

XI. ESTATE AND GIFT TAXATION

A. Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)

Present Law

In general, present law imposes transfer taxes that are designed to tax transfers once each generation. These taxes are in the form of a gift tax for lifetime transfers, an estate tax for death time transfers, and a generation skipping transfer tax for transfers to persons more than one generation younger than the transferor. A generation skipping tax is imposed on all transfers, whether directly or indirectly, to “skip persons.” A skip person includes a person who is two or more generations below the generation of the transferor or a trust, if all the interests are held by skip persons. The transferor generally is the individual who transfers property in a transaction that is subject to Federal estate or gift tax. Transfers that are subject to the generation skipping tax are direct skips (e.g., a transfer from a grandparent to a grandchild), taxable distributions (e.g., a distribution of income or corpus to a grandchild from a trust created by a grandparent), and taxable terminations (e.g., the death of a grandchild who was a beneficiary of a trust created by a grandparent).

Present law provides for a lifetime per-transferor exemption from the generation skipping transfer tax.⁸⁷¹ The amount of the generation skipping transfer tax exemption is \$1,500,000 for generation skipping transfers made in 2005, \$2,000,000 for generation skipping transfers made in 2006, 2007, or 2008, and \$3,500,000 for generation skipping transfers made in 2009. In the case of a generation skipping trust, the exemption applies to distributions from, or terminations of interests in, that fraction of the trust that the portion of the exemption that is allocated to the trust bears to the value of trust’s assets at its creation. Thus, if a generation skipping trust is created with \$1.5 million and \$1.5 million of the creator’s generation skipping transfer tax exemption is allocated to that trust, no generation skipping transfer tax ever is imposed on any distributions from, or termination of interests in, that trust regardless of the number of generations of the trust’s beneficiaries that are skipped.

Many States limit the length of time that assets can be held in trust for the benefit of beneficiaries who were not alive at the time of the creation of the trust. This limitation is

⁸⁷¹ Every transferor is entitled to a generation skipping tax exemption that may be allocated to transfers made by the transferor either during the transferor’s life or at death. The amount of the generation skipping transfer tax on a transfer technically is determined by multiplying the amount transferred by the applicable rate. The applicable rate is the maximum Federal estate tax rate multiplied by the inclusion ratio. The inclusion ratio is defined in turn as one minus the applicable fraction. The applicable fraction is a fraction the numerator of which is the generation skipping transfer exemption allocated to the trust (or the property transferred in a direct skip) and the denominator of which is the value of the property transferred to the trust (or involved in the direct skip) reduced by Federal or State estate and death taxes actually recovered from the trust (or transferred property) and any charitable deduction allowed for Federal estate and gift tax on the transfer.

generally referred to as the rule against perpetuities. The rule against perpetuities was a judicially created rule of English common law. In many cases, States adopted the rule against perpetuities when they adopted British common law as their basic law. The rule has been criticized as being inconsistent with the present capital market system, and because of its complexity and resulting uncertainty of application. In order to alleviate this uncertainty, some States have adopted the Uniform Statutory Rule Against Perpetuities. Under that uniform statute, “trust settlors may elect to create either a trust measured by lives in being at the creation of the trust plus 21 years or trust measured by ninety-years.”⁸⁷² Other States have either repealed the rule against perpetuities, or provided an ability to opt out of the rule. In a State without a mandatory rule against perpetuities, it is possible to transfer assets to a trust created in that State, to which the transferor’s generation skipping tax exemption has been allocated. The trust assets may grow for a potentially unlimited period of time without being subject to any transfer tax. Because of their potential long life and potential for substantial accumulation, such trusts generally are called “perpetual dynasty trusts.”

Reasons for Change

Perpetual dynasty trusts are inconsistent with the uniform structure of the estate and gift taxes to impose a transfer tax once every generation. In addition, perpetual dynasty trusts deny equal treatment of all taxpayers because such trusts can only be established in the States that have repealed the mandatory rule against perpetuities.

Description of Proposal

The proposal prohibits the allocation of the generation skipping tax exemption to a “perpetual dynasty trust,” except to the extent that the trust provides for distributions to beneficiaries in the generations of the transferor’s children or grandchildren. Under the proposal, the generation-skipping tax exemption effectively is limited to an exemption of a skip of one generation. A “perpetual dynasty trust” is defined as a trust whose situs (place of creation) is a State that either (1) has repealed the rule against perpetuities, (2) allows the creator of a trust to elect to be exempt from the rule against perpetuities and the creator so elects, or (3) has modified its rule against perpetuities to permit creation of interests for individuals more than three generations younger than the interest’s creator. If the situs of a trust is moved from a State that has retained the rule against perpetuities to a State that has repealed the rule against perpetuities, the inclusion ratio thereafter will be changed to one.

Effective Date

The proposal is effective for transfers made after the date of enactment.

⁸⁷² Jesse Dukeminier, “The Uniform Statutory Rule Against Perpetuities and the GST Tax: New Perils for Practitioners and New Opportunities,” *Real Property Probate & Trust Journal*, 30 (1995) at 185.

Discussion

As Congress stated both when it originally imposed a tax on generation skipping transfers in 1976 and again when it revised the generation skipping tax in 1986, the purpose of imposing gift, estate and generation skipping tax was “not only to raise revenue, but to do so in a manner that has as nearly as possible a uniform effect.”⁸⁷³ Similarly, the Congress stated that it “believed that the tax law should basically be neutral and that there should be no tax advantage available in setting up trusts.”⁸⁷⁴ The imposition of a generation skipping tax was believed necessary to achieve the uniformity of imposing a transfer tax once every generation. A \$1 million exemption from the generation skipping tax originally was provided when the generation skipping tax was revised in 1986. The size of the generation-skipping transfer tax exemption was increased beginning in 2002 to be equal to the amount of effective exemption for estate and gift taxes. Thus, the exemption from the generation skipping transfer tax is scheduled to increase to \$3.5 million by 2009. When Congress originally enacted a tax on generation skipping transfers, it noted that “[m]ost States have a rule against perpetuities which limits the duration of a trust.”⁸⁷⁵

Since that time, a number of States have either repealed the rule against perpetuities or provided an ability to opt out of such limitations. Thus, it is possible to transfer a relatively large initial amount of assets to a trust created in such States and to which the transferor’s entire generation skipping tax exemption has been allocated. Potentially unlimited growth in the trust assets may occur, while the assets are not subject to any transfer tax even though the trust’s beneficiaries have changed many generations. These “perpetual dynasty trusts” can be used to frustrate the uniform application of transfer tax that was envisioned when the generation skipping tax was enacted. This lack of uniformity is compounded by the fact that perpetual dynasty trusts can be created only in the limited number of States that have repealed or modified the rule against perpetuities.

The proposal would result in greater uniformity by limiting exemption from the generation skipping transfer tax for perpetual dynasty trusts. The proposal is consistent both with the purpose of enacting a generation skipping transfer tax, and with the operation of the present transfer tax system, which generally imposes a tax once every generation by limiting the amount of assets that can be placed beyond the present-law transfer taxes. The proposal also is consistent with the generation skipping tax exemption, in that it permits an exemption from the generation skipping transfer tax for transfers to the transferor’s grandchildren. The proposal avoids the possible constitutional limitations of alternative proposals to limit the transfer tax advantage of perpetual dynasty trusts (e.g., impose an *ad valorem* tax every set number of years on perpetual dynasty trusts). In addition, the proposal is consistent with the purposes of the rule

⁸⁷³ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, at 1263.

⁸⁷⁴ Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976* (JCS-33-76), December 29, 1976, at 565.

⁸⁷⁵ *Id.*

against perpetuities to prevent perpetuation of wealth disparities, promote alienability of property, and make property productive.⁸⁷⁶ The proposal does not prevent an individual from creating a trust in a State that has repealed the rule against perpetuities. Thus, the proposal does not prevent the creation of a trust in a State if that State otherwise would be the best State in which to create a trust. The proposal does, however, eliminate a Federal transfer tax advantage for creating a trust in a State that has repealed the rule against perpetuities.

⁸⁷⁶ Brian Layman, "Comment: Perpetual Dynasty Trusts: One of the Most Powerful Tools in the Estate Planner's Arsenal," *Akron Law Review*, 32 (1999), at 747.

**B. Determine Certain Valuation Discounts More Accurately for
Federal Estate and Gift Tax Purposes
(secs. 2031, 2512, and 2624)**

Present Law

In general

The value of property subject to transfer taxes is the fair market value of the property being transferred on the date of transfer.⁸⁷⁷ The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.⁸⁷⁸

If actual sales prices and bona fide bid and asked prices are lacking, the fair market value of stock in a closely held business is determined by looking to various factors including: the company's net worth; its prospective earning power and dividend-paying capacity; the goodwill of the business; the economic outlook in the nation and in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of businesses.⁸⁷⁹

Discounts

In general

Courts and the IRS have recognized that for various reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. For example, the value of a 50-percent shareholder's stock might differ from the value of 50 percent of the assets owned by the corporation in which the stock is held. Some (but not all) of the valuation discounts used under present law are discussed below.⁸⁸⁰ In many cases courts apply more than one discount. The

⁸⁷⁷ Secs. 2031 (estate tax), 2512 (gift tax), and 2624 (generation-skipping transfer tax). Fair market value is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternative valuation date if the executor so elects) in the case of the estate tax.

⁸⁷⁸ Treas. Reg. secs. 20.2031-1(b) and 25.2512-1.

⁸⁷⁹ Treas. Reg. secs. 20.2031-2(f)(2) and 25.2512-2(f)(2); Rev. Rul. 59-60, 1959-1 C.B. 237.

⁸⁸⁰ Other valuation discounts that courts have recognized include a blockage discount (if the sale of a block of assets, such as 80 percent of the stock of a public company, would depress the market for that asset); a key man (thin management) discount (if the value of a business declines due to the loss of a key manager); and a capital gain (or *General Utilities*) discount (to reflect the tax on gain from the eventual sale of assets acquired by gift or held by a corporation).

theories of some discounts overlap, and court decisions sometimes blur the distinctions between those discounts.

Minority (or lack of control) discount

Numerous courts and the IRS have recognized that shares of stock or other ownership interests in a closely-held business entity that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the entity.⁸⁸¹ Minority discounts arise from a division of control because the holder of a minority interest cannot control the ongoing direction of the business entity, the timing and amount of income distributed by the entity to its owners, or the liquidation of its assets. Minority discounts often result in reductions in the value of transferred property from 15 percent to 40 percent.⁸⁸²

Marketability (or illiquidity) discount

Recognizing that closely held stock and partnership interests often are less attractive to investors and have fewer potential purchasers than publicly traded stock, courts and the IRS grant discounts to reflect the illiquidity of such interests. Courts sometimes combine marketability and minority discounts into a single discount,⁸⁸³ but the discounts reflect different concerns. Whereas the minority discount compensates for lack of control over an interest, the marketability discount compensates for the limitations upon free exit inherent in interests for which no public market exists. The marketability discount may be appropriate whether valuing a controlling or a minority ownership interest.⁸⁸⁴ Generally, the size of the marketability discount is reduced as the donor's or decedent's control of the corporation or partnership increases. However, the discount has been applied to a 100-percent ownership interest in a closely-held

⁸⁸¹ See Rev. Rul. 93-12, 1993-2 C.B. 202; *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Leyman v. Commissioner*, 40 T.C. 100 (1963). More recently, a minority discount was allowed even where the total shares owned by related persons constituted a majority interest. For example, in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court upheld a minority discount on stock transferred to a trust even though the other principal shareholder of the corporation was trustee of the trust and father of its beneficiary.

⁸⁸² See David T. Lewis and Andrea Chomakos, *The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities* (ABA Publishing 2004) at 11.

⁸⁸³ E.g., *Central Trust Co. v. United States*, 305 F.2d 393 (Ct. Cl. 1962); *Estate of Titus v. Commissioner*, T.C. Memo 1989-466.

⁸⁸⁴ Controlling shares in a nonpublic corporation, which do not qualify for a minority discount, may nonetheless receive a marketability discount because there is no ready private placement market and because transaction costs would be incurred if the corporation were to publicly offer its stock.

corporation.⁸⁸⁵ Marketability discounts often result in reductions in the value of transferred property of 20 to 30 percent⁸⁸⁶ in addition to any applicable minority discount.⁸⁸⁷ Marketability discounts often are created by placing assets in a limited partnership. Marketability discounts created through the use of a limited partnership permit the donee or legatee to recreate value by liquidating the partnership or having a partner's interest redeemed by the partnership.

Fragmentation (or fractional interest) discount

Fragmentation discounts are similar to minority discounts. This discount arises from the lack of control inherent in joint ownership of an asset (e.g., a gift of an undivided fractional interest in real estate).⁸⁸⁸ Fragmentation discounts often result in reductions in the value of transferred property of 15 to 60 percent.⁸⁸⁹

⁸⁸⁵ See, e.g., *Estate of Bennett v. Commissioner*, T.C. Memo 1993-34, in which the Tax Court concluded that in determining the discount, the corporate form could not be ignored. (“Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties.”).

⁸⁸⁶ There is no established formula to compute the size of a discount. One measure of the size of a discount, applicable when valuing a controlling interest, is the total cost of registering securities with the Securities and Exchange Commission, i.e., converting nonliquid securities into liquid ones. Other factors considered are the size of any costs and the amounts realizable on a private placement or secondary offering, the opportunity cost of losing access to the invested funds, and the discounts applied in comparable transactions involving sales of comparable closely held businesses.

⁸⁸⁷ The United States Tax Court has noted that the application of a minority discount and a marketability discount is multiplicative rather than additive. According to the Court, the minority discount should be applied first and then the marketability discount should be applied to that figure. For example, a 20-percent minority discount and a 40-percent marketability discount should result in a 52-percent discount (20 percent + (40 percent x 80 percent)), not a 60-percent discount. See *Estate of Bailey v. Commissioner*, T.C. Memo 2002-152.

⁸⁸⁸ Because the holder of a fractional interest in real property has the power to compel partition (a remedy not available to minority holders of other interests), the discount should reflect the cost of partition and the value of the interest secured thereby. See Boris I. Bittker & Lawrence Lokken, *Federal Income Taxation of Estates, Gifts, and Trusts*, para. 135.3.4 (2d ed. 1993). Courts, however, often apply a minority discount instead. See, e.g., *LeFrak v. Commissioner*, T.C. Memo 1993-526.

⁸⁸⁹ See, e.g., *Estate of Van Loben Sels v. Commissioner*, T.C. Memo 1986-501.

Investment company discount

The investment company discount arises because the market values of closed-end mutual funds and investment companies often are less than the net asset values of those funds and companies. These discounts can be as high as 50 percent and may overlap with the marketability discount.⁸⁹⁰

Reasons for Change

Under present law, valuation discounts can significantly reduce the estate and gift tax values of transferred property. Minority and marketability discounts in particular often create substantial reductions in value. In some cases these reductions in value for estate and gift tax purposes do not accurately reflect value. For example, a taxpayer may make gifts to a child of minority interests in property and claim lack-of-control discounts under the gift tax even though the taxpayer or the taxpayer's child controls the property being transferred. A taxpayer also may contribute marketable property such as publicly-traded stock to a partnership (such as a family limited partnership) or other entity that he or she controls and, when interests in that entity are transferred through the estate, claim marketability discounts even though the heirs may be able to liquidate the entity and recover the full value by accessing the underlying assets directly.

Description of Proposal

In general

The proposal provides rules for determining the value of property for Federal transfer tax purposes. These rules limit the availability of minority and marketability discounts. In certain situations the proposal also may have an effect on other discounts such as the investment company discount and the fragmentation discount. The property interests to which the proposal applies include shares of stock of a corporation, interests in a partnership or limited liability company, and other similar interests in a business or investment entity or in an asset. The proposal has two parts, aggregation rules and a look-through rule. Under the proposal, step transaction principles are used to determine whether two or more transfers are treated as a single transfer. Moreover, any interest in an asset owned by the spouse of a transferor or transferee is considered as owned by the transferor or transferee.

The aggregation and look-through rules described below generally apply to all gifts made during life without consideration, transfers at death, generation-skipping events, and any transfer of an asset by gift for an amount of consideration less than the value determined under those rules. The rules described below are not intended, however, to change the principles of present law concerning whether transfers made in the ordinary course of business are, or are not, treated as gifts.⁸⁹¹

⁸⁹⁰ For example, the Tax Court in *Estate of Folks v. Commissioner*, T.C. Memo 1982-43, granted the taxpayer a 50-percent investment company discount and then applied to the resulting value a 50-percent marketability discount, resulting in a total discount of 75 percent.

⁸⁹¹ See, e.g., *Estate of Anderson v. Commissioner*, 8 T.C. 706 (1947), acq. 1947-2 C.B. 1.

Aggregation rules

Basic aggregation rule

Under the proposal, the value for Federal estate, gift, and generation-skipping transfer tax purposes of any asset transferred by a transferor (a donor or decedent) generally is a pro-rata share of the fair market value of the entire interest in the asset owned by the transferor just before the transfer (the “basic aggregation rule”).

Example 1.—Mother owns 80 percent of the interests in a limited liability company (“LLC”). LLC’s value is \$100,000, and Mother’s 80-percent interest has a value of \$80,000.⁸⁹² Mother makes related gifts of 20-percent interests to each of her two children. Under the proposal, the value of each 20-percent interest for transfer tax purposes is one-quarter (20/80) of the value of Mother’s 80-percent interest, or \$20,000. Because this value is a pro-rata share of the value of Mother’s controlling interest, the value does not reflect a minority discount.⁸⁹³

Example 2.—Mother owns a 40-percent interest in LLC. The value of this 40-percent interest is \$32,000, reflecting a 20-percent minority discount. Mother dies. This 40-percent interest passes through Mother’s estate in equal shares to two children who did not previously own any interests in the LLC. Under the proposal, the value of each 20-percent share for transfer tax purposes is \$16,000, one-half (20/40) of Mother’s interest at death.⁸⁹⁴

Transferee aggregation rule

A special rule applies if a donor or a decedent’s estate does not own a controlling interest in an asset just before a transfer of all or a portion of the asset to a donee or heir and, in the hands of the donee or heir, the transferred asset is part of a controlling interest. In that case, the estate, gift, and generation-skipping transfer tax value of the asset transferred is a pro-rata share of the fair market value of the entire interest in the asset owned by the *donee or heir* (not by the transferor) after taking into account the gift or bequest (the “transferee aggregation rule”).

Example 3.—The facts follow those in Examples 1 and 2 except that instead of making gifts and bequests to different children, Mother transfers interests in LLC only to one child. Thus, during her life Mother makes a single gift of a 40-percent interest to one child. After application of the basic aggregation rule, this gift has a value of \$40,000, one half (40/80) of the value of Mother’s entire 80-percent interest. At the time of

⁸⁹² For illustrative purposes only, the \$80,000 value, and the values described in all subsequent examples, disregard the possible existence of a control premium. The \$80,000 value also assumes a marketability discount does not apply.

⁸⁹³ The result is the same even if, just before the gifts, Mother owned only 65 percent of the LLC and her husband owned 15 percent.

⁸⁹⁴ The result for a minority discount is the same as under present law.

her death, assume that an 80-percent interest in the LLC is still worth \$80,000, but that Mother's remaining 40-percent interest is worth only \$32,000, reflecting a minority discount. After application of the transferee aggregation rule, the 40-percent interest transferred to the child has a value of \$40,000, one-half the \$80,000 value of child's 80-percent interest after the bequest. Because the child has a controlling interest after the transfer, the value of the bequest for transfer tax purposes does not incorporate a minority discount.

Look-through rule

If, after application of the aggregation rules described above, a transferred interest in an entity is part of a controlling interest owned (before the transfer) by the transferor or (after the transfer) by the transferee, a look-through rule may apply to determine the value of that transferred interest. Under the look-through rule, if at least one-third of the entity's assets (by value) consists of marketable assets, the value of a transferred interest in that entity for Federal estate, gift, and generation-skipping transfer tax purposes is the sum of (1) the net value of the entity's marketable assets allocable to that transferred interest and (2) the value of the transferor's interest in the entity attributable to nonmarketable assets. Marketable assets include cash, bank accounts, certificates of deposit, money market accounts, commercial paper, U.S. and foreign treasury obligations and bonds, corporate obligations and bonds, precious metals or commodities, and publicly traded instruments. Marketable assets do not include assets that are part of an active lending or financing business.⁸⁹⁵

If the look-through rule applies, the effect is to deny a marketability discount to the extent the entity holds marketable assets. In all cases in which the look-through rule applies, no minority discount is permitted because a condition of the look-through rule is that the transferred interest must be part of a controlling interest either before or after the transfer.

Example 4.—At her death, Aunt owns 80 percent of the interests in an LLC whose assets have a total value of \$1 million. The LLC owns publicly-traded stock worth \$600,000, real estate worth \$200,000, and a laundromat business worth \$200,000. Aunt's 80-percent interest in LLC passes through her estate to Niece. If it is assumed that a marketability discount, if available, is 25 percent, then under the proposal the estate tax value of this 80-percent interest is \$720,000, computed in the following manner. Because 60 percent of the value of LLC's assets is represented by marketable assets (the publicly-traded stock) and because Aunt owns a controlling interest before the transfer, the look-through rule applies. The \$720,000 value thus equals (1) 80 percent of the value of the publicly-traded stock, or \$480,000 (\$600,000 x 80 percent), plus (2) the value of Aunt's interest in the entity attributable to the real estate and laundromat business, or \$240,000 (80 percent of \$300,000 (with the \$300,000 representing the value of the laundromat business and real estate after taking into account a 25-percent marketability discount)).⁸⁹⁶

⁸⁹⁵ For purposes of this proposal, rules similar to those of section 6166(b)(10)(B) apply.

⁸⁹⁶ As in all of these examples, the possible existence of a control premium is ignored.

Example 5.—The facts are the same as in Example 4, except that the laundromat business is worth \$1.2 million. The total value of LLC’s assets is \$2 million. Consequently, the value of the marketable assets equals only 30 percent of the value of the LLC, and the look-through rule does not apply. The estate tax value of this 80-percent interest is \$1.2 million, which equals 80 percent of the value of the LLC (80 percent x \$2 million = \$1.6 million), less a 25-percent marketability discount (\$400,000). No minority discount is available because the 80-percent interest is a controlling interest.

Example 6.—The facts are the same as in Example 4, except that Aunt owns only a 10-percent interest in the LLC and Niece does not own any interest in it before she inherits her Aunt’s interest. Accordingly, the look-through rule does not apply because the 10-percent interest is not part of a controlling interest either before or after the transfer. Therefore, a minority discount is available. Assume the minority discount is 20 percent. The value of the 10-percent interest is therefore \$60,000, which equals 10 percent of the value of the LLC (\$100,000), less (1) a 20-percent minority discount (\$20,000) and (2) a 25-percent marketability discount (\$20,000) computed after application of the minority discount (that is, 25 percent of \$80,000, the value remaining after taking into account the minority discount).

Effective Date

The proposal applies to transfers occurring and estates of decedents dying on or after the date of enactment.

Discussion

The proposal responds to the frequent use of family limited partnerships (“FLPs”) and LLCs to create minority and marketability discounts. In a common planning technique, a taxpayer forms an FLP or LLC, contributes to that entity marketable securities, real estate, and other assets, and makes gifts of noncontrolling interests in the entity. At death, the taxpayer owns only a noncontrolling interest in the FLP or LLC (rather than the underlying assets). Under present law the gifts made during life may qualify for minority and marketability discounts, and the estate tax value of the taxpayer’s interest in the FLP or LLC also may be substantially reduced by those discounts.⁸⁹⁷ The proposal seeks to curb the use of this strategy frequently

⁸⁹⁷ Commentators have referred to this discounting as the “disappearing wealth” phenomenon: Wealth disappears from the transfer tax base even though no (or little) economic actual value is lost. See Mary Louise Fellows & William H. Painter, “Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome,” 30 *Stanford Law Review* 895 (1978); James Repetti, “Minority Discounts: The Alchemy in Estate and Gift Taxation,” 50 *Tax Law Review* (1995); Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 *Tax Notes* 1461 (2000).

Church v. United States, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff’d without published opinion*, 268 F.3d 1063 (5th Cir. 2001), provides a simple example of the creation of

employed to manufacture discounts that do not reflect the economics of the transfers during life and after death. More broadly, the proposal attempts to reduce the inefficiency caused by the creation of complicated structures that serve only to shelter value from taxation.

The proposed aggregation and look-through rules restrict a taxpayer's ability to claim minority and marketability discounts in certain situations in which those discounts do not accurately reflect the value of the property interests transferred. In general, the basic aggregation rule of the proposal determines the existence of a minority discount by taking into account the entire interest held by the transferor just before the transfer. This is because the focus of the estate and gift tax should be on the amount a transfer depletes the value of the transferor's holdings. Thus, no minority interest should apply if the transferor holds a controlling interest in the property just before the transfer. Although inconsistent with this theory, the transferee aggregation rule is proposed to prevent the strategic sequencing of multiple gifts made to the same donee. The aggregate value of a series of lifetime and testamentary gifts made by one donor to the same donee should not depend upon the order in which controlling and non-controlling interests are transferred to the donee.

The proposed look-through rule addresses abusive situations in which a marketability discount is inappropriate. If an entity whose interests are nonmarketable holds marketable assets, a marketability discount for an interest in the entity results in the undervaluing of the interest if the owner has a controlling interest in the entity and can easily access the marketable assets.

The proposal does not eliminate minority and marketability discounts in other contexts in which facts generally support those discounts. If, for example, neither the transferor nor the transferee owns a controlling interest in an entity, the estate and gift tax value of an interest in that entity may be determined by taking into account the lack of control. Similarly, where an entity's value primarily is attributable to nonmarketable assets, the estate and gift tax value of an interest in that entity may reflect that illiquidity.

The proposal is similar to, but refines, several previous legislative proposals. First, the basic aggregation rule is similar to a proposal made by the Treasury Department in 1984 as part

discounts shortly before death. Mrs. Church, who was the mother of the plaintiff and was suffering from a terminal illness, and her two children together formed a limited partnership. In exchange for limited partnership interests, Mrs. Church contributed to the partnership her interest in a Texas ranch (valued at \$380,038) together with \$1,087,710 in publicly traded securities, while her two children contributed their undivided interests in the ranch. A corporation owned equally by the two children was the general partner of the partnership. Two days after the formation of the partnership, Mrs. Church died. The District Court found that the date-of-death value of Mrs. Church's limited partnership interest was \$617,591, despite the fact that Mrs. Church transferred assets to the partnership worth \$1,467,748 just two days earlier. The court upheld a 58-percent discount based upon the noncontrolling and illiquid nature of Mrs. Church's limited partnership interest.

of a broad report on tax reform.⁸⁹⁸ The 1984 proposal, however, based the value of transferred property on the transferor's highest level of ownership after taking into account prior gifts. This tracing of ownership backward through all gifts made by a transferor during his or her lifetime would create significant administrative difficulties. The proposed basic aggregation rule, therefore, looks only to the transferor's ownership interest just before the transfer. To eliminate the advantage of strategic sequencing of gifts to the same donee, the proposal adds a donee aggregation rule. Second, the look-through rule is similar to the approach taken in the Fiscal Year 2000 Administration Budget Proposal.⁸⁹⁹ That proposal would have required an interest in an entity to be valued at a proportionate share of the net asset value of the entity to the extent the entity held non-business assets. The proposal's look-through rule is narrower than the earlier Treasury proposal, on the theory that in certain cases it may be inappropriate to look through an interest in an entity if the entity primarily holds non-marketable assets.⁹⁰⁰ Third, the proposal incorporates spousal attribution but does not include a broader family attribution approach taken by various legislative proposals. The proposal does not take this broader approach because it is not correct to assume that individuals always will cooperate with one another merely because they are related. Any proposal involving family attribution could include an exception based on family hostility, but that exception could entail significant administrative difficulties and might yield unintended incentive effects.

⁸⁹⁸ Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 2, General Explanation of the Treasury Department Proposals (November 1984) at 386-88.

⁸⁹⁹ Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (February 1999) at 167. The Fiscal Year 2001 Administration Budget Proposal included the same proposal. See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals* (February 2000) at 184-85.

⁹⁰⁰ The proposal also bases its application on the existence of marketable assets, not non-business assets. The definitions of those two terms may differ.

**C. Curtail the Use of Lapsing Trust Powers to Inflate the Gift
Tax Annual Exclusion Amount
(sec. 2503)**

Present Law

Under present law, gift tax is imposed on transfers of property by gift, subject to several exceptions. One major exception is the gift tax annual exclusion of section 2503(b). Under this exclusion, a donor can transfer up to \$11,000 of property to each of an unlimited number of donees without incurring gift tax on such transfers.⁹⁰¹ In order to qualify for the exclusion, the property interests transferred must be present interests, as opposed to future interests (such as remainders). In addition, spouses are allowed to “split” gifts for purposes of applying the exclusion.⁹⁰² For example, at both spouses’ election, a \$22,000 gift from one spouse to a third person could be treated as being made equally by both spouses, and thus would be sheltered entirely by the spouses’ combined annual exclusion amounts.

Gifts in trust are treated as made to the trust beneficiaries for purposes of applying the annual exclusion.⁹⁰³ Accordingly, if the trust beneficiaries have no right to present enjoyment of the transferred property, the annual exclusion will not apply, as no present interest will have been transferred. However, the courts and the IRS have long agreed that a temporary right of withdrawal of trust property on the part of a beneficiary may serve to create a present interest, thus qualifying such a gift for the annual exclusion. This result obtains even if the right of withdrawal is of short duration, and even if all parties involved expect that the right will not be exercised, and thus the beneficiary will not actually “enjoy” the transferred property on a current basis as a practical matter.⁹⁰⁴ For example, a married couple may establish a trust for the benefit of their minor child, and the general terms of the trust may allow distributions to the child only upon reaching age 25. This couple nevertheless can transfer \$22,000 per year to the trust, fully sheltered by the annual exclusion, as long as the child is given a temporary power to demand distribution of each new amount transferred into the trust, even if it is highly improbable that the power will be exercised. These powers, and these arrangements in general, are referred to as “Crummey powers,” and “Crummey trusts” (so named after a court case upholding one such arrangement).

While Crummey powers may be used in connection with simple transfers of cash or any other kind of asset into a trust, use of the powers is particularly common in the case of life insurance trusts. In these arrangements, a trust owns the life insurance policy, the insured makes periodic payments into the trust for the purpose of covering the premiums, and the trust

⁹⁰¹ The statute provides an amount of \$10,000, adjusted in \$1,000 increments for inflation occurring after 1997. The inflation-adjusted amount for 2005 is \$11,000.

⁹⁰² See sec. 2513.

⁹⁰³ See *Helvering v. Hutchings*, 312 U.S. 393 (1941).

⁹⁰⁴ See *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321.

beneficiaries are given Crummey powers with respect to these periodic payments, in order to ensure that the payments qualify as transfers of present interests eligible for the gift tax annual exclusion.

In recent years, taxpayers have used Crummey powers to achieve benefits extending beyond the conversion of future interests into present interests. Specifically, taxpayers have taken the position that the holder of the Crummey power need not even be a vested beneficiary of the trust, which creates the possibility of using multiple annual exclusions (one for each Crummey power holder) for what ultimately will be a gift to a single donee, as a practical matter. The Tax Court has sustained this position.⁹⁰⁵

Reasons for Change

Recent arrangements involving Crummey powers have extended the “present interest” concept far beyond what the Congress likely contemplated in enacting the gift tax annual exclusion, resulting in significant erosion of the transfer-tax base.

Description of Proposal

In general

The proposal sets forth three options that the Congress may wish to consider for improving the tax treatment of Crummey powers.

Option 1

Under the first option, for purposes of determining the applicability of the annual exclusion, a holder of a Crummey power is not treated as the donee with respect to an amount transferred into trust unless such holder is also a direct, noncontingent beneficiary of the trust. The Treasury Secretary is given regulatory authority to disregard other Crummey powers in cases in which the holder of a power is given a relatively small vested interest in a trust, with a principal purpose of avoiding the application of this provision. This option is designed simply to prevent taxpayers from claiming multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person.

⁹⁰⁵ See *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991). Taxpayers still must exercise some caution in executing this strategy: under section 2514(e), the lapse of a Crummey power may itself be treated as a taxable gift from the power holder to the beneficiary of such lapse, but only if the property subject to the lapsed power exceeds the greater of \$5,000 or five percent of the value of trust assets available to satisfy the power. To avoid the application of this rule, taxpayers either may limit their Crummey powers to \$5,000 each, or may fund the underlying trust with at least \$220,000 (such that an \$11,000 Crummey power would not exceed five percent of trust assets).

Option 2

Under the second option, for purposes of determining the applicability of the annual exclusion, powers to demand the distribution of trust property are taken into account only if they cannot lapse during the holder's lifetime. This option effectively eliminates Crummey powers as a tax planning tool.

Option 3

Under the third option, for purposes of determining the applicability of the annual exclusion, powers to demand the distribution of trust property are taken into account only if: (1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power and disregards those that are found to be essentially lacking in substance. In view of the prevalence of Crummey powers that essentially lack substance, the practical effect of this option would be to eliminate Crummey powers as a planning tool in a wide range of cases.

Effective Date

The first option is effective for transfers made after the date of enactment.

The second and third options are effective for transfers made to trusts that are established after the date of enactment.

Discussion

In general

Crummey arrangements are often essentially shams, and yet they are for the most part respected for gift tax purposes. While it is arguably troubling for any arrangement essentially lacking in substance to be given credence for any purpose under the tax law, it nevertheless may be appropriate to distinguish among various uses of Crummey powers. In many cases, even though the Crummey power is essentially a sham, the results may be considered unobjectionable, as the powers may be used simply to provide somewhat greater flexibility in making a gift in trust to a single person without running afoul of the present-interest constraint. In other cases, the results may be considered more objectionable, such as when the powers are used to claim multiple annual exclusions in connection with gifts that are intended and arranged to accrue to a single person.

Option 1

If Crummey powers held by individuals with no significant interest in the underlying trust assets are respected for purposes of determining the annual exclusion, then taxpayers are effectively free to mint multiple annual exclusions for what is in substance a gift through the trust to a single beneficiary. This power to mint exclusions is limited only by the number of friends and relatives that a donor can find and can trust not to exercise the withdrawal right during its brief existence. The use of Crummey powers for this purpose is an abuse of the annual

exclusion and may cause significant erosion of the transfer tax base. By requiring a Crummey power holder to be a significant, vested beneficiary of the underlying trust, the first option would curtail this abuse of Crummey powers. At the same time, this option would preserve the availability of the powers for the more limited purpose of allowing a donor to place practical constraints on a donee's enjoyment of a gift without running afoul of the present-interest limitation. This option would not affect standard life insurance trusts. Because this option narrowly targets abusive applications of Crummey powers, it is effective for transfers made after the date of enactment, regardless of whether the trust already existed prior to enactment.

Option 2

Crummey powers arguably have eviscerated the present-interest requirement. This requirement was originally designed to protect the integrity of the per-donee annual exclusion amount under the gift tax. As the *Cristofani* case illustrates, if an exclusion amount is allowed to attach to an interest that lapses, then it becomes possible for the benefit of the gift shielded by the exclusion ultimately to inure to some other person, resulting in an inappropriate multiplication of the exclusion amount. Narrowly targeted anti-abuse rules that leave Crummey powers basically intact--like the first option above--may leave open some avenues of abuse. The second option ensures that the benefit of a gift will inure only to the holder of a withdrawal power, by respecting that power for tax purposes only if it never lapses. On the other hand, as noted above, Crummey powers are well-established tools widely used for the purpose of making a gift in trust to a single person without running afoul of the present-interest constraint. Eliminating the powers could force a large number of individuals to revisit their family financial plans, although this problem would be mitigated significantly by grandfathering transfers made to existing trusts.

Option 3

Some may argue that Crummey powers are objectionable only insofar as they are effectively shams. According to this view, the case law on this subject is problematic only because it allows "wink and a nod" arrangements to dictate tax results, with little analysis of the surrounding facts and circumstances. It would arguably be inappropriate to disregard a lapsing withdrawal power that might actually be exercised as a practical matter, thus making the second option too aggressive according to this view. In such a case, possession of the power actually is tantamount to ownership of a present interest in property. The IRS and the courts are equipped to examine the substance of these arrangements, and doing so arguably would lead to appropriate, commonsense results: illusory powers would be given no tax effect, and real powers would be given tax effect. As a practical matter, if such a rule were applied vigorously, it would eliminate most common Crummey arrangements, as such arrangements generally involve powers that are not expected to be exercised. Thus, like the second option above, this option could force a large number of individuals to revisit their family financial plans (and thus, this option also would grandfather transfers to existing trusts). This option would present the administrative and compliance difficulties common to all rules that require facts-and-circumstances determinations.

**D. Provide Reporting for a Consistent Basis Between the Estate
Tax Valuation and the Basis in the Hands of the Heir
(sec. 1014)**

Present Law

The value of an asset for purposes of the estate tax is the fair market value at the time of death or at the alternate valuation date. The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or alternate valuation date, if elected by the executor. Under regulations, the fair market value of the property at the date of the decedent's death (or alternate date) is deemed to be its value as appraised for estate tax purposes.⁹⁰⁶ However, the value of property as reported on the decedent's estate tax return provides only a rebuttable presumption of the property's basis in the hands of the heir. Unless the heir is estopped by his or her previous actions or statements with regard to the estate tax valuation, the heir may rebut the use of the estate's valuation as his or her basis by clear and convincing evidence. The heir is free to rebut the presumption in two situations: (1) the heir has not used the estate tax value for tax purposes, the IRS has not relied on the heir's representations, and the statute of limitations on assessments has not barred adjustments; and (2) the heir does not have a special relationship to the estate which imposes a duty of consistency.

For property acquired by gift, the basis of the property in the hands of the donee generally is same as it was in the hands of the donor. However, for the purpose of determining loss on subsequent sale, the basis of property in the hands of the donee is the lesser of the donor's basis or the fair market value of the property at the time of the gift.⁹⁰⁷

Reasons for Change

Providing an heir with fair market value information gives the heir records to improve reporting of income upon future realization of gain. Providing the IRS with the same information would better enable the IRS to challenge inappropriate attempts to underreport gain upon a subsequent realization of that gain.

Description of Proposal

The proposal requires that for any property acquired as a bequest from an estate which has a Federal estate tax liability, the executor is required to provide the heir and the IRS with a statement of the value of the asset reported for estate tax purposes. The value so reported is binding on the heir as his or her basis for the purpose of computing future gain or loss as provided under present law. The proposal does not apply to items of income in respect of a decedent or property that the executor of the decedent's estate sells.

⁹⁰⁶ Treas. Reg. sec. 1.1014-3(a).

⁹⁰⁷ Sec. 1015(a).

Effective Date

The proposal is effective for transfers from estates for which the estate tax return is filed after the date of enactment.

Discussion

Under present law, generally the incentive exists for an executor to offer conservative estimates of the value of assets in an estate. For the purpose of determining gain or loss on an inherited asset, generally the heir would prefer a higher basis.⁹⁰⁸ The government is potentially whipsawed by inconsistent valuations. For example, the IRS has ruled that while value as appraised for estate tax purposes provides a presumptive value for the basis of inherited property in the hands of a beneficiary, such estate tax valuation generally is not conclusive.⁹⁰⁹ In a case discussed in a technical advice memorandum,⁹¹⁰ at the time of the decedent's death the taxpayer owned stock in two closely held corporations. On audit, the IRS proposed a higher value for the stock than the value the executor provided on the estate tax return. The estate subsequently argued for a lower valuation and the IRS agreed to an amount in between the two parties' initial valuations. Following a redemption of the inherited stock from the beneficiary, the beneficiary (in an amended return for the taxable year of redemption) claimed a basis in the stock that was higher than both the original estate tax return value and the agreed upon value.

Underlying the rebuttable presumption rule set forth in the technical advice memorandum is the theory that a taxpayer should not be estopped from claiming a basis different from the value determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination or benefit from it. This theory represents an application of an estoppel principle that is used outside the context of the estate tax. Where, however, a taxpayer succeeds in presenting clear and convincing evidence of a higher basis than the value used for estate tax purposes, this principle conflicts with one rationale for the section 1014 basis step-up rule. Some analysts argue that the step-up of an asset's basis at death is an appropriate adjustment to prevent property transferred at death from being subject to both Federal income tax and estate tax. If the basis in the hands of the heir exceeds the value used for estate tax purposes, an exemption from income tax in excess of the appreciation in decedent's hands has been implicitly created. By helping to ensure consistency in value for estate and income tax purposes, the proposal at least mitigates the whipsawing of the government that may occur under present law.

⁹⁰⁸ This preference is especially clear in the case of a spouse of the decedent. That spouse will not bear the burden of an estate tax on his or her bequest. Other beneficiaries generally will bear the burden of the estate tax and therefore may have competing preferences.

⁹⁰⁹ In Rev. Rul. 54-97, 1954-1 C.B. 113, the IRS concluded, "Except where the taxpayer is estopped by his previous actions or statements, such value [the value of the property as determined for estate tax purposes] is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence."

⁹¹⁰ Tech. Adv. Mem. 199933001 (January 7, 1999).

In general, in the computation of capital gain or loss, establishing basis in property is a problem area for taxpayers and the IRS, because the basis in the property only becomes important for determining tax liability when the asset is sold, often many years after the asset is acquired. Taxpayers may lose records in the interim. The difficulty would be particularly acute where the taxpayer did not purchase the asset in question and thereby would have no records (e.g., receipts or other purchase documentation) to begin with. Thus, another rationale for the basis step-up rule of present law section 1014 is to provide administrative simplicity for the heir and the IRS because the heir's fair market value basis will potentially already have been determined for estate tax purposes. The proposal achieves this administrative advantage by having basis reported at the time an asset is bequeathed, thereby establishing a record comparable to purchase documentation. Present law arguably fails to achieve this advantage, both because the executor is not required to report the estate tax value to the heir, and because the heir is not required in all cases to use such value in determining basis.

Under the proposal there would be instances in which the value of an asset reported by an executor to an heir differs from the ultimate value of the asset used for estate tax purposes. For example, if the IRS challenges an estate valuation and prevails, the executor will have reported to the heir a valuation that is "too low" and the heir may arguably be overtaxed on a subsequent sale of the asset. This same problem exists under present law to the extent the initially reported estate tax value is presumptively the heir's basis. To provide complete consistency between estate tax valuation and basis in the hands of an heir may be impractical as ultimate determination of value for estate tax purposes may depend upon litigation and an heir may sell an asset before the determination of value for estate tax purposes.

By requiring the value of an asset reported for estate tax purposes to be reported and used by the heir in determining basis, however, the proposal has the salutary effect of encouraging a more realistic value determination in the first instance. This salutary effect would be lost if there were a relief mechanism for heirs and estates (and recoupment for the government) if the basis used by heirs differs from the fair market value ultimately determined for estate tax purposes.⁹¹¹ Thus, the proposal does not contain any such relief mechanism.

⁹¹¹ Compare *Ford v. United States*, 276 F.2d 17 (Ct. Cl. 1960) (permitting taxpayers for income tax purposes to use a basis for inherited assets greater than the fair market value reported for estate tax purposes; two dissenting judges argued that the government was entitled to recoupment from the taxpayers for previous underpayment of estate taxes based on a lower property valuation).

**E. Modify Transfer Tax Provisions Applicable to
Section 529 Qualified Tuition Accounts
(sec. 529)**

Present Law

Overview

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.⁹¹² A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”). In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”).

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals on behalf of a designated beneficiary, with decisions with respect to the contract or account to be made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”) whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account or contract. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.⁹¹³ Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose, without the consent of the designated beneficiary. As a result, in many qualified tuition programs, neither the contributor nor the designated beneficiary has legally

⁹¹² For purposes of this description, the term “account” is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

⁹¹³ Section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term account owner, which is a commonly used term among qualified tuition programs.

enforceable protections designed to assure that the account will be used to provide education or other benefits to the designated beneficiary.

Section 529 does not provide for any quantitative limits on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account, other than to require that the account provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary. Many qualified tuition programs impose limits on the maximum amount of contributions that may be made, or account balances that may accrue, for the benefit of a designated beneficiary.⁹¹⁴

Generally applicable transfer tax provisions⁹¹⁵

A gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. A taxpayer may exclude \$11,000 (for 2005) of gifts made to any one donee during a calendar year. The annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders). Married individuals may treat gifts made to any one donee as having been made one-half by such donor and one-half by his or her spouse, effectively allowing a married couple to exclude \$22,000 (for 2005) of gifts made to any one donee during a calendar year.

The gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.⁹¹⁶ If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. For example, a power to distribute corpus for the education of the beneficiary generally is a power limited by such a standard, whereas a power to distribute corpus for the happiness of the beneficiary is not.⁹¹⁷

⁹¹⁴ For example, a qualified tuition program might provide that contributions to all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit (e.g., \$250,000), or that the maximum account balance for all accounts established for the benefit of a particular designated beneficiary may not exceed a specified limit. In the case of prepaid tuition contracts, the limit might be expressed in terms of a maximum number of semesters.

⁹¹⁵ The principles described in this section are certain of the generally applicable gift, generation-skipping transfer, and estate tax rules that generally apply to taxpayers to determine transfer tax consequences. As is described below, the generally applicable transfer tax provisions are modified by present-law section 529 with respect to qualified tuition accounts.

⁹¹⁶ Treas. Reg. sec. 25.2511-1(a).

⁹¹⁷ Treas. Reg. sec. 25.2511-1(g)(2).

For estate tax purposes, the value of the decedent's gross estate includes the value of all property to the extent of the decedent's interest therein at the time of his or her death,⁹¹⁸ including the value of certain interests in property transferred by the decedent during his or her life (sections 2035 through 2038), and special kinds of property and powers held by the decedent or on the life of the decedent (sections 2039 through 2042, including powers of appointment governed by section 2041).⁹¹⁹ For example, section 2036 provides for the inclusion of transferred property with respect to which the decedent retained the income or the power to designate who shall enjoy the income of the property, and section 2038 provides for the inclusion of transferred property if the decedent had at the time of his or her death the power to change the beneficial enjoyment of the property.

A generation-skipping transfer ("GST") tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). In general, if an outright gift is not subject to gift tax because of application of the gift tax annual exclusion, then it will not be subject to GST tax.

Absent the specific transfer tax provisions of section 529, the generally applicable gift, GST, and estate tax provisions would apply to qualified tuition accounts.

Income tax treatment of qualified tuition accounts

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax. Contributions to a qualified tuition account (or with respect to a prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education expenses, no portion of the distribution is subject to income tax.⁹²⁰ If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax,⁹²¹ and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).⁹²² A change in the designated beneficiary of an account or

⁹¹⁸ Sec. 2033.

⁹¹⁹ Treas. Reg. sec. 20.2031-1(a).

⁹²⁰ Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

⁹²¹ Sec. 529(c)(3)(A) and (B)(ii).

⁹²² Sec. 529(c)(6).

prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.⁹²³

Gift and GST tax treatment of qualified tuition accounts

Section 529 modifies the generally applicable gift and GST tax provisions that otherwise would apply to qualified tuition accounts.⁹²⁴ A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary. Such contributions qualify for the per-donee annual gift tax exclusion, and, to the extent of such exclusions, also are exempt from the GST tax. A contributor may contribute up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax. Those taxes apply, however, to a change of designated beneficiary if the new designated beneficiary is in a generation below that of the former beneficiary or is not a member of the family of the former beneficiary.⁹²⁵

Estate tax treatment of qualified tuition accounts

Section 529 modifies the generally applicable estate tax provisions that otherwise would apply to qualified tuition accounts.⁹²⁶ Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual. Amounts distributed on account of the death of the designated beneficiary, however, are includible in the

⁹²³ Sec. 529(c)(3)(C)(ii). For this purpose, “member of family” means, with respect to a designated beneficiary, the spouse of such beneficiary, or an individual who bears one of the following relationships to such beneficiary: a son, daughter, or a descendant of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law, or the spouse of any such individual; and the first cousin of such beneficiary. Sec. 529(e)(2).

⁹²⁴ Sec. 529(c)(2) and (5).

⁹²⁵ Prior to enactment of section 406(a) of the Working Families Tax Relief Act of 2004, P.L. No. 108-311, a new beneficiary was not explicitly required to be a member of the family of the former beneficiary in order to avoid imposition of the gift and GST taxes upon a change of beneficiary. Section 406(a) of the Act amended section 529(c)(5) to provide that gift and GST taxes are imposed on a change of designated beneficiary unless (1) the new beneficiary is of the same or a higher generation than the former beneficiary, and (2) the new beneficiary is a member of the family of the former beneficiary. The amendment made by the Act was effective as if included in the Taxpayer Relief Act of 1997.

⁹²⁶ Sec. 529(c)(4).

designated beneficiary's gross estate. If a contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed by the contributor that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.

Reasons for Change

Present law regarding the transfer tax treatment of section 529 accounts is unclear in many situations, and in other situations imposes transfer taxes in a manner that is inconsistent with otherwise applicable transfer tax provisions. In addition, the present-law section 529 transfer tax rules do not adequately reflect the structural changes that have occurred to qualified tuition programs over the past few years, many of which have been designed to provide maximum flexibility to the program's account owners, rather than assure that account funds will be used to fund educational expenses of a designated beneficiary.

Description of Proposal

Modify special transfer tax provisions of section 529

In general

The proposal modifies the special transfer tax (gift, GST, and estate tax) provisions of present-law section 529, and generally subjects qualified tuition accounts to otherwise applicable transfer tax provisions. In general, a contribution to a qualified tuition account is not treated as a completed gift, and is includible in the estate of the contributor or account owner, unless the terms governing the account satisfy certain requirements. The proposal defines an account owner as the person whom the program administrator may look to for decisions, recordkeeping, and reporting with respect to the qualified tuition account. The present-law income tax rules applicable to qualified tuition accounts do not change.

Contributions treated as completed gifts to designated beneficiary

Under the proposal, an amount contributed to a qualified tuition account is treated as a completed gift of a present interest to the designated beneficiary (and becomes includible in the estate of the designated beneficiary) at the time of the contribution only if: (1) the designated beneficiary is living at the time the account is established; (2) only the designated beneficiary may terminate the account or change the designated beneficiary during the designated beneficiary's lifetime, and such termination or change of beneficiary may not occur prior to the designated beneficiary's attaining age 18, receiving a high school diploma, or becoming learning disabled; (3) if the designated beneficiary dies before attaining age 18, the personal representative of the deceased beneficiary may designate a successor designated beneficiary who is a member of the family (and of the same generation as) the designated beneficiary, or terminate the account; and (4) a distribution upon termination of the account may be made to or for the benefit of a person (including to an educational institution) other than the designated beneficiary only if (a) such other person is irrevocably designated at the time the contract is executed, or is a member of the family of (and in the same generation as) the designated

beneficiary,⁹²⁷ and is a person other than the contributor and account owner; and (b) such distribution may be made only if the designated beneficiary dies, becomes learning disabled, certifies that the designated beneficiary has reached the age of 18 and will not attend a college or university, has received a scholarship in an amount equal to or greater than the amount of the distribution, or certifies that the account balance or prepaid benefit exceeds the designated beneficiary's actual educational expenses. If such conditions are satisfied, then the contribution is treated as a completed gift of a present interest by the contributor (whether the account owner or a person other than the account owner) to the designated beneficiary, the contributor may elect to take the contribution into account as a gift ratably over the five-year period beginning with the year of the contribution,⁹²⁸ and no further transfer tax consequences apply upon a change of account owner, a change of designated beneficiary, or a distribution from the account.

Example.—Mother establishes a qualified tuition account and designates her living child (Child) as the designated beneficiary. The account's terms provide that Mother is the account owner, but that only Child may terminate the account or change the designated beneficiary, and that any distribution other than to or for the benefit of Child must satisfy the other conditions described above. Mother makes a \$55,000 contribution to the account in Year 1. In Year 5, a distribution of \$25,000 is made from the account for Child's benefit and paid to an eligible educational institution. Under the proposal, Mother's contribution is treated as a completed gift of a present interest by Mother to Child in Year 1, and Mother may elect to treat the gift as made ratably over the five-year period (i.e., \$11,000 per year) beginning with Year 1. If Child's grandparent (Grandfather), rather than Mother, makes the contribution to the account, then Grandfather is treated as making the completed gift to Child and may elect the application of the special five-year rule. The distribution in Year 5 is not a transfer for transfer tax purposes.

Amounts treated as includible in estate of account owner

In those circumstances involving qualified tuition accounts that do not satisfy the requirements described above, a completed gift to the designated beneficiary does not occur until an amount is distributed from the qualified tuition account to or for the benefit of the designated beneficiary. In such cases, the transfer tax consequences of a contribution to a qualified tuition account depend upon whether the contribution is made by the account owner or by a person other than the account owner. Contributions made by the account owner are not a completed gift and remain includible in the account owner's estate. Contributions made by a person other than the account owner are governed by generally applicable transfer tax principles, and may constitute a completed gift of a present interest to the account owner at the time of the contribution that

⁹²⁷ The proposal contemplates that an account need not provide for irrevocable designations of distributees at the time the account is established, and may permit changes to the person designated as entitled to receive a distribution upon termination of the account if the person is a member of the family (and in the same generation as) the designated beneficiary.

⁹²⁸ In such a case, no additional gift is treated as made at the time the account is used for the benefit of the designated beneficiary, whether for educational or other purposes.

become includible in the account owner's estate.⁹²⁹ A completed gift of a present interest by the account owner occurs at the time an amount is distributed from the account to or for the benefit of a person other than the account owner (e.g., the designated beneficiary), whether for educational or other purposes.⁹³⁰ In these cases, a change of account owner is a completed gift to the new account owner (not eligible for the special five-year rule), but a change of designated beneficiary is not a completed gift.

Example.—Mother establishes a qualified tuition account and designates her living child (Child) as the designated beneficiary. The account's terms provide that Mother is the account owner, and that Mother may terminate the account, change the designated beneficiary, and direct that a distribution be made other than to or for the benefit of Child. Mother makes a \$55,000 contribution to the account in Year 1. In Year 5, a distribution of \$25,000 is made from the account for Child's benefit and paid to an eligible educational institution. Under the proposal, Mother's contribution in Year 1 is not a completed gift by Mother to Child, and the account remains includible in Mother's estate. If Child's grandparent (Grandfather), rather than Mother, makes the contribution to the account, Grandfather is treated as making a completed gift of a present interest to Mother (rather than to Child), and Grandfather may not elect the application of the special five-year rule. The \$25,000 distribution from the account for the benefit of Child constitutes a completed gift of a present interest by Mother to Child (not eligible for the special five-year rule) at the time of the distribution, and may be excludable as a qualified transfer within the meaning of section 2503(e)(2) if paid for Child's tuition.

Effective Date

The proposal applies to contributions (and earnings thereon) made in taxable years beginning after the date of enactment. The proposal does not apply to contributions made on or before the effective date (and earnings thereon). Separate accounting of such contributions is required.

Discussion

Recent changes in qualified tuition account program design

Present-law section 529 is unclear with respect to the transfer tax consequences of certain events pertaining to qualified tuition accounts, imposes transfer taxes in a manner that is inconsistent with otherwise applicable transfer tax principles, and creates opportunities for abuse by taxpayers who may establish such accounts with no intention of providing education benefits to others. In addition, present-law section 529 affords taxpayers who establish qualified tuition

⁹²⁹ In such cases, the special five-year rule is not available to permit the contributor to treat the gift as made to the account owner ratably over a five-year period, because the benefit of the five-year rule is limited to those instances where the account is irrevocably dedicated for the benefit of the designated beneficiary.

⁹³⁰ At the time of such a distribution, an exclusion from gift tax is available if the distribution satisfies the requirements of section 2503(e) (i.e., is made as tuition to an educational organization).

accounts a combination of income tax and transfer tax benefits that is more favorable than those available for other tax-favored accounts, such as individual retirement accounts and health savings accounts. Although other tax-favored accounts obtain income tax benefits similar to those available for section 529 accounts, qualified tuition accounts are unusual in that section 529 permits a taxpayer to avoid estate, gift and GST taxes even if (as is the case in many qualified tuition programs) the taxpayer effectively retains control of the qualified tuition account.

Section 529 was enacted in 1996.⁹³¹ Since then, qualified tuition programs have increased significantly, both in the number of accounts and aggregate funds, with more than \$35 billion invested in such programs as of early 2004.⁹³² Some have estimated the number of section 529 accounts at approximately five million,⁹³³ and program assets soon approaching \$50 billion.⁹³⁴ Others have predicted that total assets in qualified tuition programs will reach \$300 billion by 2010.⁹³⁵

In 1986, the State of Michigan adopted the first prepaid tuition program in the United States.⁹³⁶ The Michigan prepaid tuition program prohibited the account owner from changing the designated beneficiary, and limited the ability of the account owner to use the funds other

⁹³¹ Pub.L. No. 104-188, sec. 1806(a) (effective for tax years ending after August 20, 1996).

⁹³² Opening Statement of Chairman Michael G. Oxley, House Financial Services Committee, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Investing for the Future: 529 State Tuition Savings Plans*, June 2, 2004.

⁹³³ Statement of Charles Toth on Behalf of The College Savings Foundation and Securities Industry Association Before the United States Senate Committee on Finance on the Role of Higher Education Financing in Strengthening U.S. Competitiveness in a Global Economy, July 22, 2004 (citing Financial Research Corporation, Quarterly Update April 2004, and reporting that most of the growth in program assets has occurred since 2001, from \$8.5 billion at the end of 2001 to over \$40 billion in the first quarter of 2004).

⁹³⁴ Morningstar Investment Research Firm estimates that investors have assets totaling more than \$47 billion in section 529 accounts. Morningstar Testimony to the House Financial Services Committee, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, June 2, 2004.

⁹³⁵ Opening Statement of Ranking Democratic Member Paul E. Kanjorski, House Financial Services Committee, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Investing for the Future: 529 State Tuition Savings Plans*, June 2, 2004 (citing Financial Research Corporation).

⁹³⁶ *State of Michigan and Michigan Education Trust v. U.S.*, 40 F.3d 817, 818 (6th Cir. 1994).

than for the beneficiary's education expenses.⁹³⁷ The current Michigan prepaid tuition program retains these restrictions. Under the current Michigan prepaid tuition program, only a student who is at least 18 years of age or has obtained a high school diploma may terminate a prepaid tuition account and compel a distribution of the account balance.⁹³⁸ A parent or purchaser of the prepaid contract may not terminate the account for any reason other than if the student has died or has become learning disabled. If the student reaches age 18 or receives a high school diploma, the student has the option of transferring the account to an immediate family member or terminating the account to obtain a refund paid to a refund designee established at the time the account was established.⁹³⁹ A student who receives a scholarship or other type of tuition assistance may receive the excess account funds not needed to pay for the student's educational expenses. Use of the prepaid tuition account for other purposes is not permitted under the program.

As of January 2004, there were 17 State prepaid tuition programs, and 51 State savings programs.⁹⁴⁰ Few qualified tuition programs impose requirements designed to meaningfully restrict beneficiary changes or limit use of the account or contract to qualified higher education expenses. Present-law section 529 provides the same transfer tax outcomes for all qualified tuition accounts, without regard to the rights and controls retained by the contributor or account owner. The proposal provides for uniform transfer tax treatment for all plans that satisfy the proposed requirements that treat a contribution as a completed gift of a present interest. The transfer tax consequences for accounts established under programs that do not satisfy the proposed requirements would depend upon the particular terms and restrictions applicable to the account.

The Administration's Fiscal Year 2005 Budget included a proposal to modify certain of the rules regarding qualified tuition accounts. The explanation of the Administration's proposal stated that "[c]urrent law regarding the transfer tax treatment of section 529 accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions... In addition, the lack of any limits on who can be named a [designated

⁹³⁷ Priv. Ltr. Rul. 8825027 (describing the account terms as follows: individual A contributes amounts to trust to be used to provide educational benefits to B, an irrevocably designated beneficiary; cash refund of prepaid amount may be made to C, a person irrevocably designated by A at the time the contract is executed, but only if B dies, is denied admission to a Michigan public educational institution, or certifies that B has reached the age of 18 and will not attend a college or university, or if the State program is determined to be actuarially unsound).

⁹³⁸ A student who is mentally disabled or under 18 years of age must be represented by a legal guardian.

⁹³⁹ The refund designee may be the student or another person designated at the time the account was established. A change of beneficiary of the prepaid tuition account may be accomplished only through these limited account transfer provisions.

⁹⁴⁰ National Association of Student Financial Aid Administrators (NASFAA) State Plan Summary Chart, *available at* www.nasfaa.org/PDFs/2002/CSP0202.pdf.

beneficiary] creates opportunities for the unintended and inappropriate use of section 529 plans. For example, taxpayers may seek to use section 529 accounts as retirement accounts, with all the tax benefits but none of the restrictions and requirements of qualified retirement accounts, or to avoid gift and GST taxes by changing the [designated beneficiary] of existing section 529 accounts.”⁹⁴¹ The Administration stated that the law “should be clarified to provide taxpayers with certainty as to the tax consequences of a transfer and to eliminate the inappropriate imposition of transfer taxes.”⁹⁴²

Subjecting qualified tuition accounts to generally applicable transfer tax provisions would reduce the potential for abuse by taxpayers who establish such accounts with no intention of ultimately providing education benefits to other persons, and would put qualified tuition accounts on a more level playing field with other tax incentive vehicles such as IRAs, while retaining the substantial income tax benefits provided by the present-law section 529 provisions for qualified tuition accounts. Under the proposal, a taxpayer could treat the contribution of amounts to a qualified tuition account as a completed gift, excludable from his or her estate, only if he or she relinquished control over the use and enjoyment of the account. Other potential solutions offered to prevent abuse of the accounts, such as imposing aggregate quantitative per-contributor or per-beneficiary limits on contributions or account balances, would be difficult to administer because they would require coordination of recordkeeping and reporting by the various State-sponsored and private qualified tuition programs. In addition, the present-law provisions cannot be made consistent with generally applicable transfer tax principles without materially altering the structural design of most qualified tuition programs.

Transfer tax deficiencies of present-law section 529

Section 529 does not explicitly address the transfer tax consequences of certain events that are commonplace under existing qualified tuition programs. For example, section 529 does not address the transfer tax consequences of a change of account owners of a qualified tuition account. It is unclear whether a change of account owner is to be regarded as a completed gift of a present interest from the former account owner to the new account owner, or as having no tax consequences because a completed gift had been made to the designated beneficiary. Further, section 529 does not identify which party is responsible for payment of the transfer tax when it is imposed (i.e., in instances involving a change of designated beneficiary to a person who is in a

⁹⁴¹ Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2005 Revenue Proposals*, February 2005, 136-37.

⁹⁴² *Id.* The Administration’s proposal generally would modify certain income tax, gift tax, generation-skipping transfer tax, and estate tax rules with respect to changes in designated beneficiaries of qualified tuition accounts, impose new eligibility rules for designated beneficiaries, require that a qualified tuition account be a custodial arrangement maintained for the benefit of a designated beneficiary, and impose new excise taxes on amounts that are used other than for qualified higher education expenses. For a description and analysis of the Administration’s proposal, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2005 Budget Proposal*, (JCS-3-04), February 2004, 306-17.

generation lower than the former beneficiary). In such cases, it is not clear whether the gift tax should be imposed on the former designated beneficiary, the original contributor, the account owner, or perhaps on the account. This lack of clarity creates complexity for taxpayers in arranging their affairs, and for the IRS in attempting to administer the present-law rules.

In addition, section 529 departs from otherwise generally applicable transfer tax principles in at least five ways. First, present-law section 529 treats a contribution to a qualified tuition account as a completed gift of a present interest to the designated beneficiary,⁹⁴³ even though in most instances the designated beneficiary possesses no rights to control the qualified tuition account or withdraw funds, and such control (including the right to change beneficiaries or to withdraw funds, including for the benefit of someone other than the designated beneficiary) is vested in the account owner.⁹⁴⁴ Second, a change of designated beneficiary to a new beneficiary who is in a generation lower than the former beneficiary constitutes a taxable gift, even though the new designated beneficiary would not, under otherwise applicable transfer tax principles, be regarded as receiving a completed gift. Third, an account owner is not required to include in the account owner's estate the amount held in a qualified tuition account, even if the account owner possesses at his or her death the right to withdraw funds for the benefit of someone other than the designated beneficiary or to change the designated beneficiary.⁹⁴⁵ Fourth, a distribution from a qualified tuition account is not treated as a taxable gift unless the distributee is of a generation lower than the designated beneficiary.⁹⁴⁶ Fifth, under present-law section 529, there is no express requirement that the multiple annual present interest exclusion is

⁹⁴³ Sec. 529(c)(2).

⁹⁴⁴ Absent section 529, such contributions generally would not be treated as completed gifts to the designated beneficiary under otherwise applicable transfer tax principles. Under otherwise applicable transfer tax principles, the designated beneficiary's lack of control over the qualified tuition account generally would be regarded as a future interest, and any completed gift of a present interest would be regarded as having been made from the contributor to the account owner (rather than to the designated beneficiary). In cases where the contributor and the account owner are the same person, no gift would take place under generally applicable transfer tax principles.

⁹⁴⁵ Under otherwise applicable estate tax principles, the account owner generally would be regarded as possessing rights with respect to the qualified tuition account that cause the account balance to be includible in the account owner's estate for Federal estate tax purposes. See, e.g., secs. 2036 and 2038.

⁹⁴⁶ Under otherwise applicable principles, such distributions would be a taxable gift by the account owner unless the account owner has an obligation to provide such benefits (e.g., the beneficiary is a dependent of the account owner and is obligated to provide education support under State law) or the distribution is a direct purchase of tuition from the school by the qualified tuition account (and would be excludable under section 2503(e)). This exclusion for distributions made to a person who is of a generation of the same generation of the designated beneficiary seems to apply even if the distribution is used by the designated beneficiary other than for qualifying educational expenses.

available only if there is a present intent to allow the designated beneficiary to receive the benefits of the qualified tuition account.⁹⁴⁷

For example, under present-law section 529, a taxpayer might establish 20 separate qualified tuition accounts for 20 separate designated beneficiaries, and immediately deposit \$55,000 in each account.⁹⁴⁸ By doing so, the taxpayer may treat the full amount of each contribution as a completed gift to the designated beneficiary, elect the section 529 five-year annual exclusion treatment for each of the contributions, and exclude the entire \$1.1 million (up to \$2.2 million under gift-splitting) from estate, gift, and GST taxes.⁹⁴⁹ Under present law, the taxpayer may be the account owner with respect to each of these accounts, which under many qualified tuition programs permits the taxpayer to control the account through changes in the designated beneficiary and the withdrawal of funds for any purpose. The taxpayer has avoided the imposition of the estate, gift, and GST taxes even if the account ultimately is not used for education purposes.⁹⁵⁰ The taxpayer also may avoid imposition of the GST by designating beneficiaries who are in generations more than one generation below the generation of the taxpayer. Because section 529 imposes no restrictions on the identity or number of persons for whom qualified tuition accounts may be established, or to which contributions may be made, it has been suggested that the literal application of section 529 could permit a closely-held business employer to establish qualified tuition accounts for each of its employees, and later change the beneficiaries of the accounts to a single individual, without incurring transfer taxes on the transfers to the accounts.⁹⁵¹

⁹⁴⁷ Thus, a contributor may make contributions eligible for multiple \$11,000 annual exclusions by naming multiple beneficiaries of multiple qualified tuition accounts, even if the contributor has no present intent to allow the named beneficiaries (or any beneficiaries) to receive any benefits from the accounts.

⁹⁴⁸ The taxpayer might deposit \$110,000 in each account if he or she is married and elects with the spouse to gift-split for annual exclusion purposes.

⁹⁴⁹ A taxpayer who makes the special five-year ratable allocation annual exclusion election is required to include a portion of the contribution in his or her estate if he or she dies within five years of making the contribution.

⁹⁵⁰ The distribution of the funds for uses other than qualifying educational expenses will be subject to income tax, and an additional 10-percent tax, however, on the earnings portion of the distribution.

⁹⁵¹ Letter from Carlyn S. McCaffrey of the American College of Trust and Estate Counsel to the Internal Revenue Service, February 25, 2003, Q/A-21 Abusive Situations (providing a similar example in the employer-employee context, and noting that section 529 might permit a father that owns a business to transfer \$1,000,000 gift tax-free to his son through the use of section 529 accounts initially established for employees, and stating that the College does not believe that Congress intended to undermine the integrity of the gift tax system by enacting section 529).

Some might argue that the proposal effectively eliminates transfer tax benefits for most qualified tuition programs, and that retention of the special transfer tax principles of present law is desirable to encourage savings for educational purposes. Others might argue that the proposal does not go far enough to maximize the likelihood that the account ultimately is used for educational purposes, and would endorse the imposition of an excise tax (in addition to the present-law additional 10-percent tax) in cases where monies are withdrawn for noneducational purposes. Such an excise tax might be limited to cases where the withdrawal is for the benefit of someone other than the initial designated beneficiary, because in such cases additional transfer tax benefits (such as through generation skipping) might have been derived from the arrangement.