tax rates.

Sections 2012 and 2035 of the Internal Revenue Code prescribe tax treatment for gifts in contemplation of death and the related gift tax. The required tax computation provides that the amount of the gift be added to the decedent's estate and that the estate tax be calculated on the increased amount.

The gift tax is then allowed, in full or part, as a credit against the estate tax. 1/ The credit is limited to the lesser of

--the gift tax paid on the gift included in the estate
or

--the estate tax attributable to the inclusion of the gift in the estate.

This treatment of gifts in contemplation of death usually results in a tax benefit unintended by the law. If the property had been transferred at death rather than given as a gift in contemplation of death, the value of the estate would have included the amount of the gift tax, as well as the gift. But, because the gift tax is not added to the estate, the gift transaction is not fully reversed and the taxpayer usually obtains the benefit of a lower taxable estate and a lower estate tax. In some cases, however, there is an additional unintended tax burden because of the legal limitation on gift tax credit.

The objective of the gift tax, imposed in 1924, repealed in 1926, and reimposed in 1932, was to prevent complete tax

1/ The credit is allowable even though the gift tax may be paid after the decedent's death. In such cases, the gift tax is deducted from the estate as a debt of the decedent.

avoidance while still retaining some tax advantage for lifetime gifts by taxing them at a lower rate than death transfers. We found no express or implied congressional intent to provide a tax advantage--or for that matter, an additional tax burden--for gifts made in contemplation of death.

To determine the tax effect of the present treatment of gifts in contemplation of death, we screened about 3,400 estate tax returns accepted as filed or closed by audit during fiscal year 1973. About 200 estates included gifts in contemplation of death. In 22 cases a gift tax was paid or due, and the total tax liability was affected because the gift tax was not added to the estate.

In 9 of the 22 cases, inclusion of the gift tax in the estate would have affected the estate tax by 5 percent or more. For the 22 cases, a full reversal of the gift transaction would have increased tax revenues by about \$1 million--an average of \$47,500 per case.

The tax impact of the use of gifts in contemplation of death is further illustrated by one large case not in our sample--an estate of \$176 million in which the guardians of a wealthy individual made gifts on his behalf of \$36 million 2 months before he died. As a result of these gifts and the tax treatment of the related gift tax, there was a reported saving of over \$16 million to the estate and the beneficiaries.

The following examples, taken from cases in our sample, compare the tax calculated by applying sections 2012 and 2035 of the Internal Revenue Code with the tax which would result if there were a full reversal of the original gift transaction.

Case 1

The decedent died in 1970 and left a gross estate of \$293,621, including, as a transfer in contemplation of death, gifts of \$169,103 made to a daughter in 1969. The estate filed a gift tax return 1 month after death and subsequently paid a gift tax of \$31,111. In accordance with present tax treatment, the gift tax liability was deducted from the gross estate to arrive at the taxable estate. The tax benefit resulting from the present treatment of the gift in contemplation of death was \$8,586, computed as follows:

	<u>Actual tax treatment</u>	<u>Full reversal of gift transaction</u>
Gross estate	\$ <u>293,621</u>	\$ <u>293,621</u>
Less:		
Gift tax due	31,111	-
Other deductions and exemption	<u>61,500</u>	<u>61,500</u>
	<u>92,611</u>	<u>61,500</u>
Taxable estate	\$ <u>201,010</u>	\$ <u>232,121</u>
Gross estate tax (less credit for State death taxes)	\$ <u>48,339</u>	\$ <u>56,925</u>

The \$48,339 tax liability consisted of \$31,111 in payment of gift tax plus \$17,228, the net estate tax payable after deducting the credit for the gift tax.

Case 2

This case differs from the preceding case only in that the allowable credit for gift tax was limited to the amount of estate tax attributable to the inclusion of the gift in the decedent's gross estate.

The estate of the decedent, who died in 1971, reported a gross estate valued at \$25,589,445. Included in the estate were gifts made by the decedent 2 months before his death, valued at \$4,628,625, for estate tax purposes. The gift tax of \$2,447,307 was unpaid at the date of death, and, in accordance with present tax treatment, the debt was deducted from the gross estate to arrive at the taxable estate. The tax benefit from the gifts in contemplation of death was \$895,758, computed as follows:

	<u>Actual tax treatment</u>	<u>Full reversal of gift transaction</u>
Gross estate	<u>\$25,589,445</u>	<u>\$25,589,445</u>
Less:		
Gift tax due	2,447,307	-
Other deductions and exemption	<u>5,593,210</u>	<u>5,593,210</u>
	<u>8,040,517</u>	<u>5,593,210</u>
Taxable estate	<u>\$17,548,928</u>	<u>\$19,996,235</u>
Gross estate tax (less credit for State death taxes)	\$ 9,616,647	\$11,109,503
Less:		
Gift tax credit (limited)	<u>1,850,209</u>	<u>-</u>
Net estate tax	7,766,438	11,109,503
Gift tax payable	<u>2,447,307</u>	<u>-</u>
Total amount to Government	<u>\$10,213,745</u>	<u>\$11,109,503</u>
Tax benefit	<u>\$ 895,758</u>	

In this case the savings of about \$1.5 million from not having to bear the estate tax on the amount of the gift tax (\$11.1 million less \$9.6 million) exceeded the difference of about \$600,000 of gift tax paid, but not allowed as a credit (\$2.4 million less \$1.8 million). Consequently, even though the full amount of the gift tax was not allowed as a credit, the estate realized a substantial tax benefit of almost \$900,000.

Case 3

Because the law limits the amount of allowable gift tax credit, gifts in contemplation of death may result in additional taxes. This may occur when there is a substantial decline in the gift's value from the date of the gift to the date of death, resulting in a higher gift tax than the estate tax attributable to the subsequent inclusion of the gift in the estate. This situation may also occur when, even with

inclusion of the gift in the estate, the estate tax is minimal or a significant portion of the estate consists of items subject to marital or charitable deductions.

The following case illustrates a situation in which a gift in contemplation of death resulted in higher Federal taxes because the estate tax was minimal.

The estate of the decedent, who died in 1970, reported a gross estate valued at \$237,244. Included in the gross estate were gifts made by the decedent 3 weeks before his death, valued at \$49,917 for estate tax purposes, for which a gift tax of \$3,916 was due. The allowable credit for gift tax was limited to the amount of estate tax attributable to the inclusion of the gift in the decedent's gross estate. In this case, the gift in contemplation of death treatment resulted in payment of additional Federal taxes of \$3,473, computed as follows:

	<u>Actual tax treatment</u>	<u>Full reversal of gift transaction</u>
Gross estate	\$ <u>237,244</u>	\$ <u>237,244</u>
Less:		
Gift tax due	3,916	-
Other deductions and exemption	<u>226,698</u>	<u>226,698</u>
	<u>230,614</u>	<u>226,698</u>
Taxable estate	\$ <u>6,630</u>	\$ <u>10,546</u>
Gross estate tax	\$ 264	\$ 560
Less:		
Gift tax credit (limited)	<u>147</u>	-
Net estate tax payable	117	560
Gift tax payable	<u>3,916</u>	-
Total amount to Govern- ment	\$ <u>4,033</u>	\$ <u>560</u>
Additional tax		<u>\$ 3,473</u>

The tax liability under the present treatment was higher because inclusion of the gift in the estate increased the estate tax by only \$147 and the taxpayer was limited to a credit of this amount even though the gift tax payable was \$3,916.

INCONSISTENT TREATMENT OF
GIFT TRANSACTIONS BY IRS

A further problem relating to gifts in contemplation of death is the inconsistent treatment of gift transactions by IRS. Of the 200 estate tax returns containing gifts in contemplation of death, 50 showed gifts exceeding \$33,000--the level above which most gift transactions would be taxable. About 90 other cases involved gifts between \$3,000 and \$33,000, some of which may also be taxable. However, in none of these cases had the estates filed gift tax returns for such gifts, and IRS had not required them to do so. While this resulted in what we consider to be a more equitable treatment--full reversal of the gift transaction--for estate tax purposes, it neither treated all taxpayers uniformly nor conformed to Internal Revenue Code provisions and IRS procedures.

In cases in which a gift tax return should have been filed, failure to do so may have affected the total tax liability. In some such cases, in which the taxable estate is relatively small or the value of the transferred property declined from the date transferred to the date of death, the absence of a gift tax return on property transferred in contemplation of death resulted in a lower total tax. In others, in which the taxable estate was increased by the amount of gift taxes that would have been payable, the absence of a gift tax return resulted in a higher total tax.

The following case illustrates the tax effect resulting from failure of IRS to require the decedent's estate to file a gift tax return or to properly adjust the estate tax return.

Case 4

The estate of the decedent, who died in 1971, reported a gross estate valued at \$145,380. Included in the gross estate were gifts of \$140,349 to two persons made 4 days before the decedent's death. Because her previous gift history was not readily available, we assumed that, in addition to the \$3,000 annual exclusion for each recipient, her entire \$30,000 lifetime exemption would be deductible in computing the gift tax due. By not filing a gift tax return, the estate saved at least \$2,202 in Federal taxes, computed as follows:

	<u>Present tax treatment</u>	<u>Gift tax return required</u>
Gross estate	\$ <u>145,380</u>	\$ <u>145,380</u>
Less:		
Other deductions and exemption	64,175	64,175
Gift tax due	<u>-</u>	<u>16,503</u>
	<u>64,175</u>	<u>80,678</u>
Taxable estate	\$ <u>81,205</u>	\$ <u>64,702</u>
Gross estate tax (less credit for State death taxes)	\$ 15,107	\$ 10,619
Less:		
Gift tax credit (limited)	<u>-</u>	<u>a/9,813</u>
Net estate tax payable	15,107	806
Gift tax payable	<u>-</u>	<u>16,503</u>
Total amount to Govern- ment	\$ <u>15,107</u>	\$ <u>17,309</u>
Tax benefit	\$ <u>2,202</u>	

a/ The allowable credit for gift tax was limited to the amount of estate tax attributable to the inclusion of the gift in the decedent's gross estate.

It should be noted that the circumstances pertaining to this case are similar to case 3, except that in case 3 the estate filed a gift tax return.

CONCLUSIONS

Under the law, the value of a gift made in contemplation of death must be added to the decedent's estate and made subject to estate taxation, credit being given for gift tax paid or due. However, the related gift tax is not added to the decedent's estate--as would be required for full reversal of the gift transaction--and is not subject to estate taxation. Gifts made in contemplation of death may act, therefore, to reduce estate taxes. Sometimes taxes may be increased.

We found no evidence, express or implied, of a congressional intent to provide tax benefits for gifts made in contemplation of death or, for that matter, to impose additional tax burdens. If anything, the apparent intent was simply to negate the tax effect of the gift.

Although gifts made in contemplation of death are not a factor in most estate cases, the tax effect in individual cases can be relatively significant.

The Internal Revenue Code should be amended to provide for a full reversal of gift transactions considered to be in contemplation of death. This could be accomplished by either refunding to the estate the amount of any gift tax paid or terminating the liability for any gift tax due and adding such amount to the amount of the gift in the gross estate.

Also, IRS should issue instructions to estate tax return examiners emphasizing that under the present law gift tax returns must be filed for all gifts made in contemplation of death--something that has not been required in all cases.

RECOMMENDATION TO THE JOINT COMMITTEE
ON INTERNAL REVENUE TAXATION

We recommend that the Congress initiate legislation to amend sections 2012 and 2035(a) of the Internal Revenue Code to achieve a full reversal of transactions involving gifts deemed to have been made in contemplation of death.

The following language is proposed to accomplish the recommended changes. Language which we propose be added to the Internal Revenue Code of 1954 is underscored; language to be stricken is bracketed.

"§2012. CREDIT FOR GIFT TAX

(a) In General.--If a tax on a gift has been paid under chapter 12 (sec. 2501 and following) [, or under corresponding provisions of prior laws,] and thereafter on the death of the donor any amount in respect of such gift together with the amount of gift tax paid by the donor in respect of such gift is required to be included in the value of the gross estate of the decedent for purposes of this chapter, then there shall be credited against the tax imposed by section 2001 the amount of the tax paid on a gift under chapter 12 [, or under corresponding provisions of prior laws, with respect to so much of the property which constituted the gift as] to the extent that such tax is included in the gross estate. [, except that the amount of such credit shall not exceed an amount which bears the same ratio to the tax imposed by section 2001 (after deducting from such tax the credit for State death taxes provided by section 2011) as the value (at the time of the gift or at the

time of the death, whichever is lower) of so much of the property which constituted the gift as is included in the gross estate bears to the value of the entire gross estate reduced by the aggregate amount of the charitable and marital deductions allowed under sections 2055, 2056, and 2106(a)(2).] Any amount of gift tax included in the gross estate which is in excess of the amount of the estate tax imposed by section 2001 shall be refunded to the estate.

No credit shall be allowed for any gift tax which is due but unpaid at the date of the decedent's death.

[(b)--In applying, with respect to any gift, the ratio stated in subsection (a), the value at the time of the gift or at the time of the death, referred to in such ratio, shall be reduced--(1) by such amount as will properly reflect the amount of such gift which was excluded in determining (for purposes of section 2503(a)), or of corresponding provisions of prior laws, the total amount of gifts made during the calendar quarter (or calendar year if the gift was made before January 1, 1971) in which the gift was made; (2) if a deduction with respect to such gift is allowed under section 2056(a) (relating to marital deduction)--then by an amount which bears the same ratio to such value (reduced as provided in paragraph (1) of this subsection) as the aggregate amount of the marital deductions allowed under section 2056(a) bears to the aggregate amount of such marital deductions computed without regard to subsection (c) thereof; and (3) if a deduction with respect to such gift is allowed under section 2055 or 2106(a)(2) (relating to charitable deduction)--then by the amount of such value, reduced as provided in paragraph (1) of this subsection.]

(b) [(c)]--Where the decedent was the donor of the gift but, under the provisions of section 2513, [or corresponding provisions of prior laws,] the gift was considered as made one-half by his spouse, --(1) the term "the amount of the tax paid on a gift under chapter 12", as used in subsection (a), includes the amount paid with respect to each half of such gift, the amount paid with respect to each being computed in the manner provided in subsection (c) [(d)]. [; and (2) in applying, with respect to such gift, the ratio stated in subsection (a), the value at the time of the gift or at the time of the death, referred to in such ratio, includes such value with respect to each half of such gift, each such value being reduced as provided in paragraph (1) of subsection (b).

(c) [(d)]--(1) For purposes of subsection (a), the amount of tax paid on a gift under chapter 12 [or under corresponding provisions of prior laws,] with respect to any gift shall be an amount which bears the same ratio to the total tax paid for the calendar quarter (or calendar year if the gift was made before January 1, 1971) in which the gift was made as the amount of such gift bears to the total amount of taxable gifts (computed without deduction of the specific exemption) for such quarter or year.

(2) For purposes of paragraph (1), the "amount of such gift" shall be the amount included with respect to such gift in determining (for the purposes of section 2503(a)) [, or of corresponding provisions of prior laws] the total amount of gifts made during such quarter or year, reduced by the amount of any deduction allowed with respect to such gift under section 2522 [, or under corresponding provisions of prior laws] (relating to charitable deduction) or under section 2532 (relating to marital deduction)."

"§2035. TRANSACTIONS IN CONTEMPLATION OF DEATH

(a) General Rule.--The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, in contemplation of his death.

In addition, the value of the gross estate shall include the amount of any gift tax paid by the donor under chapter 12 in respect of such transfers.

If any part of the gift tax in respect of a transfer in contemplation of death, imposed under chapter 12, has not been paid at the date of the decedent's death, then the liability for the unpaid gift tax shall terminate and the amount shall not be considered as a debt in respect of the decedent. Any amount of gift tax paid by a donee in respect of a transfer in contemplation of death shall be refunded to such donee.

RECOMMENDATION TO THE COMMISSIONER
OF INTERNAL REVENUE

We recommend that, pending the proposed amendments to the Internal Revenue Code, the Commissioner of Internal Revenue issue instructions to estate tax return examiners emphasizing that gift tax returns must be filed for all gifts made in contemplation of death.

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By letter dated August 28, 1975, the Commissioner of Internal Revenue stated that IRS endorses both proposals relating to gifts in contemplation of death under the present dual system of taxation. He stated further that IRS will alert its field examining personnel to the need to secure required gift tax returns from estate executors.

The Commissioner noted that the Service has long advocated a unified estate-gift (transfer) tax in lieu of the present system; under a unified system, the inclusion of completed gifts within a short period of death would not be particularly important in the computation of the aggregate of transfers at date of death values; a unified system would be extremely valuable administratively, since it would render largely obsolete the "contemplation of death" rule. (See app. I.)

CHAPTER 3

ALTERNATE VALUATION METHOD

The executor of a decedent's estate may elect to value the estate either as of the date of death or 6 months after the date of death. The latter date is the alternate valuation date. Section 2032 of the Internal Revenue Code prescribes the tax treatment when alternate valuation is chosen.

The purpose of this option, first made available to executors in 1935, was to permit relief from the burden of estate taxation when sharply falling market prices reduced the value of the estate during the period following the decedent's death. The 1-year period initially established for alternate valuation was reduced to 6 months for individuals dying after December 31, 1970.

If alternate valuation is used, it applies to all items in the estate. Property disposed of during the 6-month period is valued as of the date of disposition; other property is valued as of 6 months after the decedent's death.

Although alternate valuation is intended for use when estate value declines after the date of death, it is sometimes used advantageously when the estate value increases. This latter use results in unintended tax benefits.

Although higher valuation usually results in a higher estate tax, other tax advantages can provide an overall saving. One advantage is an increase, under section 1014 of the Internal Revenue Code, of the basis of property in the hands of beneficiaries which reduces the amount of taxable gains later realized.

Other advantages are (1) the higher basis provided to a beneficiary for computing depreciation on business property and (2) the increase in marital and charitable deductions which reduce the value of the taxable estate.

To test the incidence and application of alternate valuation, we screened about 3,400 returns. We found that 411 estates had used the alternate valuation method and that 42 estates had used an alternate valuation which was higher than that at the date of death.

Following are examples of potential or realized savings in income tax to beneficiaries through use of a higher alternate valuation.

Case 1

The gross estate had a value of \$95,390 at the date of death and \$103,316 at the alternate date. The difference between the date-of-death value and the alternate value was attributable to an increase in the value of securities which the decedent owned either individually or jointly with his surviving spouse. All the securities were on hand 6 months after the date of death, and the entire estate was left to the surviving spouse. The specific exemption and the marital and other deductions amounted to \$114,736, which was more than the value of the gross estate; thus there was no estate tax due. The surviving spouse, however, obtained a higher basis of \$7,926 on the securities and a potential saving in future income taxes.

Case 2

The gross estate had a value of \$452,148 at the date of death and an alternate valuation of \$505,626. Allowable deductions amounted to \$555,837, resulting in no taxable estate under either valuation method. The entire estate was left to the surviving spouse. The increase in value of \$53,478 was attributable to securities owned by the decedent, most of which were sold before the alternate valuation date.

Since the alternate valuation was selected, the sales price was the basis for tax purposes and therefore no taxable gain on the sale was recognized. The surviving spouse had an income tax saving because of the higher basis for the securities which were sold.

Case 3

The gross estate had a value of \$625,885 at the date of death and an alternate value of \$707,900. The higher valuation was attributable to the sale, before the alternate valuation date, of stocks and bonds over which the decedent held a general power of appointment. Most of the estate was left to the surviving spouse, and the full marital deduction (one-half of the adjusted gross estate) was claimed. The election of the higher valuation resulted in additional estate tax of \$11,266. However, since the sales price of the stocks and bonds sold became the basis to the beneficiaries, the \$82,015 profit on the sale would not be subject to income tax.

CONCLUSION

Under the law, the executor of a decedent's estate may elect to value the estate either as of the date of death or as of 6 months thereafter. Normally, alternate valuation is used when the value of the gross estate declines from date of death.

However, it is sometimes used when the value of the estate increases because the increased basis of the property will provide a future income tax benefit to the estate's beneficiary.

In deciding whether a higher estate valuation provides a tax advantage, the executor must consider how it affects overall tax costs. Some factors to be considered are

- the size of the taxable estate, since the estate tax is relatively low on smaller estates;
- the effect of higher valuation on the basis of the property and hence on future capital gains and taxes;
- whether the higher valued property will be used in business and subject to provision for depreciation; and
- the effect of higher valuation on the marital and charitable deductions and hence on the estate tax.

The legislative history of the alternate valuation method shows that it was established to provide relief from declines in estate value during the period following the decedent's death. Because use of alternate valuation when the estate value increases results in unintended tax benefits, we believe the Internal Revenue Code should be amended to permit use of alternate valuation only when estate values decrease after death.

RECOMMENDATION TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

We recommend that the Congress initiate legislation to amend section 2032 of the Internal Revenue Code to limit use of the alternate valuation method to its intended purpose--to provide estate tax relief to beneficiaries only when there is a decline in the value of estate property.

The following language is proposed to accomplish the recommended change. Language which we propose be added to the Internal Revenue Code of 1954 to implement our recommendation is underscored.

"§ 2032. ALTERNATE VALUATION

(a) General.--When there is a decrease in the value of the gross estate subsequent to the decedent's death, the value of the gross estate may be determined, if the executor so elects, by valuing all the property included in the gross estate as follows: * * *

- - - -

By letter dated August 28, 1975, the Commissioner of Internal Revenue stated that IRS has made legislative proposals that the alternate valuation method be used only by those estates which have decreased in value since the date of death. Therefore, IRS endorses the proposed amendment to section 2032 of the Internal Revenue Code. (See app. I.)

Internal Revenue Service

Department of the Treasury

Commissioner

Washington, DC 20224

AUG 28 1975

Mr. Victor L. Lowe
Director, General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

We have completed our review of your draft report to the Joint Committee on Internal Revenue Taxation proposing certain changes in estate taxation. We regret the delay in responding within the period requested in your July 8, 1975 letter; however, we have been in touch with Mr. Coffman, who granted an extension.

As the report indicates, the present sections 2012 and 2035 of the Internal Revenue Code can result in many unintended tax benefits or burdens dependent on the facts in each case. Certainly from a tax administration viewpoint, section 2035 relating to gifts in contemplation of death, has created many problems for the Service. A determination as to the motive for a transfer in contemplation of death is a factual one and, as such, most difficult and time consuming to establish. This issue generally results in litigation with only partial success for the Government.

Therefore, the Service endorses both proposals relating to gifts in contemplation of death under the present dual system of taxation. However, I must add that the Service has long advocated a unified estate-gift (transfer) tax in lieu of the present system. Under a unified system, the inclusion of completed gifts within a short period of death would not be particularly important in the computation of the aggregate of transfers at date of death values; a unified system would be extremely valuable administratively, since it would largely obsolete the "contemplation of death" rule.

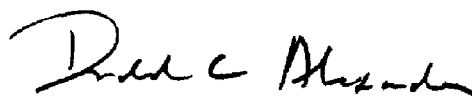
The alternate valuation method proposal also has our endorsement. For sometime, we have made legislative proposals that this method be used only by those estates which have decreased in value since the date of death. As the report indicates, the use of an appreciated value creates an unintended tax benefit for beneficiaries by inflating the basis of property for subsequent disposition.

Our estate tax examiners are instructed to consider the question of gift tax liability when examining estate tax returns. If a liability exists, the examiner is instructed to secure the required returns from the executor. Nevertheless, we will alert our field examining personnel to your findings.

Thanks for the opportunity to provide our comments on your proposals for legislative changes in the estate tax area. As requested, the copies of the draft report are enclosed.

With kind regards,

Sincerely,

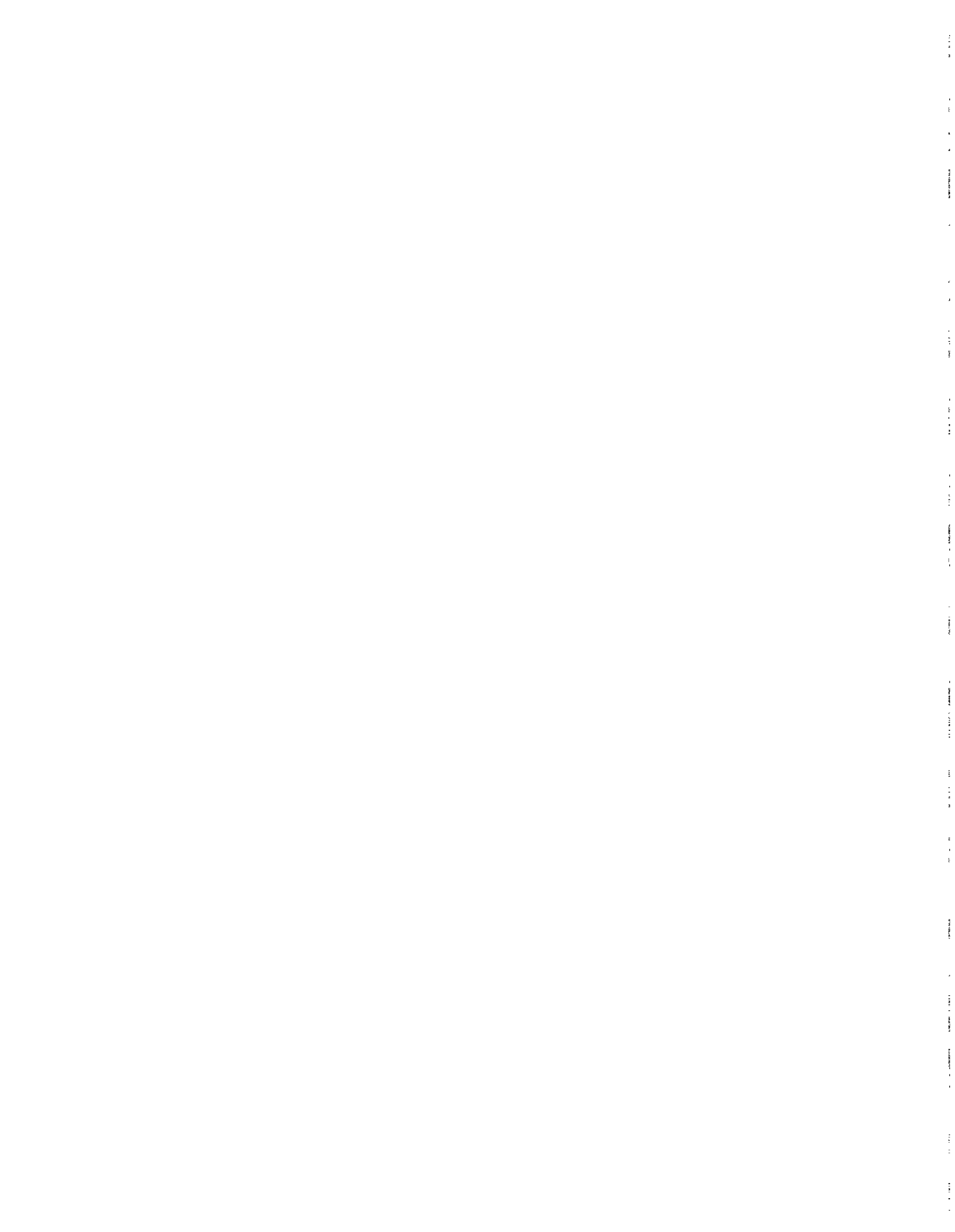
A handwritten signature in cursive script, appearing to read "Donald C. Alexander".

Donald C. Alexander

Enclosure

PRINCIPAL OFFICIALS RESPONSIBLE
FOR ADMINISTERING ACTIVITIES
DISCUSSED IN THE REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF THE TREASURY:		
William E. Simon	Apr. 1974	Present
George P. Shultz	June 1972	Apr. 1974
COMMISSIONER OF INTERNAL REVENUE:		
Donald C. Alexander	May 1973	Present
Raymond F. Harless (acting)	May 1973	May 1973
Johnnie M. Walters	Aug. 1971	Apr. 1973
ASSISTANT COMMISSIONER (COMPLIANCE):		
Singleton B. Wolfe	Mar. 1975	Present
John F. Hanlon	Jan. 1972	Mar. 1975
John F. Hanlon (acting)	Nov. 1971	Jan. 1972





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