Administration History Appendix
Chapter One: Fiscal Discipline

Estate Tax

94-139620

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

November 8, 1994

ACTION

MEMORANDUM FOR SECRETARY BENTSEN

FROM: LESLIE B. SAMUELS LBS
ASSISTANT SECRETARY FOR TAX POLICY

SUBJECT: Estate and Gift Tax Simplification Provision

SUMMARY: This memorandum is to apprise you that Ways and Means Republican staff has requested that the tax simplification package currently under consideration be modified to include a provision that would limit the IRS's ability to redetermine the value of a gift after the gift tax statute of limitations has expired. The proposal would promote taxpayer fairness. The IRS opposes the proposal, however, principally because the IRS currently lacks the resources to examine gift tax returns as they are filed.

RECOMMENDATION: We recommend that we support the proposal, provided that more resources can be devoted by the IRS to the examination of gift tax returns.

ACTION: ✓ LMB Agree with recommendation.

________ Disagree.

________ Let's discuss.

DISCUSSION:

Background. The statute of limitations for assessing gift taxes generally runs for a period of no longer than six years. In a number of cases, however, the courts have allowed the Commissioner to redetermine the value of a gift for estate tax purposes long after the gift tax limitations period has expired. A revaluation of a gift at this time can result in the collection of additional estate taxes. Thus, under current law, a taxpayer's valuation of a gift is open to IRS challenge until after the statute of limitations expires on the taxpayer's estate tax return, which may not be until many years after the gift has been made.

Proposal. The proposal would provide that a gift could not be revalued once the statute of limitations for assessing the gift tax had expired. Proponents of the proposal believe it would significantly improve the fairness of the estate tax audit procedures.

EXECUTIVE SECRETARIAT

IRS concerns. The IRS objects to the proposal for several reasons. First, the IRS currently devotes few resources to reviewing gift tax returns. In a recent survey, exam personnel estimated as many as 70 to 90 percent of gift tax returns show no tax due because the donor has not yet reached the $600,000 unified credit threshold for taxable gifts and estates. The IRS generally does not examine these returns, and believes doing so would not be worthwhile because adjustments usually would not result in the collection of additional taxes. In addition, the IRS believes that a significant portion of the taxpayers who file gift tax returns will never owe gift or estate tax because the value of their gifts and estates will never exceed the $600,000 unified credit amount. Second, the IRS believes that reviewing gift tax returns is often fruitless because donors' patterns of giving, and other facts and circumstances that affect donors' tax liabilities will not be discernable until estate tax returns are filed. Thus, the IRS questions the utility of devoting significant additional resources to the examination of gift tax returns. Third, the IRS is concerned that eliminating its ability to revalue a gift at the time an estate is examined would have a negative impact on taxpayer compliance because it would provide an additional incentive for taxpayers to undervalue gifts.

Comments. Although the IRS seems to have valid concerns about the usefulness of devoting additional resources to the examination of gift tax returns, it seems unfair to require an estate to prove the value of any gifts made by the decedent more than six years previously. We believe this unfairness outweighs the IRS's concerns. Nonetheless, we think it would be worthwhile to obtain additional information from the IRS on how often gifts are revalued during the examination of estate tax returns in order to determine how useful the IRS finds the extended statute of limitations for gift valuation.

cc: Cynthia Beerbower
Maurice Foley

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

Information

July 18, 1997

MEMORANDUM FOR SECRETARY ROBERT E. RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **DON LUBICK**
ACTING ASSISTANT SECRETARY (TAX POLICY)

SUBJECT: Estate Tax Compromises: Revised

This memo describes a set of estate tax options that would reduce the cost of estate tax changes proposed in the Congressional tax packages and lessen the budgetary cost of estate tax changes beyond the ten-year budget window. We start with a defense of the President's June 30 proposal, followed by several options that move closer to the Congressional proposals. As background, the House bill contains a phased-in increase in the unified estate and gift tax exemption to $1 million by 2007. The provision costs $7.5 billion through 2002 and $27.0 billion through 2007. The Senate bill also increases the exemption to $1 million by 2007, but increases the exemption more gradually. It also includes a modified Daschle-like proposal for qualified businesses. The two primary Senate estate tax provisions cost $6.2 billion through 2002 and $36.1 billion through 2007. Various options are summarized in the following table.

Summary of Estate Tax Options		
	Cost (in billions)	
Policy (all options include the Daschle small business and family farm proposal)	Through 2002	Through 2007
President's June 30 Proposal (Option 1 below) Leave the estate tax exemption unaltered	$2.3	$7.2
Index $600,000 estate tax exemption (Option 2)	$3.8	$18.8
Phase-in estate tax exemption to $700,000 by 2002, index thereafter	$4.6	$20.4
Phase-in estate tax exemption to $800,000 by 2002, index thereafter (Option 3)	$7.0	$30.0
Phase-in exemption to $900,000 by 2002, index	$9.2	$37.9
House Bill (described above)	$7.5	$27.0
Senate Bill (described above)	$6.2	$36.1

Option 1: The President's Proposal

The President's June 30 tax package left the $600,000 estate tax exemption unchanged, but added a special $900,000 exclusion for qualified family-owned businesses and farms.

- o Congressional negotiators will surely criticize us for not increasing the unified credit from its 1987 level. In response we should point out the following facts:

  - If the estate tax exemption were indexed starting in 1954 it would now be $359,599.

  - If the estate tax exemption were indexed starting in 1977 (when it increased to $126,667) it would now be $321,022.

  - If the estate tax exemption were indexed starting in 1982 (when it increased to $225,000) it would now be $376,072.

    -- The exemption equivalent increased from $225,000 in 1982 to $600,000 in 1987. By 1987, only 0.88 percent of adult deaths resulted in a taxable estate, which is the lowest percentage since 1935.

- o The estimated cost of the President's package is $2.3 billion through 2002 and $7.2 billion through 2007. Unlike the Senate bill and the Daschle proposal, this estimate assumes that the proposal adjusts the basis of the exempted property. This technical modification should also be made for the Senate package, which would reduce its cost.

Option 2: Index the $600,000 exemption, reduce estate tax rates, and add the special $900,000 small business and family farm exclusion.

- o This option recognizes that there will be further pressure to increase the $600,000 exemption if it is not indexed. It provides modest estate tax relief by lowering all estate tax rates above the $600,000 exclusion by 1 percentage point (i.e., the 37% marginal rate stays at 37%, but the 39% rate falls to 38%, and all rates above the 39% rate fall by 1 percentage point). Finally, the President's June 30 family-owned business proposal is retained.

- o As illustrated under Option 1 above, the estate tax exemption is already higher than it would have been had it been indexed in 1954, 1977 or 1982. Indexation from the current level will prevent decedents from entering the estate tax rolls due to inflation.

- o The slight decrease in the estate tax rates is offered in order to counteract the bracket creep that is inherent in indexation of the exemption amount.

- o Estimated cost is $5.3 billion through 2002 and $23.8 billion through 2007.

Option 3: Increase the estate tax exemption in $40,000 increments to $800,000 by 2002 and index thereafter. Include the special $900,000 small business and family farm exclusion.

- This option would gradually increase the exemption so that by 2002 it would be roughly equal in real terms to the exemption level in 1986. Indexation would then keep the real value of the exemption at roughly the 1986 level.

- The option could be argued to be consistent with the 1981 legislation, which is the most recent legislation to increase the exemption. The 1998 through 2002 increases in the exemption under the Administration proposal are consistent with the 1981 legislation, which increased the exemption annually from 1982 through 1987. The 1981 legislation increased the exemption partially to offset the effects of high inflation in the late 1970's and early 1980's on the real value of the exemption and partially to offset future expected inflation. But because inflation declined sharply in the mid-1980's, the 1987 exemption probably provided for a larger real exemption than intended. Thus, providing a real exemption roughly equal to the 1986 exemption also seems consistent with the 1981 legislation.

- Expected cost is $7.0 billion through 2002 and $30.0 billion through 2007.

Option 4: Broaden the estate tax base and lower estate tax rates

- Well-advised taxpayers can structure their financial affairs in ways to significantly reduce estate taxes, which undermines confidence in the estate tax and leads to inequitable outcomes where equivalent estates end up with significantly different tax liabilities. This option would index the exemption amount as in Option 2, broaden the estate tax base by eliminating numerous loopholes and planning opportunities that exist under current law, and significantly reduce the estate tax rates. This option would also give estate tax relief to family businesses and farms by extending the availability and benefits of the estate tax installment payment plan.

- Relief for closely-held businesses and farms would include the changes proposed by the President in the original 1998 budget proposal, as well as those included in the House and Senate bills. Thus, the interest rate would be lowered, the length of time for payment would be extended, the amount of tax subject to the favorable interest rate would be greatly increased, the operation of the payment plan would be simplified and the installment payment plan would be made available to many more types of entities.

- Tax policy believes that this is ultimately the proper direction for estate tax reform, and therefore we are including it as one of the options for negotiation.

- The details of this package could be specified to meet any desired revenue loss target.

1997-SE-007927

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

July 22, 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: DON LUBICK DCL/JT
ACTING ASSISTANT SECRETARY (TAX POLICY)

RE: **Estate Tax Options**

This memorandum outlines two possible estate tax options for your consideration. Both options include an increase in the unified credit and some estate tax relief for family businesses and farms.

Option 1: Increase the Unified Credit and Add an Exemption for Family-Owned Business.

The unified credit would be increased so as to increase the exemption amount by $20,000 per year for 10 years, creating an effective exemption from estate tax of $800,000 in 2007. This amount could then be indexed or not. **Revenue estimate**: $3.0 billion/$15.5 billion.

Add a provision exempting certain qualified family owned business interests, similar to the proposal in the June 30 offer, but with the following changes: Each person would be able to exempt up to $1,000,000 of qualified family owned business interest, but the use of this exemption would be offset by (or would offset) the unified credit. Since the unified credit is never subject to recapture, it is assumed that estates would use the unified credit before the family business exemption. Thus, for example, in 1998, a person who owned a qualifying business interest worth in excess of $1,000,000 would use their unified credit to shelter the first $620,000 of value, and elect to apply the exemption to the next $380,000. Once the unified credit is fully phased in, the maximum exemption under this provision would be $200,000. **Revenue estimate**: $0.9 billion/$2.5 billion.

Option 2: Increase the Unified Credit and Expand the Benefits of Estate Tax Deferral.

Increase the unified credit as outlined above. **Revenue estimate**: $3.0 billion/$15.5 billion.

Adopt all of the estate tax deferral (section 6166) changes from the Administration's original budget proposal and those added in the House and Senate bills as follows: Increase the low interest rate portion of the deferral provision from $1,000,000 to $2,500,000 (budget proposal). Eliminate the interest on such portion (House and Senate bills). Reduce the interest rate on the amounts above $2.5 million to 45% of the usual IRS rate on tax underpayments and make such interest payments nondeductible for estate and income tax purposes (as in budget, House and Senate). Extend period for deferral from 14 years to 24 years (House and Senate). Expand the availability and benefits of deferral to all closely held businesses whether owned directly or through holding companies (budget proposal). Authorize the Secretary of the Treasury to accept security arrangements in lieu of the special estate tax lien (budget proposal). We estimate that the present value of a dollar of estate tax (within the range qualifying for the zero interest rate) is 36 cents, and that the present value of a dollar of estate tax (within the range where interest is charged) is 65 cents. **Revenue estimate**: $0.7 billion/$1.9 billion.

2000-SE-007863 To LS 2/13 Please log and file

June 13, 2000

MEMORANDUM FOR SECRETARY SUMMERS
DEPUTY SECRETARY EIZENSTAT

FROM: **LEN BURMAN**
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)

SUBJECT: Menu of Estate Tax Options

As you know, the President asked us to look at three options for modifying the estate tax: raise the exempt amount, lower marginal tax rates, or enact carryover basis and repeal the estate tax. This memo presents some options for raising the exempt amount and reducing rates and explains why political and budget considerations would make carryover basis inadvisable. We also present some options for limiting the budgetary cost of the options.

Background

For context, I've been asked to report on some conversations I had today with Ways and Means Democrats. Mark Iwry, Frank Toohey, and I met with Representatives Neal and Cardin to talk about pension legislation. (I can send you notes from that meeting if you are interested.) They got sidetracked on a discussion about the bad outcome for the estate tax. They agreed that the Democratic alternative was brilliant, because it took effect immediately rather than in ten years, and would exempt most current estate taxpayers from the tax. They thought that estate tax repeal won so decisively because the Democratic alternative was not available when the 45 Democratic cosponsors signed onto the Republican bill, and because repeal was effectively a free vote insofar as the Senate or the Administration could be counted on to block the legislation. They did not seem to think that the size of the Democratic proposal was a key factor in its failure to prevent a debacle.

After the meeting, I ran into John Buckley and asked him where he thought the Administration should be on the estate tax. He urged most strongly that we not raise the bar from that set by the Democratic alternative. He thought that the Democratic alternative would be effective in the Senate and we should be promoting that approach.

Janice Mays, who called the meeting with Neal and Cardin, left for another meeting before I could ask her advice. Bill Fant tried to call her this evening, but did not reach her. We will talk to her tomorrow.

Among your advisers, there is general agreement that we should start with the Democratic alternative. There is not general agreement about whether, or how far, we should go beyond that proposal.

Description of Options

Unless otherwise specified, effective dates for all of the options apply to persons dying and gifts made after December 31, 2000. Please note that the ten-year cost estimates are very rough approximations subject to significant revision. A summary table is at the end of this memo.

1. Baseline Option (House Democratic Alternative)

The base option is the alternative proposed by House Democrats on June 9, 2000. It would immediately raise the exempt amount from $675,000 to $1.1 million; and raise the exemption to $1.2 million in 2005. It would reduce estate tax rates across the board by 20 percent, so the top rate would fall from 55 percent to 44 percent, and pay for this by converting the state death tax credit to a deduction. It would exempt up to $4 million of small farm and business income (QFOBI) for a couple ($2 million for singles). It would limit the revenue cost by closing some estate tax loopholes, some of which were proposed in our budget.

Details

- Reduce all tax rates (except for the 5% surtax) by 20 percent. The resulting statutory rate structure ranges from 14.4 percent on taxable estates under $10,000 to 31.2 percent on taxable estates worth $750,000 less than $1,000,000[1], and continues on as follows:
  - 32.8% on estates of $1,000,000 under $1,250,000
  - 34.4% on estates of $1,250,000 under $1,500,000
  - 36% on estates of $1,500,000 under $2,000,000
  - 39.2% on estates of $2,000,000 under $2,500,000
  - 42.4% on estates of $2,500,000 under $3,000,000
  - 44% on estates of $3,000,000 or more.

- Modify and expand the qualified family owned business interest (QFOBI) benefit.
  - Change the QFOBI deduction to an exclusion equivalent amount.
  - Increase the applicable exclusion amount (the amount exempted by QFOBI plus the unified credit) from $1.3 million to $2.0 million.
  - Allow the second spouse to die to use any unused QFOBI exclusion amount, provided that the first spouse also qualified for the QFOBI election.

- Increase the amount exempted by the unified credit to $1,100,000 for 2001 through 2005, and to $1,200,000 for 2006.

- Restore the phase-out of the unified credit for estates in excess of $10,000,000. (Included in the Administration's FY 2001 Budget proposal.)

[1] These lower rate brackets are effectively wiped out by the unified credit. However, they still have an effect on the 5 percent surtax, which phases out the effect of the graduated rate schedule (and under the proposal, the effect of the unified credit) for taxable estates of $10,000,000 or more. The effect of the current structure (rates beginning at the first dollar of taxable estate with a unified credit) could be also be achieve by a zero bracket amount (plus surtax).

- Eliminate non-business valuation discounts. (Included in the Administration's FY 2001 Budget proposal.)
- Eliminate the ability to claim valuation discounts on account of lack of voting control, where members of the decedent's family have voting control.
- Eliminate the state death tax credit and allow a deduction for all state death taxes paid. (See discussion of issues raised by this proposal below.)
- Provide for the taxation of certain gifts and bequests from expatriates.

Cost: About $30 billion over 10 years.

Discussion: Unlike the Republican proposal (H.R. 8), the estate tax relief in the Democratic alternative is effective immediately. Thus revenue costs are apparent, and not hidden outside of the budget window. All estates would benefit from the reduction in tax rates, and all but the very largest estates would benefit from the increases in the unified credit. Additional relief would be targeted to qualified family owned business interests (QFOBI).

We believe that much of the animosity toward the transfer tax system stems from the top marginal rates that are in excess of 50 percent. By keeping the top rate at 44 percent (effective rate of 49 percent in the credit phase-out region), the Democratic alternative ensures that no taxpayer will owe more than half of his or her taxable estate to the government.

The proposal is paid for in part by the conversion of the state death tax credit to a deduction. We would expect state revenues to fall as a result of this provision. Under current law, state death taxes are creditable against the federal tax, up to a limit. States generally levy death taxes equal to the federal credit, thereby shifting revenue from the federal government to the state governments. Some states have done this by writing laws that refer directly to the federal credit. Other states have specified that their taxes will lapse if the federal tax is repealed. Our understanding is that if we were to repeal the federal tax, virtually all states would have to enact new laws that are independent of the federal credit, or forego this revenue. States might also compete with one another to enact the most favorable death tax provisions.

The proposal is also paid for in part by imposing a transfer tax (at the highest transfer tax rate) on the recipients of certain gifts and bequests from expatriates. This provision represents one piece of Representative Rangel's proposal (H.R. 3099) to overlay a mark-to-market regime on the current expatriate tax regime. While we support the spirit of this provision, we prefer the comprehensive remedy that was offered in the Administration's FY 2001 Budget. The Administration's proposal would enact a mark-to-market regime and repeal the current expatriate tax regime. It would tax the recipients of certain gifts and bequests from expatriates at the highest transfer tax rate, but would collect the tax through the income tax system (rather than through the transfer tax system).

We support the two revenue raisers that were adopted from the Administration's FY 2001 Budget proposal. The restoration of the phase-out of the unified credit for estates in excess of

$10,000,000 would correct a technical error in the Taxpayer Relief Act of 1997 that inadvertently provided a tax cut to estates in excess of $17,184,000. The elimination of non-business valuation discounts would eliminate the incentive to place marketable assets in family limited partnerships or limited liability company and then make transfers of fractional interests in these entities, solely to reduce the value of the assets for transfer tax purposes. The provision is needed to stop this erosion of the estate tax base.

2. Raise the Exempt Amount

These options would exempt more estates from tax by (a) increasing the exempt amount to $1.5 million, (b) allowing an exemption for couples that is effectively twice the exemption for singles, and (c) provide a $5 million exemption from QFOBI for couples ($2.5 million for singles).

Option 2a. The Democratic alternative (Option 1) plus:

- Increase the amount exempted by the unified credit to $1.5 million.

Cost: About $60 billion over 10 years.

Discussion: This option could be rationalized as a response to the inflated value of personal residences, especially in California. Relative to fully phased in current law, this higher exemption would include an automatic allowance of $500,000 per estate. Note that it is not contingent on owning a home. Since many elderly people dispose of their homes when they move to assisted living facilities or nursing homes, this is obviously fairer, more efficient, and easier to administer.

Option 2b. Option 2a plus:

- Allow the second spouse to die to use any unified credit unused by the first spouse to die.

Cost: About $65 billion over 10 years.

Discussion: Under the proposal, married couples would be able to obtain the full unified credit to which they are entitled without engaging in complicated estate planning practices. Couples in which the first spouse to die leaves their entire estate to the second spouse would not lose the benefit of the first spouse's unified credit. In order to take advantage of the provision, the surviving spouse would need to maintain records documenting the amount of unified credit used by the first spouse, even if no tax return was required. This potentially adds to taxpayers' administrative burdens. However, surviving spouses who chose not to keep such records would be no worse off than they are under current law.

This proposal would effectively exempt at least $3 million in assets from the estate tax for a couple.

Option 2c. Option 2a plus:

- Increase the amount exempted by the unified credit plus QFOBI to $2.5 million.

Cost: About $65 billion over 10 years.

Discussion: This would benefit all QFOBI property owners. (The number of estates affected by this provision is fairly small, because the number of estates comprised primarily of qualified farms and businesses is also small.) Because of the portability provision in the Democratic alternative, this proposal would effectively exempt up to $5 million of qualified farms and small businesses from tax for a couple.

3. Reduce Marginal Estate Tax Rates

The President asked us to look at options that would lower the top estate tax rate to the top individual income tax rate. These two options would either (a) replace the progressive rate structure with a flat 39.6 percent rate, or (b) retain a progressive rate structure and limit the top rate to 39.6 percent for all but the estates over $10 million. Note that these options would not increase marginal or average tax rates for anyone compared with current law.

Option 3a. Option 2a (which is the Democratic alternative, plus a further increase in the unified credit) plus:

- Implement a flat transfer tax rate of 39.6 percent.

Cost: About $75 billion over 10 years.

Discussion: Under current law the marginal estate tax rate on estates of $1,000,000 to $1,250,000 is 41 percent, and the top rate (ignoring the 5 percent surtax to phase out the benefit of the graduated rate schedule), applicable to estates of $3,000,000 or more is 55 percent. The current marginal rate on estates of $1,500,000 (the new exempt amount under Option 2a) is 45 percent. Under the Democratic alternative, rates would range from 32.8 percent to 44 percent; and under Option 2a rates would range from 36 percent to 44 percent. A flat 39.6 percent rate would bring all transfer tax rates very close to the top individual tax rate, and would deflect the argument that the estate tax is confiscatory. The marginal rate on estates with assets between $1,500,000 and $2,500,000 would be higher than under the Democratic alternative, but less than under current law (and these estates would also benefit from the further increase in the unified credit under Option 2a).

Option 3b: Option 2a plus progressive lower rate schedule:

- 30% on estates under $2,500,000
- 35% on estates of $2,500,000 under $5,000,000
- 39.6% on estates of $5,000,000 under $10,000,000
- 45% on estates of $10,000,000 or more.

Cost: About $80 billion over 10 years.

Discussion: Under current law, statutory marginal estate tax rates range from 18 percent to 55 percent (plus a 5 percent surtax to phase out the benefit of the graduated rates on estates worth $10,000,000 or more). The unified credit effectively wipes out the lower brackets so that by 2006, the lowest effective marginal estate tax rate will be 41 percent.[2] Under the fully phased in Democratic alternative, rates would be 20 percent lower than current law in every bracket. Therefore both Option 3b and the Democratic alternative would reduce rates and mitigate the argument that estate tax rates are confiscatory. Option 3b would retain a slightly higher rate for estates of $10,000,000 or more, but would have lower rates in every other bracket than the Democratic alternative, and the rate on those estates would not exceed the top individual income tax rate.

4. Repeal Estate Tax and Enact Carryover Basis

The President asked us to consider repealing the estate tax and enacting a carryover basis provision, under which heirs would assume the same cost basis of an appreciated asset as the decedent.[3] Thus, bequests would be treated the same as gifts.

This proposal has considerable policy merit, as it would reduce a serious defect in the income tax, would reduce the incentive for people to hold assets until death, and would still defer tax on assets that are not sold—addressing a concern of farmers and business owners. However, it would raise tax on hundreds of thousands of people who would not otherwise be subject to the estate tax—all of those with appreciated property worth less than the estate tax exclusion. Because the tax would be deferred until assets are sold, it would be very expensive in the budget window. Moreover, heirs of property that had passed through multiple generations would have a nearly impossible task measuring their capital gains (as would the IRS in trying to administer the provision). The concern about complexity was a major factor behind the public outcry about carryover basis when it was enacted in 1976, which led to its delay and ultimate repeal before it could become effective.

For all of these reasons, this proposal should not be advanced.

5. Options to Reduce Revenue Cost

There is general agreement that it would be ill advised to propose an estate tax cut much larger than the Democratic alternative. There are three options to restrain the cost, one of which was adopted in the Democratic alternative: (a) convert the state death tax credit to a deduction, (b) adopt estate tax provisions from our budget, or (c) phase in the increase in the unified credit.

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[2] However, the structure of the lower rate brackets does affect the design of the surtax, which phases out the benefit of the graduated rate schedule and, under the proposal, the benefit of the unified credit, for taxable estates worth $10,000,000 or more.

[3] Under current law, someone who purchases an asset for $1,000 that is worth $10,000 at death does not have to pay tax on the capital gain, and his or her heir assumes a basis of $10,000, rather than the decedent's cost basis of $1,000. This is called step-up in basis. Under the proposal, the heir would have a basis of $1,000—the same as the decedent.

5a. Convert the state death tax credit to a deduction

Revenue gain: About $45 billion over 10 years (note that this amount is included in the estimates for all of the options under 1, 2, and 3).

Discussion: As noted above, the Democratic alternative is paid for in part by the conversion of the state death tax credit to a deduction. Put differently, the estate tax includes about $45 billion of revenue sharing with the states that is being recaptured by our proposal. The options thus allow federal estate tax rates to be lower, but at the expense of the states. Because of the way in which state tax laws interact with the federal provisions, we would expect state revenues to fall if the credit is converted to a deduction. States might also compete with one another to enact the most favorable death tax provisions.

Although there was not an outcry from the states about the Democratic alternative, they might be more exercised if the proposal originated with the Administration. FYI, the largest state death tax credits in 1998 were for decedents from California ($0.7 billion) and New York ($0.5 billion).

5b. Enact Loophole Closers From Budget

The option would enact the other revenue raisers from the Administration's FY 2001 Budget proposal:

- Require consistent valuation for estate and income tax purposes. Under current law, income taxpayers may report as the basis of property acquired from a decedent a fair market value that is different from the fair market value reported for estate tax purposes. Taxpayers should be required to take consistent positions. The proposal would require executors to report the value of assets for estate tax purposes to the heirs; and for the heirs to use that value as their basis for income tax purposes.

- Require basis allocation for part sale/part gift transactions. The donor and donee in a part gift, part sale transaction should be required to take consistent positions so that no basis is lost or created by the transaction.

- Conform the treatment of surviving spouses in community property States. In a community property State, each spouse is treated as owning one-half of all marital property. Under current law, surviving spouses in community property states receive a step-up in basis on both the decedent's share of the property passing to spouse and on the their own share of the property. This is inconsistent with the treatment of couples in common law States who own property jointly. (In those States, the surviving spouse receives a step-up in basis on only the decedent's share of the property.) The proposal would eliminate the step-up in basis on the surviving spouse's share of community property.

- Include qualified terminable interest property (QTIP) trust assets in the surviving spouse's estate. Under current law, QTIP trust assets receive a marital deduction in the estate of the first spouse to die, but must be included in the estate of the second spouse to die. Some taxpayers have attempted to whipsaw the government by claiming the marital deduction in the first estate, and then, after the statute of limitations on the first estate has run out, arguing that the assets are not includable in the estate of the surviving spouse, because of some technical flaw in the QTIP election. The proposal would require the assets to be included in the estate of the second spouse to die, if a marital deduction for QTIP assets was allowed for the estate of the first spouse to die.

- Eliminate the gift tax exemption for personal residence trusts. Under current law, if an interest is retained by a grantor in a trust when other interests are transferred to family members, then the retained interest is valued at zero for gift tax purposes unless if takes the form or and annuity (GRAT), unitrust (GRUT), remainder interest after a GRAT or GRUT. However, there is a further exception for the transfer of personal residences, allowing more favorable treatment of personal residence trusts. We favor consistent treatment of personal residences.

- Modify requirements for annual exclusion gifts. Under current law, gifts of "present interests" of up to $10,000 per donee per donor each year are exempt from the gift tax. Transfers in trusts are not generally gifts of present interests. However, the decision of Crummey v. Commissioner has allowed transfers in trust to be considered gifts of present interests if the beneficiaries had the power to withdraw the assets, even for only a very limited period of time (often 30 days or less). The decision of Cristofani v. Commissioner has further allowed for a gift tax exclusion even when the holder of the withdrawal power is not the ultimate beneficiary of the trust and has no substantial economic interest in the trust. Typically withdrawal powers are granted to multiple "beneficiaries" who, by pre-arrangement or understanding, will never exercise these rights, thus multiplying the annual exclusion gifts that can be used to transfer assets to the true beneficiary. The proposal would conform the gift tax rule to the generation skipping transfer tax rule and allow the gift tax exclusion on behalf of an individual only if (i) during the life of the individual, no other person may benefit from the trust and (ii) if the trust does not terminate before the death of the individual, the assets of the trust are included in the individual's gross estate.

Revenue Gain: $2 billion over 10 years.

Discussion: These options make sense to include in an Administration proposal because we have already proposed them and have already experienced whatever heat they might generate. However, there is a touchy issue of budgeting. Using these offsets to pay for estate tax breaks, which weren't in our budget, may be viewed as double counting since we used them in our budget to offset other proposals that are still on the table. By the same logic, we should not consider the effect of our budget raisers in the Democratic alternative. On the other hand, it is not clear who would raise this objection given that the Republicans are inclined to offer much larger net tax cuts, and disinclined to provide any offsets.

Note that other options exist that could raise much more revenue, and would make the tax simpler and fairer, but they would also be controversial.

5c. Phase in Increase in Unified Credit

- The Democratic alternative (Option 1), plus increase the amount exempted by the unified credit to $1.5 million in 2010, and
- Allow a QFOBI-like exemption of up to $1.5 million for principal residences, owned as of 6/1/2000, which constitute more than 50 percent of the value of an estate. The value of the personal residence for this purpose is the value as of the date of sale or death, whichever is earlier. The exemption is implemented as a credit equivalent (as QFOBI is done in the Democratic alternative). The maximum exempt amount, including principal residence, is limited to $1.5 million (so it is never worth more than the increase in the exemption effected in 2010).

Revenue gain: to be determined.

Discussion: The increase in the unified credit to $1.5 billion in Option 2a costs about $30 billion over ten years. An immediate increase may be desirable because it would defuse the concerns of Californians, in particular, that inflation in home prices is making moderate-income taxpayers subject to tax. The cost could be limited slightly by limiting the increase to decedents' equity in their principal residences, but that would cause terrible estate planning incentives. For example, taxpayers would be advised to own homes worth at least the amount of the residence exemption, and to hold them even if they move to a retirement community, assisted living facility, or nursing home. One can easily imagine units in such facilities being recharacterized as condos to take advantage of this provision.

Option 5c would effectively create a kind of transition rule to allow a higher exempt amount for those whose home equity as of a fixed date (6/1/00) is more than 50 percent of their estate value. Because of the fixed date, there is no incentive to buy a home to qualify for the higher credit, and selling the home before death would not disqualify one for the credit. Because the maximum exempt amount is $1.5 million, the proposal would effectively phase out in 2010, when the generally higher unified credit takes effect.

The proposal could be criticized on several grounds. First, there is no good policy reason to provide relief to homeowners. Homes pass tax-free from one spouse to another, so a widow or widower never has to sell their home to pay estate tax. Second, from the point of view of heirs, there seems to be little hardship from having to sell a parent's home to pay tax. In that respect, it is much like any other asset. Third, it is unclear why we should favor homeowners over others for estate tax purposes. The proposal would seem especially unfair to those who have already sold their home to move into an assisted living facility or nursing home.

Menu of Estate Tax Reform Options – Very Preliminary

Proposal	Very Preliminary Revenue Estimate, 2001-2010 (in billions)
Option 1: Baseline Option (Democratic Alternative)	-$30
Option 2: Raise the Exempt Amount	
Option 2a: Option 1 plus increase amount exempted by the unified credit to $1.5 million	-$60
Option 2b: Option 2a plus allow portability of the unified credit between spouses	-$65
Option 2c: Option 2a plus increase the amount exempted by the unified credit plus QFOBI to $2.5 million	-$65
Option 3: Lower Rates	
Option 3a: Option 2a plus a flat tax rate of 39.6%	-$75
Option 3b: Option 2a plus rate reduction	-$80
Options to Reduce Revenue Cost	
Convert the state death tax credit to a deduction*	+$45
Budget Proposals	+$2
Phase-in the increase in the exempt amount	Not available

*This was included in the Democratic Alternative, therefore is assumed in the options under 1, 2, and 3.

Note: These estimates are very rough and subject to significant revision.

Appendix: Other Options to Close Estate Tax Loopholes

On tax policy grounds, there is a compelling argument for broadening the estate tax base to pay for rate reduction and a higher exempt amount. (The political merits are indicated by the fact that this argument is made in an appendix.) The artifices taxpayers engage in to avoid the estate tax are costly and inefficient, and result in horizontal inequities among estate taxpayers. However, powerful interests benefit from estate tax planning and would presumably resist fundamental tax reform. (They presumably are also not thrilled about repeal.) Transition rules to accommodate those who have already engaged in costly tax planning could be complex and reduce the revenue gain from reform.

<u>**Summary of Options**</u>

- Establish a family attribution rule. In valuing transfers of interests in business entities, no minority discount will be allowed if the transferor owns more than 50 percent of the entity including the current transfer and all prior transfers to related persons, including transfers in trust to related persons (whether or not for adequate consideration). This would eliminate the incentive to make gratuitous transfers solely for the purpose of obtaining minority discounts and eroding the estate tax base.

- Eliminate the gift tax exemption for grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs). Under current law, if an interest is retained by a grantor in a trust when other interests are transferred to family members, then the retained interest is valued at zero for gift tax purposes unless if takes the form of a GRAT or GRUT. We favor elimination of the exception for GRATs and GRUTs in part because they involve the use of actuarial tables that the taxpayer (with better information about his or her own situation) can nearly always game to his or her advantage. Repeal of this exception would also eliminate the incentive to engage in several forms of estate planning that are used only used to gain a tax advantage.

- Repeal the estate tax deduction for interest and expenses for management and conservation of the estate assets. To the extent allowed by law, it is proper that these deductions be taken on the estate's income tax return, as they accrue after the decedent's death.

- Repeal the NIMCRUT provision for charitable remainder trusts. This would repeal the provision that allows a charitable remainder trust to pay out the lesser of trust income or the unitrust amount and "make up" the shortfall in a later year when income exceeds the unitrust amount. The net income unitrust would still be permitted, but no make up provision would be allowed.

- Limit the marital deduction to $50 million. The purpose of the marital deduction is to provide for the surviving spouse by deferring taxes on assets bequeathed to the survivor by the first spouse, until the death of the surviving spouse. A deduction of $50 million is far more than adequate to ensure the welfare of the surviving spouse.

- Allow a deduction in respect of a decedent for state death taxes. Under current law distributions from some assets made at death may be taxed at a higher rate than distributions made just prior to death, because only the federal estate tax attributable to the assets is allowed as a deduction. (This would lose revenue.)

- Require that IRA and other retirement assets be distributed within five years of the decedent's death, unless the named beneficiary is the decedent's spouse. Under current law, if an IRA is left to a named beneficiary who is not the spouse then the beneficiary must begin to take distributions in the year of the decedent's death. However, if the decedent died before reaching age 70½, these distributions and the corresponding income tax payments may be made over the course of the beneficiary's own expected lifetime. The purpose of deferring the tax on the contributions to and the buildup of income in retirement accounts is to encourage saving and provide for the retirement of the contributor (and spouse). It is not to allow for the deferral of tax for younger beneficiaries. Together with the state death tax deduction proposal, this provision would eliminate any asymmetry in the tax treatment of IRA assets distributed just prior to death or at death.

Total Revenue: N/A

2000-SE-006463

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

INFORMATION

June 15, 2000

MEMORANDUM FOR NEC PRINCIPALS

FROM **STUART E. EIZENSTAT**

SUBJECT: Estate Tax Issues and Options

The President asked us to look at three options for modifying the estate tax: raise the exempt amount, lower marginal tax rates, or enact carryover basis and repeal the estate tax. After a brief discussion of the legislative climate, this memo presents options for raising the exempt amount and reducing rates and explains why political and budget considerations would make carryover basis inadvisable. An appendix describes some options for limiting the revenue cost of estate tax reform.

Current Legislative Climate

We have discussed with members and staff from the tax-writing committees the question of where the Administration should position itself. While many Members told us that the Democratic alternative did not provide sufficient cover to the House vote, the current view from the Ways and Means Democrats is that we should either lie low or rally behind the Democratic alternative. They believe that their alternative would have prevented a debacle on the House floor if it had been presented to members before they signed onto the repeal legislation. The main advantages of the Democratic alternative over the House-passed bill are that it would become effective immediately rather than in ten years, would exempt about half of estate taxpayers from tax in 2001, would exempt almost all farmers and small business owners, and would be more fiscally responsible. They believe that many members viewed last week's repeal vote as a free vote insofar as the Senate or the Administration could be counted on to block the legislation. They did not seem to think that the size of the Democratic proposal was a key factor in its failure.

Ways and Means staff has urged us not to overreact by raising the bar from that set by the Democratic alternative. They are convinced that an override vote would fail in the House.

Staff of the Senate Finance Committee and Minority Leader do not yet know what they need to do to attract broad Democratic support. There are currently eight Democratic co-sponsors of an estate tax repeal bill, including three members of the Finance Committee – Kerrey, Breaux, and Robb. Majority Leader Trent Lott reportedly said that the Senate would take up the estate tax repeal bill as a stand-alone measure sometime in July.

Summary

The options the President asked us to evaluate would be expensive. Raising the exempt amount for estates from $675,000 under current law (scheduled to increase to $1 million by 2006) to $1.5 million and setting the estate tax rate at the top individual income tax rate would cost over $100 billion over ten years. That is, it would cost more than the phased in repeal of the estate tax that was passed by the House. The cost could be reduced by more than $50 billion by adopting the revenue offsets in the House Democratic alternative, but one of those – replacement of the state death tax credit with a deduction – is potentially controversial. The state death tax credit effectively rebates state estate taxes, making such taxes a relatively painless source of revenue for states. Even with the optimistic offset package, the options would cost $60 billion or more over ten years, depending on the details. Moreover, there is a significant risk that any estate tax offer would be stripped of its controversial offsets and undermine fiscal discipline or, even worse, used as a justification for adopting the less costly (in the budget window) House repeal proposal.

The carryover basis option has policy merit, but it is both politically infeasible and fiscally imprudent. It is politically infeasible because it would raise taxes on hundreds of thousands of heirs with appreciated property who would not otherwise be subject to the estate tax under current law. Since capital gains tax would be levied at low rates (generally 20 percent or less) and deferred until the asset is sold, it would raise far less revenue in the budget window than the estate and gift taxes it would replace.

The most viable option would be to build on the House Democratic alternative, which would cut estate tax rates, raise the unified credit, and raise the exemption for farm and business assets. We could add to that proposal portability of the unified credit among spouses (so that the effective exemption for couples is double the amount for singles) and relief for homeowners. A phased in version of this option with immediate relief for homeowners could be accomplished for about $5 billion more than the House Democratic alternative, or $35 billion over ten years. (Treasury estimates the Democratic alternative as costing about $30 billion over ten years, compared with JCT's estimate of $22 billion.)

In considering this and other options that build on the Democratic substitute, keep in mind that the relatively modest cost assumes that the state death tax credit could be repealed despite strong opposition from the states.

Description of Options

Unless otherwise specified, effective dates for all of the options apply to persons dying and gifts made after December 31, 2000. Please note that the ten-year cost estimates are very rough approximations subject to significant revision. A summary table is at the end of this memo.

1. Baseline Option (House Democratic Alternative)

The base option is the alternative proposed by House Democrats on June 9, 2000. It would immediately raise the exempt amount from $675,000 to $1.1 million; and raise the exemption to $1.2 million in 2006. It would reduce estate tax rates across the board by 20 percent, so the top rate would fall from 55 percent to 44 percent, and pay for this by converting the state death tax credit to a deduction. It would exempt up to $4 million of small farm and business income (QFOBI) for a couple ($2 million for singles). It would limit the revenue cost by closing some estate tax loopholes and converting the QFOBI deduction to an applicable exclusion amount. Two of the proposals to close loopholes were proposed in our FY 2001 budget.

Details

- Reduce all tax rates (except for the 5% surtax) by 20 percent. The resulting statutory rates would range from 32.8% on estates under $1,250,000 to 44% on estates of $3,000,000 or more.

- Modify and expand the qualified family owned business interest (QFOBI) benefit.
  - Change the QFOBI deduction to an applicable exclusion amount.
  - Increase the applicable exclusion amount (the amount exempted by QFOBI plus the unified credit) from $1.3 million to $2.0 million.[1]
  - Allow the second spouse to die to use the QFOBI exclusion amount not used by the first spouse to die, provided that the first spouse also qualified for but did not make the QFOBI election.

- Increase the amount exempted by the unified credit to $1,100,000 for 2001 through 2005, and to $1,200,000 for 2006.

- Eliminate the state death tax credit and allow a deduction for all state death taxes paid. (See discussion of issues raised by this proposal below.)

- Provide for the taxation of certain gifts and bequests from expatriates.[2]

- Eliminate the ability to claim valuation discounts on account of lack of voting control, where the transferor and members of the transferor's family together have voting control.

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[1] Note that QFOBI effectively substitutes for the unified credit for estates with qualifying farms and businesses valued at more than the amount exempted by the unified credit. Thus, for example, a person whose qualifying business was valued at $1.5 million would have a credit equal to the tax liability on that amount. If the business was worth $5 million, the credit would exempt $2 million of assets. Note that the QFOBI exemption is <u>not</u> in addition to the general unified credit.

[2] The revenue raisers are discussed in detail in the Appendix.

- Restore the phase-out of the unified credit for estates in excess of about $16,000,000. (Included in the Administration's FY 2001 Budget proposal.)

- Eliminate non-business valuation discounts. (Included in the Administration's FY 2001 Budget proposal.)

Cost: About $30 billion over 10 years.

Discussion: Unlike the Republican proposal (H.R. 8), the estate tax relief in the Democratic alternative is effective immediately. Thus revenue costs are apparent, and not hidden outside of the budget window. All estates that are now taxable would benefit from the reduction in tax rates, and all but the very largest estates would benefit from the increases in the unified credit. Additional relief would be targeted to qualified family owned business interests (QFOBI).

We believe that much of the animosity toward the transfer tax system stems from the top marginal rates that are in excess of 50 percent. By keeping the top rate at 44 percent (with a marginal rate of 49 percent in the region where the unified credit and graduated rates are phased out), the Democratic alternative ensures that no taxpayer will owe more than half of his or her taxable estate to the government.

The proposal is paid for in part by the conversion of the state death tax credit to a deduction. We would expect state revenues to fall as a result of this provision. Under current law, state death taxes are creditable against the federal tax, up to a limit. States generally levy death taxes equal to the federal credit, thereby shifting revenue from the federal government to the state governments. For example, for the largest estates, the effective Federal marginal tax rate is 39 percent (rather than 55 percent) and the effective state marginal tax rate is 16 percent. Most state laws refer directly to the federal credit. Thus, repealing the federal credit would effectively reduce state revenues to zero. Virtually all states would have to enact new laws that are independent of the federal credit, or forego this revenue. States might also compete with one another to enact the most favorable estate and inheritance tax provisions—the very situation that the state death tax credit was designed to avoid.

2. Raise the Exempt Amount

These options would exempt more estates from tax by (a) increasing the exempt amount to $1.5 million, (b) allowing an exemption for couples that is effectively twice the exemption for singles, and (c) provide a $5 million exemption from QFOBI for couples ($2.5 million for singles).

Option 2a. The Democratic alternative (Option 1) plus:

- Increase the amount exempted by the unified credit to $1.5 million.

Total Cost: About $60 billion over 10 years.[3]

Discussion: This option would be presented as a response to the inflated value of personal residences, especially in California. It would provide relief targeted at people whose home equity constitutes the majority of their estate. Relative to fully phased in current law, this higher exemption would include an automatic allowance of $500,000 per estate. Note that it is not contingent on owning a home. Since many elderly people dispose of their homes when they move to assisted living facilities or nursing homes, this is obviously fairer, more efficient, and easier to administer than an exclusion tied specifically to homeownership at death.

The option would reduce the number of taxable estates by about 40 percent in 2010.

Option 2b. Phase in increase in the unified credit and provide interim relief for homeowners:

- Option 1, plus:
- increase the amount exempted by the unified credit to $1.5 million in 2010, and
- Allow a QFOBI-like exemption of up to $1.5 million for principal residences, owned as of June 1, 2000, which constitute more than 50 percent of the value of an estate. The value of the personal residence for this purpose is the value as of the date of sale or death, whichever is earlier. The exemption is implemented as a credit equivalent (as QFOBI is done in the Democratic alternative). The maximum exempt amount, including principal residence, is limited to $1.5 million (so it is never worth more than the increase in the exemption effected in 2010).

Total Cost: About $32 billion over 10 years.

Discussion: The increase in the unified credit to $1.5 billion in Option 2a adds about $30 billion to the cost in the 10-year budget window. Deferring the full increase in the credit to 2010 would move all of the incremental cost outside the budget window. But an immediate increase may be necessary to defuse the concerns of Californians, in particular, that inflation in home prices is making moderate-income taxpayers subject to tax. The cost could be reduced by limiting the increase to decedents' equity in their principal residences, but that would cause terrible estate planning incentives. For example, taxpayers would be advised to own homes worth at least the amount of the residence exemption, and to hold them even if they move to a retirement community, assisted living facility, or nursing home. One can easily imagine units in such facilities being re-characterized as condos to take advantage of this provision.

[3] Note all cost estimates are total rather than incremental costs. Thus, the Democratic alternative with the higher exclusion would cost about $60 billion over ten years. The incremental cost of going to the higher exclusion is about $30 billion.

Option 2b would effectively create a kind of transition rule to allow a higher exempt amount for those whose home equity as of a fixed date (6/1/00) is more than 50 percent of their estate value. Because of the fixed date, there is no incentive to buy a home to qualify for the higher credit, and selling the home before death would not disqualify one for the credit. Because the maximum exempt amount is $1.5 million, the proposal would effectively phase out in 2010, when the generally higher unified credit takes effect.

Although this option is probably the best way to address the concerns of homeowners without great cost in the budget window or creating undesirable estate planning incentives, it might still be subject to criticism. First, a preference for homeowners may seem especially unfair to those who have already sold their home to move into an assisted living facility or nursing home. Second, a temporary preference for residences might lead to pressure for a permanent preference for homes or for tax preferences for other assets. Third, the phase-in could be criticized as biased budgeting, because the bulk of the cost is outside the budget window. Nevertheless, we believe this is an essential ingredient in any Presidential proposal.

<u>Option 2c</u>. Option 2b, plus:

- Allow the second spouse to die to use any unified credit unused by the first spouse to die. This would make the combined exempt amount for a couple equal to $2.2 million in 2001, $2.4 million in 2006, and $3.0 million in 2010.

Total Cost: About $35 billion over 10 years.

Discussion: Under the proposal, married couples would be able to obtain the full unified credit to which they are entitled without engaging in complicated estate planning. Couples in which the first spouse to die leaves their entire estate to the second spouse would not lose the benefit of the first spouse's unified credit. In order to take advantage of the provision, the surviving spouse would need to maintain records documenting the amount of unified credit used by the first spouse, even if no tax return was required. This potentially adds to taxpayers' administrative burdens. However, surviving spouses who chose not to keep such records would be no worse off than they are under current law.

Portability, in combination with the increase in the unified credit, would approximately cut in half the number of estate taxpayers in 2010.

<u>Option 2d</u>. Option 2b plus:

- Increase the amount exempted by the unified credit plus QFOBI to $2.5 million.

Total Cost: About $35 billion over 10 years.

Discussion: This would benefit farmers and small business owners with assets above $2 million ($4 million for couples). Because of the portability provision in the Democratic alternative, this proposal would effectively exempt up to $5 million of qualified farms and small businesses from tax for a couple.

3. Reduce Marginal Estate Tax Rates

The President asked us to look at options that would lower the top estate tax rate to the top individual income tax rate. These two options would either (a) replace the progressive rate structure with a flat 39.6 percent rate, or (b) retain a progressive rate structure and limit the top rate to 39.6 percent for all but the estates over $10 million. Note that these options would not increase marginal or average tax rates for anyone compared with current law.

Option 3. Option 2b plus:

- Implement a flat transfer tax rate of 39.6 percent.

Total Cost: About $45 billion over 10 years.

Discussion: Under current law, the marginal estate tax rate on estates of $1,000,000 to $1,250,000 is 41 percent, and the top rate (ignoring the 5 percent surtax to phase out the benefit of the graduated rate schedule), applicable to estates of $3,000,000 or more is 55 percent. Under the Democratic alternative, rates would range from 32.8 percent to 44 percent; and under Option 2a, rates would range from 36 percent to 44 percent. A flat 39.6 percent rate would equal the top individual income tax rate, and would deflect the argument that the estate tax is confiscatory. The marginal rate on estates with assets between $1,500,000 and $2,500,000 would be higher than under the Democratic alternative, but less than under current law (and these estates would eventually benefit from the further increase in the unified credit under Option 2b).

4. Repeal Estate Tax and Enact Carryover Basis

The President asked us to consider repealing the estate tax and enacting a carryover basis provision, under which heirs would assume the same cost basis of an appreciated asset as the decedent.[4] Thus, bequests would be treated the same as gifts.

This proposal has considerable policy merit, as it would address a serious defect in the income tax, would reduce the incentive for people to hold assets until death, and would still defer tax on assets that are not sold—addressing a concern of farmers and business owners. However, it would raise taxes on hundreds of thousands of people who would not otherwise be subject to

[4] Under current law, someone who purchases an asset for $1,000 that is worth $10,000 at death does not have to pay tax on the capital gain, and his or her heir assumes a basis of $10,000, rather than the decedent's cost basis of $1,000. This is called step-up in basis. Under the proposal, the heir would have a basis of $1,000--the same as the decedent.

the estate tax—all of those with appreciated property worth less than the estate tax exclusion.[5] Because the tax would be deferred until assets are sold, it would be very expensive in the budget window. Moreover, heirs of property that had passed through multiple generations would have a nearly impossible task measuring their capital gains (as would the IRS in trying to administer the provision). The concern about complexity was a major factor behind the public outcry about carryover basis when it was enacted in 1976, which led to its delay and ultimate repeal before it could become effective.

For all of these reasons, this proposal should not be advanced.

[5] The Republican proposal (H.R. 8) avoided taxing those not subject to estate tax by allowing generous exemptions from the carryover basis rule. For each decedent, up to $3 million in property passing to a surviving spouse and up to $1.3 million in property passing to other beneficiaries would receive a step-up in basis.

Menu of Estate Tax Options – Very Preliminary

Proposal	Total Revenue Cost (cumulative) 2001-2010 (in billions)
Option 1: Baseline Option (Democratic Alternative)	-$30
Option 2: Raise the Exempt Amount	
2a. Option 1, plus increase amount exempted by the unified credit to $1.5 million	-$60
2b. Option 2a phased in, with interim personal residence exclusion	-$32
2c. Option 2b, plus allow portability of the unified credit between spouses	-$35
2d. Option 2b, plus increase the amount exempted by the unified credit plus QFOBI to $2.5 million	-$35
Option 3: Lower Rates	
3. Option 2b, plus a flat tax rate of 39.6%	-$45
Options to Reduce Revenue Cost (see appendix)	
Convert the state death tax credit to a deduction*	+$45
Budget Proposals**	+$2
Phase-in the increase in the exempt amount***	+$30

*This was included in the Democratic Alternative, therefore is assumed in the options under 1, 2, and 3. Those options would cost about $45 billion more if the state death tax credit were retained.

**The Democratic Alternative also includes two additional Budget proposals that raise about $7 billion over ten years.

***The phase-in is included in the revenue estimates for options 2b-2d, and 3. They would cost about $30 billion more without the phase in.

Note: These estimates are very rough and subject to significant revision.

Appendix: Possible Estate Tax Offsets

The House Democratic alternative includes over $50 billion in revenue offsets, some from the Administration's budget, which make it possible to immediately raise the unified credit, reduce rates, and extend relief to farms and small businesses without sacrificing fiscal responsibility. Additional offsets exist in the budget; more controversial options could raise even more revenue.

On tax policy grounds, there is a compelling argument for broadening the estate tax base to pay for rate reduction and a higher exempt amount. A substantial portion of estate planning is done to ensure the orderly transition of assets and would be done even in the absence of the estate tax. However, some taxpayers engage in contortions to avoid the estate tax that are costly and inefficient, and result in horizontal inequities among estate taxpayers. However, powerful interests benefit from estate tax planning and would presumably resist fundamental tax reform. (They presumably are also not thrilled about repeal, although incentives to engage in estate planning for income tax avoidance and other purposes would remain.) Transition rules to accommodate those who have already engaged in costly tax planning could be complex and reduce the revenue gain from reform.

<u>**Revenue Raisers in the House Democratic Alternative**</u>

- Eliminate the state death tax credit and allow a deduction for all state death taxes paid. (Raises about $45 billion over ten years—roughly the cost of the 20-percent rate reduction in the Democratic alternative.)

State revenues would almost certainly fall as a result of this provision. Under current law, state death taxes are creditable against the federal tax, up to a limit. States generally levy death taxes equal to the federal credit, thereby shifting revenue from the federal government to the state governments. For example, for the largest estates, the effective Federal marginal tax rate is 39 percent (rather than 55 percent) and the effective state marginal tax rate is 16 percent. Most state laws refer directly to the federal credit. Thus repealing the federal credit would effectively reduce state revenues to zero. Virtually all states would have to enact new laws that are independent of the federal credit, or forego this revenue. States might also compete with one another to enact the most favorable estate and inheritance tax provisions, the very situation that the state death tax credit was designed to avoid.

Although there was not an outcry from the states about the Democratic alternative, the states might be more exercised if the proposal originated with the Administration. FYI, the largest state death tax credits in 1998 were for decedents from California ($0.7 billion) and New York ($0.5 billion).

- Provide for the taxation of certain gifts and bequests from expatriates.

The proposal would impose a transfer tax (at the highest transfer tax rate) on the recipients of certain gifts and bequests from expatriates. This provision represents one piece of Representative Rangel's proposal (H.R. 3099) to overlay a mark-to-market regime on the current expatriate tax regime. While we support the spirit of this provision, we prefer the comprehensive remedy that was offered in the Administration's FY 2001 Budget. The Administration's proposal would enact a mark-to-market regime and repeal the current expatriate tax regime. It would tax the recipients of certain gifts and bequests from expatriates at the highest transfer tax rate, but would collect the tax through the income tax system (rather than through the transfer tax system).

- Eliminate the ability to claim valuation discounts on account of lack of voting control, where the transferor and members of the transferor's family together have voting control.

The spirit of this proposal is laudable, but it could raise objections from members of the business community.

- Restore the phase-out of the unified credit for estates in excess of $10,000,000. (Included in the Administration's FY 2001 Budget proposal.)

The restoration of the phase-out of the unified credit for estates in excess of $10,000,000 would correct a technical error in the Taxpayer Relief Act of 1997 that inadvertently provided a tax cut to estates in excess of $17,184,000.

- Eliminate non-business valuation discounts. (Included in the Administration's FY 2001 Budget proposal.)

The elimination of non-business valuation discounts would eliminate the incentive to place marketable assets in family limited partnerships or limited liability company and then make transfers of fractional interests in these entities, solely to reduce the value of the assets for transfer tax purposes. The provision is needed to stop this erosion of the estate tax base.

<u>Loophole Closers From Budget</u>

The Democratic alternative included two of the Administration's FY 2001 Budget proposals, that together would raise about $7 billion over ten years. The other revenue raisers from the Administration's FY 2001 Budget proposal include the following:

- Require consistent valuation for estate and income tax purposes.

Under current law, income taxpayers may report as the basis of property acquired from a decedent a fair market value that is different from the fair market value reported for estate tax purposes. Taxpayers should be required to take consistent positions. The proposal would require executors to report the value of assets for estate tax purposes to the heirs; and for the heirs to use that value as their basis for income tax purposes.

- Require basis allocation for part sale/part gift transactions.

The donor and donee in a part gift, part sale transaction should be required to take consistent positions so that no basis is lost or created by the transaction.

- Conform the treatment of surviving spouses in community property States.

In a community property State, each spouse is treated as owning one-half of all marital property. Under current law, surviving spouses in community property states receive a step-up in basis on both the decedent's share of the property passing to spouse and on the their own share of the property. This is inconsistent with the treatment of couples in common law States who own property jointly. (In those States, the surviving spouse receives a step-up in basis on only the decedent's share of the property.) The proposal would eliminate the step-up in basis on the surviving spouse's share of community property.

- Include qualified terminable interest property (QTIP) trust assets in the surviving spouse's estate.

Under current law, QTIP trust assets receive a marital deduction in the estate of the first spouse to die, but must be included in the estate of the second spouse to die. Some taxpayers have attempted to whipsaw the government by claiming the marital deduction in the first estate, and then, after the statute of limitations on the first estate has run out, arguing that the assets are not includable in the estate of the surviving spouse, because of some technical flaw in the QTIP election. The proposal would require the assets to be included in the estate of the second spouse to die, if a marital deduction for QTIP assets was allowed for the estate of the first spouse to die.

- Eliminate the gift tax exemption for personal residence trusts.

Under current law, if an interest is retained by a grantor in a trust when other interests are transferred to family members, then the retained interest is valued at zero for gift tax purposes unless it takes the form of an annuity (GRAT), unitrust (GRUT), or a remainder interest after a GRAT or GRUT. However, there is a further exception for the transfer of personal residences, allowing more favorable treatment of personal residence trusts. We favor eliminating special treatment of personal residence trusts.

- Modify requirements for annual exclusion gifts.

Under current law, gifts of "present interests" of up to $10,000 per donee per donor each year are exempt from the gift tax. Transfers in trusts are not generally gifts of present interests. However, the decision in Crummey v. Commissioner has allowed transfers in trust to be considered gifts of present interests if the beneficiaries had the power to withdraw the assets, even for only a very limited period of time (often 30 days or less). The decision in Cristofani v. Commissioner has further allowed for a gift tax exclusion even when the holder of the withdrawal power is not the ultimate beneficiary of the trust and has no substantial economic interest in the trust. Typically withdrawal powers are granted to multiple "beneficiaries" who, by pre-arrangement or understanding, will never exercise these rights, thus multiplying the annual exclusion gifts that can be used to transfer assets to the true beneficiary. The proposal would conform the gift tax rule to the generation skipping transfer tax rule and allow the gift tax exclusion on behalf of an individual only if (i) during the life of the individual, no other person may benefit from the trust and (ii) if the trust does not terminate before the death of the individual, the assets of the trust are included in the individual's gross estate.

Other Options to Close Estate Tax Loopholes

- Establish a family attribution rule.

In valuing transfers of interests in business entities, no minority discount will be allowed if the transferor owns more than 50 percent of the entity including the current transfer and all prior transfers to related persons, including transfers in trust to related persons (whether or not for adequate consideration). This would eliminate the incentive to make gratuitous transfers solely for the purpose of obtaining minority discounts and eroding the estate tax base.

- Eliminate the special gift tax treatment for grantor retained annuity trusts (GRATs) and grantor retained unitrusts (GRUTs).

Under current law, if an interest is retained by a grantor in a trust when other interests are transferred to family members, then the retained interest is valued at zero for gift tax purposes unless it takes the form of a GRAT or GRUT. We favor elimination of the exception for GRATs and GRUTs in part because they involve the use of actuarial tables that the taxpayer (with better information about his or her own situation) can nearly always game to his or her advantage. Repeal of this exception would also eliminate the incentive to engage in several forms of estate planning that are only used to gain a tax advantage.

- Repeal the estate tax deduction for interest and expenses for management and conservation of the estate assets.

These deductions should not reduce the estate because they accrue after the date of death and relate to the ongoing management of assets, rather than to the costs of transferring the assets. To the extent allowed by law, these deductions may be taken on the estate's income tax return.

- Repeal the NIMCRUT provision for charitable remainder trusts.

This would repeal the provision that allows a charitable remainder trust to pay out the lesser of trust income or the unitrust amount and "make up" the shortfall in a later year when income exceeds the unitrust amount. The net income unitrust would still be permitted, but no make up provision would be allowed.

2000-SE-006564

June 21, 2000

MEMORANDUM FOR THE PRESIDENT

FROM: **LAWRENCE H. SUMMERS**
GENE SPERLING

SUBJECT: Estate Tax Issues and Options

This memorandum briefly describes the current legislative status of estate tax repeal and discusses the three options you asked us to examine for reforming the estate tax: raise the exempt amount, lower marginal tax rates, or enact carryover basis and repeal the estate tax. This memo emphasizes factual information about alternative estate tax relief proposals; your economic advisers believe it is important to have a strategic discussion about how we would make a proposal or an offer on the estate tax.

Legislative Background

The House recently approved the Death Tax Elimination Act (H.R. 8) by a vote of 279-136, with 65 Democrats voting in favor of passage. H.R.8 would repeal the estate and gift taxes gradually over a 10 year period. You sent a letter to Speaker Hastert and Minority Leader Gephardt before floor action saying that you would veto estate tax repeal. (We have attached a memo that briefly describes and analyzes the House Democratic alternative).

Senate Majority Leader Lott has discussed taking H.R. 8 directly to the floor, bypassing the Finance Committee. This could occur as early as next week, although Senator Daschle reported at a Democratic caucus meeting yesterday (attended by Secretary Summers) that this is unlikely based upon his conversations with Senator Lott.

Senators Daschle, Moynihan and Baucus are presently formulating a Democratic alternative. They appear to favor an option that would (1) increase the amount exempt from tax (currently at $675,000) over time to $1.5 million per individual, (2) increase the special exemption amount for family farms and small businesses (currently at $1.3 million) to $2.5 million, and (3) provide "portability," that is, allow the second spouse to die to use the portion of the unified credit and the family farm/small business exception not used by the first spouse. At the caucus, many Senators expressed support for this type of approach. Several others argued that the best counter to estate tax repeal would be a package of middle class tax cuts or benefits, such as your College Opportunity Tax Cut, long term care credit, or prescription drug benefits. Senators Feinstein and

Boxer want a special estate tax exclusion for principal residences. Senator Kerrey spoke in favor of repeal. He and eight other Democrats are cosponsors of an estate tax repeal bill.

Discussion of Options

1. **Increase Exemption Amounts**

Retarget the Estate Tax at Very Wealthy People

Under current law, the so-called "unified credit" allows up to $675,000 in value to be excluded from tax. This exemption amount is scheduled to increase by 2006 to a level where $1 million is excluded from tax. That would result in an estate taxpaying population in 2010 equal to about 2 percent of all decedents—the same level it is at now.

An increase in the unified credit would further reduce the number of estate taxpayers and assure that it applies to only the truly wealthy. We believe it is the fairest, most efficient way to provide estate tax relief. For example, an approach similar to that currently being considered by Senate Democrats–immediately implementing a $1 million exclusion in 2001, phased up to $1.5 million by 2010–would cut the number of estate taxpayers by about 33 percent in 2001 compared with current law, and by about 45 percent in 2010. That is, over 16,000 people would be removed from the estate tax rolls in 2001, and more than 24,000 would be removed in 2010. Moreover, a tax credit provides the same tax reduction to someone with a $1.5 million estate as to someone with a $15 million estate. This option would cost about $40 billion over ten years. A slower phase-in could cut the cost to about $25 billion. (See attached table).

Provide Targeted Relief for Farmers and Small Businesses

Current law provides special estate tax treatment to family farms and small businesses. First, a special exclusion is provided for the value of up to $1.3 million of certain qualifying family farms and small businesses. Second, special valuation rules are provided for real property used in a qualified farm or business. Third, taxes attributable to farms and small business may be deferred and paid in installments over 14 years at below-market interest rates.

In 1998, only an estimated 642 taxable estates were comprised primarily of farm assets, and only an estimated 521 taxable estates were comprised primarily of closely-held business assets. About 96 percent of these estates with family farms were worth less than $5 million; 71 percent of these estates with businesses were worth less than that amount. Thus, we believe with a relatively modest increase in the special exclusion amount (e.g., raising the exempt amount to $5 million for couples and $2.5 million for single taxpayers) that virtually all family farms and a substantial percentage of small business could avoid the estate tax.[1] This would remove the strongest political argument that the Republicans have for full repeal – the adverse effect on passing family farms and small businesses between generations. This type of proposal would add about $5 billion to the cost over 10 years.

[1]For technical reasons, the exact number of small businesses and family farms could be different from the numbers given above.

Make the Estate Tax Simpler and Fairer (Portability of Unified Credit)

Under current law, much estate tax planning is involved in maximizing the benefit to couples of the unified credit—that is, to ensure that they could exclude the entire $675,000 per spouse—making for what is effectively a $1,350,000 unified credit for the couple. Married individuals who leave their entire estate to a surviving spouse effectively sacrifice the first spouse's unified credit—that is, the couple gives up the opportunity to bequeath $675,000 to their heirs tax free. Thus, similar couples can pay very different amounts of tax depending on whether they have seen a tax lawyer. Wealthier people may pay tax at a lower rate because they are more likely to have expert estate planning advice. Thus, the complexity of the estate tax law creates both horizontal and vertical inequities.

As part of a fiscally responsible package, we would recommend allowing portability of the unified credit, so that the second spouse to die could use any portion of the unified credit that was unused by the first spouse. Thus, if the first spouse leaves his entire estate to his wife and zeroes out his taxable estate due to the marital deduction, his wife's estate could claim credits that would exempt up to $1,350,000 of estate from tax (using both her husband's and her own credit). In combination with the increase in the unified credit, portability would, when fully phased in, allow a couple to exclude up to $3 million of assets from tax, without any estate tax planning. Portability would add about $5 billion to the cost of estate tax reform over ten years.

Provide Transitional Targeted Relief for Homeowners

Legislators in areas where house prices have greatly appreciated have stressed the importance of providing relief for homeowners who are house rich but don't feel wealthy. This is particularly important to the California delegation.

Some have proposed an exclusion of up to $500,000 per spouse of home equity from estate tax. Such a proposal could result in highly inefficient tax sheltering activity. For example, the exclusion could induce renters to purchase homes solely as an estate tax shelter, or cause older people who move to retirement homes, assisted living, or nursing homes to hold onto their principal residence solely for tax purposes. Those who have to move out of their homes, because of an extended stay in a nursing home, would reasonably view a preference for those healthy enough to stay in their homes as unfair.

Senator Feinstein apparently has a different concern than the rest of the delegation. Her staff has told us she wants to exclude the full value of residences when they are left to children who continue to live in the home after the parent's death.

One possible alternative for addressing this issue would be to allow transitional relief (in the form of a special exemption amount) for current homeowners until the higher unified credit proposed above is fully phased in. Once the increased unified credit is fully phased in combined with portability, taxpayers would be able to exclude up to $3 million of housing equity (and other assets), which should be sufficient. Such an option would add about $1 billion to the cost of the package over ten years.

2. Reduce Marginal Tax Rates

Rate reduction is expensive and provides a disproportionate share of the benefits to the very wealthiest estates. The 20-percent across the board rate reduction done by the House Democrats would have cost $50-60 billion over ten years; a flat 40 percent rate would cost an additional $30 billion or more. In contrast, the options outlined above all help the least wealthy estate taxpayers.

Federal estate tax rates are inflated by the fact that they effectively cover state inheritance and estate taxes as well. This is because current law allows state inheritance and estate taxes to be credited against the federal tax, up to a limit, which varies by size of the gross estate. The federal tax credit effectively rebates the state taxes. As a result, all states currently levy inheritance and estate taxes that are equal to or greater than the maximum federal credit allowed for each estate.

Thus, in contrast to the federal income tax, the federal marginal rate effectively includes both the federal tax and the state tax. For example, by providing a 16-percent state death tax credit for the largest estates, the statutory federal marginal estate tax rate of 55 percent combines an effective 16 percent state tax rate and a 39 percent effective federal estate tax rate.

The House Democratic alternative would finance federal estate tax rate reduction by replacing the state death tax credit with a deduction for state inheritance and estate taxes. This option could cause many states to repeal or sharply curtail their inheritance and estate taxes. Such taxes are an important source of revenue in many states, including California, Florida, and New York. Thus, this option, which sharply reduced the cost of the House Democratic alternative could be very controversial with the States.

It is also important to note that, because of many deductions and credits, the average estate tax rate is much lower than the statutory rates. Total estate tax liability in 1998 equaled about 25 percent of the value of taxable estates. (This number does not reflect the loopholes that reduce the size of gross estates.)

3. Repealing Estate Tax and Enacting Carryover Basis

The carryover basis option would repeal the estate tax, but essentially require that capital gains are eventually paid on all assets, rather than being forgiven at death. This proposal has considerable policy merit, insofar as it would address a serious defect in the income tax, would reduce the incentive for people to hold assets until death, and would still defer tax on assets that are not sold—addressing a concern of farmers and business owners.

However, it is politically infeasible because it would raise taxes on hundreds of thousands of heirs with appreciated property who would not otherwise be subject to the estate tax under current law —all of those with appreciated property worth less than the estate tax exclusion.[2]

[2] The Republican proposal (H.R. 8) avoided taxing those not subject to estate tax by allowing large exemptions from the carryover basis rule. For each decedent, up to $3 million in property passing to a surviving spouse and up to $1.3 million in property passing to other beneficiaries would receive a step-up in basis.

Also, since capital gains tax would be levied at low rates (generally 20 percent or less) and deferred until the asset is sold, it would raise far less revenue in the budget window than the estate and gift taxes it would replace. Finally, heirs of property that had passed through multiple generations would have a nearly impossible task measuring their capital gains (as would the IRS in trying to administer the provision). The concern about complexity was a major factor behind the public outcry about carryover basis when it was enacted in 1976, which led to its delay and ultimate repeal before it could become effective.

Recommendation

Encourage Senate Democrats to adopt an alternative similar to the option currently favored by Senators Daschle, Moynihan and Baucus. This approach would have several elements and would accomplish several important objectives that would have political appeal.

- Immediately increase unified credit to $1 million and increase to $1.5 million by 2010.
    - Unlike H.R. 8, the immediate increase in the unified credit will remove one-third of estates from the estate tax and provide significant relief to others.
    - Continuing to increase the unified credits would significantly reduce (by 2010, about half of) the number of people who are subject to the estate tax, so that it is targeted at the truly wealthy.

- Increase the family farm and small business exclusion from $1.3 million to $2.5 million.
    - This would address the special concerns of family farmers and small business owners and would allow virtually all family farms and a significant percentage of small businesses to avoid the estate tax.

- Allow the estate of the second spouse to die to use any portion of the unified credit and family farm/small business exclusion not used by the first spouse.
    - This increases fairness and significantly simplifies the tax so that those who do not engage in costly estate tax planning will not be disadvantaged.

In total, this package would cost substantially less than H.R. 8 (particularly in the out years). This approach would cost somewhere between $35 billion and $50 billion depending on how quickly increases in the unified credit are phased in. In 2010 and beyond (i.e., when full repeal would take effect in H.R. 8), this approach would cost less than one-fifth as much as full repeal ($10 billion a year as compared to $50 billion).

We also believe that it may be important politically to provide targeted relief for homeowners who seem wealthy simply because their homes have vastly increased in value. This is particularly important in California, where housing prices in various areas have skyrocketed. Senate Democrats do not have any provision targeted at homeowners. We, however, recommend that the Administration publicly reiterate its support for the concept of targeted relief for such homeowners.

Finally, we should seriously consider the context under which we should present any estate tax reform proposal. Your economic advisers have been discussing whether we should support a more progressive and targeted approach to the estate tax as a stand-alone measure or whether we should offer limited estate tax relief in exchange for targeted, middle-class oriented tax cuts, like the Earned Income Tax Credit, long-term care tax credits, or the college opportunity tax cut. We will be discussing further strategic options with you as we develop them.

Appendix 1. House Democratic Alternative

Democrats on the Ways and Means Committee proposed an alternative option to reform the estate tax. It would immediately raise the exempt amount from $675,000 to $1.1 million; and raise the exemption to $1.2 million in 2006. It would reduce estate tax rates across the board by 20 percent, so the top rate would fall from 55 percent to 44 percent, and pay for this by converting the state death tax credit to a deduction. It would exempt up to $4 million of small farm and business income (QFOBI) for a couple ($2 million for singles). It would limit the revenue cost by closing some estate tax loopholes and converting the QFOBI deduction to an applicable exclusion amount. Two of the proposals to close loopholes were proposed in our FY 2001 budget.

<u>Details</u>

- Reduce all tax rates (except for the 5% surtax) by 20 percent. The resulting statutory rates would range from 32.8% on estates under $1,250,000 to 44% on estates of $3,000,000 or more.

- Modify and expand the qualified family owned business interest (QFOBI) benefit.
  - Change the QFOBI deduction to an applicable exclusion amount.
  - Increase the applicable exclusion amount (the amount exempted by QFOBI plus the unified credit) from $1.3 million to $2.0 million.[3]
  - Allow the second spouse to die to use the QFOBI exclusion amount not used by the first spouse to die, provided that the first spouse also qualified for but did not make the QFOBI election.

- Increase the amount exempted by the unified credit to $1,100,000 for 2001 through 2005, and to $1,200,000 for 2006.

- Eliminate the state death tax credit and allow a deduction for all state death taxes paid. (See discussion of issues raised by this proposal below.)

- Provide for the taxation of certain gifts and bequests from expatriates.

- Eliminate the ability to claim valuation discounts on account of lack of voting control, where the transferor and members of the transferor's family together have voting control.

- Restore the phase-out of the unified credit for estates in excess of about $16,000,000. (Included in the Administration's FY 2001 Budget proposal.)

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[3] Note that QFOBI effectively substitutes for the unified credit for estates with qualifying farms and businesses valued at more than the amount exempted by the unified credit. Thus, for example, a person whose qualifying business was valued at $1.5 million would have a credit equal to the tax liability on that amount. If the business was worth $5 million, the credit would exempt $2 million of assets. Note that the QFOBI exemption is <u>not</u> in addition to the general unified credit.

- Eliminate non-business valuation discounts. (Included in the Administration's FY 2001 Budget proposal.)

Cost: About $30 billion over 10 years.

Discussion: Unlike the Republican proposal (H.R. 8), the estate tax relief in the Democratic alternative is effective immediately. Thus revenue costs are apparent, and not hidden outside of the budget window. All estates that are now taxable would benefit from the reduction in tax rates, and all but the very largest estates would benefit from the increases in the unified credit. Additional relief would be targeted to qualified family owned business interests (QFOBI).

We believe that much of the animosity toward the transfer tax system stems from the top marginal rates that are in excess of 50 percent. By keeping the top rate at 44 percent (with a marginal rate of 49 percent in the region where the unified credit and graduated rates are phased out), the Democratic alternative ensures that no taxpayer will owe more than half of his or her taxable estate to the government.

The proposal is paid for in part by the conversion of the state death tax credit to a deduction. We would expect state revenues to fall as a result of this provision. Under current law, state death taxes are creditable against the federal tax, up to a limit. States generally levy death taxes equal to the federal credit, thereby shifting revenue from the federal government to the state governments. For example, for the largest estates, the effective Federal marginal tax rate is 39 percent (rather than 55 percent) and the effective state marginal tax rate is 16 percent. Most state laws refer directly to the federal credit. Thus, repealing the federal credit would effectively reduce state revenues to zero. Nearly all states would have to enact new laws that are independent of the federal credit, or forego this revenue. States might also compete with one another to enact the most favorable estate and inheritance tax provisions—the very situation that the state death tax credit was designed to avoid.

- Prepared by Len Burman and Jon Talisman (Tax Policy)
- LS ok per SS
- Len B to WH
- NCL/TR to LS (reading)
  SE
- email cc from Len B.
  to SS
  JS
  SF

6/20/00

Please log in

2000-SE-006730

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 27, 2000

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers

SUBJECT: Options to Reduce Top Estate Tax Rates

Summary

In response to your request, this memorandum considers two options for reducing top estate tax rates. The first option would replace the progressive schedule of estate tax rates that exists under current law with a flat 39.6 percent rate—the top individual income tax rate. The second option would cut estate tax rates across the board by 20 percent, retaining the progressive rate structure, but cutting the top rate from 55 percent to 44 percent. That option was included in the House Democrat's estate tax proposal.[1]

In summary, either option to reduce rates would cost roughly $90 billion over ten years if made effective in 2001. Between two-thirds and four-fifths of the benefits of tax rate reduction would go to estates larger than $5 million. If combined with options to remove smaller estates and family-owned farms and businesses from the estate tax rolls, as discussed in the June 21 memo, the total cost could increase into the $120 to $140 billion range.

By comparison, the House Republican estate tax repeal bill was scored as costing about $100 billion over ten years. However, the revenue estimate for the House bill hides most of its cost because repeal would not become fully effective until 2010—and not show up on estate tax returns until 2011. When fully phased in, the annual cost of repeal is around $50 billion <u>per year</u>. The comparable annual cost for rate reduction would be one quarter as much—about $12 billion per year.

Although it is true that estate tax rates appear to be quite high, ranging up to 55 percent for large estates, that appearance is somewhat deceptive. The statutory rates under the federal tax include both state and federal components, because state inheritance and estate taxes are rebated by means of a federal tax credit. For the largest estates, the 55 percent statutory tax rate includes a

[1] Ways and Means Democrats proposed on June 9, 2000 to: (1) raise the amount exempt from estate tax from $675,000 to $1.1 million in 2001, and to $1.2 million in 2006; (2) reduce estate tax rates 20 percent; and (3) raise the amount of small farm and business assets that is exempt from tax from $1.3 million to $2 million per estate ($4 million per couple). It would limit the revenue cost by replacing the state death tax credit with a deduction (discussed below) and closing some estate tax loopholes.

16-percent state rate plus a 39-percent net federal rate. That 39-percent net rate compares favorably with the 39.6 percent top individual income tax rate. Moreover, the one-time estate tax is intended as a backstop against the effects of lifetime tax avoidance, whereas the income tax is assessed annually. Thus, arguably, federal estate tax rates are not excessive when all things are considered.

Recommendation

Given those considerations and the high cost and regressivity of estate tax rate relief, we recommend that estate tax reform focus instead on removing small estates, family farms, and family-owned businesses from the tax rolls. That targeted relief, which would benefit all estate taxpayers, could be accomplished at relatively modest cost by raising the unified credit and increasing the tax-free allowance for family-owned farms and businesses.

Attachment

Option 1: Flat 39.6 percent rate

Under current law, marginal estate tax rates range from 37 percent on taxable estates under $750,000 to a top rate of 55 percent on estates in excess of $3,000,000. A 5-percent surtax, designed to phase out the benefit of graduated estate tax rates, applies to very large estates (over $10 million).

Under the option, a flat 39.6 percent rate would replace the progressive rates and surtax. That rate would equal the top individual income tax rate, and would help defuse the argument that the estate tax is confiscatory.

The proposal would provide the largest tax cut to estates over $3,000,000, and an especially large tax cut for those estates over $10 million that are currently subject to the 5-percent surtax. It would provide little or no tax relief for smaller estates. In 2010, estates larger than $5 million would receive 80 percent of the benefit of this option.

The proposal would cost about $90 billion over ten years if effective in 2001.

Option 2: Cut tax rates across the board by 20 percent

The House Democratic alternative proposed to reduce all tax rates (except for the 5% surtax for very large estates) by 20 percent. The resulting statutory rates would range from 29.6 percent to 44 percent. This option would retain a progressive rate structure while somewhat constraining the revenue cost, by assessing lower estate tax rates than Option 1 on estates smaller than $2.5 million and higher rates on large estates. In 2010, estates larger than $5 million would receive two-thirds of the benefit of this option.

The proposal would also cost about $90 billion over ten years. If the top rate were limited to 39.6 percent (as in Option 1), a progressive rate schedule would cost more than $100 billion.

Possible Revenue Offset: Replace state death tax credit with a deduction.

The House Democratic alternative would have eliminated the state death tax credit and allowed a deduction for all state inheritance and estate taxes paid. We would expect revenues from such taxes to fall as a result of this provision. Under current law, state death taxes are fully creditable against the federal tax, up to a limit. The federal tax credit effectively rebates the state taxes. As a result, all states currently levy inheritance and estate taxes that are equal to or greater than the maximum federal credit allowed for each estate.

The logic behind repeal of the state death tax credit is that the federal marginal estate tax rate effectively includes both the federal tax and the state tax. As a result, under current law, the federal government is "blamed" for both its own tax and the embedded state tax. For example, by providing a 16-percent state death tax credit for the largest estates, the statutory federal marginal estate tax rate of 55 percent combines an effective 16 percent state tax rate and a 39 percent effective federal estate tax rate.

Most state laws refer directly to the federal credit. In those states, repealing the federal credit would effectively reduce state revenues from inheritance and estate taxes to zero. States would have to enact new laws that are independent of the federal credit, or forgo this revenue. They might also compete with one another to enact the most favorable estate and inheritance tax provisions—the very situation that the state death tax credit was designed to avoid.

Although there was not an outcry from the states about the Democratic alternative, the states might be more exercised if the proposal originated with the Administration. The largest amount of state death tax credits in 1998 were for decedents from California ($0.7 billion), Florida ($0.5 billion), and New York ($0.5 billion).

Replacing the state death tax credit with a deduction would reduce the cost of rate reduction by around $65 billion over ten years. Note that the Administration's budget proposed $9 billion of loophole closers that could also be used to reduce the net cost of estate tax reform. House Democrats proposed $7 billion of those offsets.

Prepared by
Len Burman

TR original to
WH

NCC cc to SE (reading)

NCC cc to SS
TS
CK
NC/PA/AK/TR

6/28/00

Please log and file

FEDERAL RESERVE

THE SECRETARY OF THE TREASURY
WASHINGTON

93 116326

January 21, 1993

MEMORANDUM FOR: THE PRESIDENT

FROM: LLOYD BENTSEN LMB

It is important that we avoid putting public pressure on the Federal Reserve Board to ease monetary policy. Their historical sensitivities on "independence" and the internal politics there are such that this actually makes it harder for the Fed to accommodate our fiscal policy.

The press is accustomed to public confrontation between the Executive Branch and the Fed and is eager to stir the pot again. The New York Times, for example, tried to do so on Monday. Even indirect comments by senior members of the economic team will be blown out of proportion.

Our stance should be that we both have the same goal: balanced fiscal and monetary policies which will promote non-inflationary growth. We expect to work cooperatively.

cc: The Vice President
OMB Director Panetta
Chairperson Tyson
Assistant to The President for Economic Policy, Bob Rubin

DEPARTMENT OF THE TREASURY
WASHINGTON

FAX TRANSMITTAL SHEET

DATE: 1/22/93

NUMBER OF SHEETS TO FOLLOW: 1

TO: Chairperson Tyson

ADDRESSEE'S FAX #: 395-6947

ADDRESSEE'S CONFIRMATION #: ____________

FROM: Ed Knight

SENDER'S FAX #: 202-622-0073

SENDER'S CONFIRMATION #: 202-622-1700

SPECIAL INSTRUCTIONS/COMMENTS:

DEPARTMENT OF THE TREASURY
WASHINGTON

FAX TRANSMITTAL SHEET

DATE: 1/22/93

NUMBER OF SHEETS TO FOLLOW: 1

TO: OMB Director Panetta

ADDRESSEE'S FAX #: 395-~~1005~~ 3174

ADDRESSEE'S CONFIRMATION #: ______________

FROM: Ed Knight

SENDER'S FAX #: 202-622-0073

SENDER'S CONFIRMATION #: 202-622-1700

SPECIAL INSTRUCTIONS/COMMENTS:

DEPARTMENT OF THE TREASURY
WASHINGTON

FAX TRANSMITTAL SHEET

DATE: 1/22/93

NUMBER OF SHEETS TO FOLLOW: 1

TO: Bob Rubin

ADDRESSEE'S FAX #: 456-2878

ADDRESSEE'S CONFIRMATION #:

FROM: Ed Knight

SENDER'S FAX #: 202-622-0073

SENDER'S CONFIRMATION #: 202-622-1700

SPECIAL INSTRUCTIONS/COMMENTS:

DEPARTMENT OF THE TREASURY
WASHINGTON

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FAX TRANSMITTAL SHEET

DATE: 1/22/93

NUMBER OF SHEETS TO FOLLOW: 1

TO: Vice President

ADDRESSEE'S FAX #: 456-7044

ADDRESSEE'S CONFIRMATION #: ____________

FROM: Ed Knight

SENDER'S FAX #: 202-622-0073

SENDER'S CONFIRMATION #: 202-622-1700

SPECIAL INSTRUCTIONS/COMMENTS:

ADMINISTRATION HISTORY APPENDIX
CHAPTER ONE: FISCAL DISCIPLINE

GOLD STANDARD

96-155052

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

February 6, 1996

MEMORANDUM FOR THE PRESIDENT

THROUGH: ROBERT RUBIN R.E.R.

FROM: LAWRENCE SUMMERS

SUBJECT: Gold Standard and the Economy

Steve Forbes has talked about returning America to the gold standard. You asked what this would mean. Here are some key points:

A gold standard is a system under which the only aim of U.S. monetary policy is to keep the value of the dollar constant when measured in gold.

- Monetary policy is used to keep the gold price of the dollar fixed, and as long as monetary policy is used for this purpose it cannot be used for anything else.

- Under a gold standard, interest rates cannot be reduced to try to stop (or at least ameliorate) a recession -- had the U.S. been on a gold standard, the Federal Reserve-produced reductions in interest rates that have been used to fight every recession since 1950 would have been next to impossible.

- Under a gold standard, interest rates cannot be reduced to try to stop a wave of bank failures -- had the U.S. been on a gold standard, the beginning of the 1990s would have seen a large wave of commercial bank failures.

- In fact, the recent definitive history of the Great Depression by Berkeley professor Barry Eichengreen, *Golden Fetters,* gives the gold standard the lion's share of the blame for the failure of governments to prevent the bank failures that deepened the Great Depression.

- Politicians' beliefs in the gold standard were the "golden fetters" that kept them from taking the steps needed to keep the Great Depression from becoming a decade-long catastrophe.

The U.S. would lose control of its money supply under a gold standard.

- Inflation or deflation in the U.S. would depend on conditions in the gold market.

- The world's largest source of gold is South Africa: the principal determinant of inflation or deflation in the U.S. under a gold standard is the state of South African politics as it affects gold production. Political crisis in South Africa means deflation--and probably depression -- in the United States.

- The world's second largest source of gold is Russia: the secondary determinant of inflation or deflation in the U.S. is the state of Russian politics as it affects gold production.

- The third important factor influencing the world's supply of monetary gold is *Chinese* politics: instability in China that led to an increase in gold hoarding could also generate deflation -- and perhaps depression -- in the United States.

- In the early 1970s no one imagined that a decade-long economic crisis in the U.S. could be set in motion by the combination of an Arab-Israeli War, a U.S. policy to build up the Iranian military, and the key role played by oil in the U.S. energy sector. Adopt a gold standard and the health of the U.S. economy is once again made hostage to overseas political developments in less-than-stable countries.

ADMINISTRATION HISTORY APPENDIX
CHAPTER ONE: FISCAL DISCIPLINE

MEDICAID

95-152820

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 29, 1995

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Glen Rosselli
Deputy Assistant Secretary
(Economic Policy)

CC: Sylvia Mathews

SUBJECT: Medicaid Program

To: Glen Rosselli
From: Bob Rubin
Thank you. I kept last page, to keep numbers

Given all the discussion of late involving Medicaid I thought that it might be useful for you to have this short summary of the program as a review.

The Medicaid Program

- Medicaid is a joint Federal and State entitlement program that provides medical services to low-income, disabled and elderly individuals. There were 33.4 million people enrolled in Medicaid in 1994 at a total cost of $138 billion; Federal spending was $79 billion. CBO predicts Federal Medicaid spending to be almost $100 billion in 1996.

Why isn't this enormously powerful, politically.

- Subject to Federal guidelines, each State:

  (1) establishes its own eligibility standards;
  (2) determines the type, amount, duration, and scope of services;
  (3) sets the rate of payments for services; and
  (4) administers its own program.

  As a result, Medicaid should be viewed as 50 distinct programs.

- In general, States are required to provide medical services for certain groups of individuals, primarily individuals receiving Federally assisted income maintenance programs (AFDC, SSI). States are also required to cover children under 6 years old and pregnant women in families with income up to 133 percent of the Federal poverty level. States must also cover children up to age 19 born after September 20, 1983 in families with incomes below 100 percent of the Federal poverty level. In addition, States have the option of setting up programs for other individuals who do not qualify under the above conditions.

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- In 35 states, Medicaid covers nursing home care for non-poor elderly. In order to qualify, individuals must require nursing home care and have income and assets below a level set by the State, subject to Federal guidelines. Individuals whose assets are greater than the State limit must pay for nursing home care out-of-pocket ("spend down") until their asset level falls below the State limit.

- The Federal share of Medicaid expenditures is determined by a statutory formula. States with a lower per capita income have a higher matching rate. The minimum Federal matching rate is 50 percent and the maximum is 83 percent.

- In 1993, roughly 30 percent of recipients were aged, blind, or disabled; almost 70 percent of payments were on behalf of these beneficiaries. Roughly 70 percent of the recipients were either children or qualifying adults in families with dependent children, receiving 30 percent of payments.

- General inpatient hospital services and skilled nursing facility services are the largest expenditures, each accounting for 25 percent of payments in 1993.

Financial Status of Medicaid

- Medicaid is currently one of the fastest growing programs in the Federal Budget. Federal Medicaid spending rose at annual average rate of 18 percent from 1988 to 1994, increasing from 2.5 to 5 percent of total Federal outlays. In addition, Medicaid is becoming an increasingly important source of Federal funds for States. In 1994 Medicaid constituted nearly 40 percent of Federal grants and aid to the States.

<u>The Administration's Approach</u>

- The Administration's budget calls for $54 billion in Medicaid savings over the next seven years, with $150 billion in Federal Medicaid spending in 2002, for a 1995-2002 annual average increase of 8 percent.

- The Administration is proposing a per capita cap on Medicaid spending. This would provide states with a fixed amount of money per Medicaid recipient in a particular category (say $X per eligible child and $Y per eligible disabled adult). This would allow states to expand the eligible population and cover more individuals in response to the business cycle without reducing per capita spending. Block grants would not provide this same flexibility.

The Secretary of the Treasury

December 4, 1995

NOTE FOR GLENN ROSSELLI

FROM: BOB RUBIN

Thank you. I kept last page,
to keep numbers.

Why isn't this enormously
powerful, politically.

Attachment

TREASURY CLEARANCE SHEET

NO. 95-152820
Date November 29, 1995

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☒ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ____

FROM: Glen Rosselli
THROUGH: ____
SUBJECT: Medicaid Program

REVIEW OFFICES (Check when office clears)

- ☐ Under Secretary for Finance
  - ☐ Domestic Finance
  - ☐ Economic Policy
  - ☐ Fiscal
    - ☐ FMS
    - ☐ Public Debt
- ☐ Under Secretary for International Affairs
  - ☐ International Affairs
- ☐ Enforcement
  - ☐ ATF
  - ☐ Customs
  - ☐ FLETC
  - ☐ Secret Service
- ☐ General Counsel
- ☐ Inspector General
- ☐ IRS
- ☐ Legislative Affairs
- ☐ Management
- ☐ OCC
- ☐ Policy Management
  - ☐ Scheduling
- ☐ Public Affairs/Liaison
- ☐ Tax Policy
- ☐ Treasurer
  - ☐ E & P
  - ☐ Mint
  - ☐ Savings Bonds
- ☐ Other ____

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Gus Faucher	GF	11/29/95	Economist, Economic Policy	2-0714
REVIEWERS				
John Hambor	JH	11/29/95	Director, Ofc. of Policy Analysis	2-2350

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

95-152993

December 5, 1995

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN

FROM: Glen Rosselli
Deputy Assistant Secretary
(Economic Policy)

CC: Sylvia Mathews

SUBJECT: Medicaid

Our Medicaid proposal has three components: a per capita cap; increased flexibility for states; and reduced and re-targeted disproportionate share hospital (DSH) spending. What follows is a summary review of the main points of our proposal and a comparison of our provisions that would enhance program flexibility with those endorsed by the National Governor's Association.

Under a per capita cap, the federal guarantee of coverage would be retained, and spending per beneficiary would be federally matched up to a set level. The cap would be set using spending per beneficiary in base year, increased by an annual growth limit.

States would be given increased flexibility to manage their Medicaid programs.

DSH payments would be limited in size and retargeted.

PER CAPITA GROWTH LIMITS POLICY

A "per capita cap" is a policy designed to limit federal spending without risking the loss of health coverage. It works by setting for each state a federal spending "cap" per beneficiary, which adapts automatically to the size and type of Medicaid beneficiary population that the state covers.

The "cap" would be the estimate of what the spending for a group of beneficiaries would have been had spending growth per beneficiary been limited to a specified index, such that the amount of savings from the limits and the DSH program restructuring equals $54 billion over the 7 year period. If a state's actual spending exceeds the cap, then the Federal government would match only up to the <u>cap</u> using the current federal medical assistance percentage (FMAP).

The "cap" would be coupled with enhanced flexibility so that states can be creative in strategies to control Medicaid costs.

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Calculation of the Cap

The cap would be the product of three components:

1. Total State and federal spending per beneficiary in 1995, the base year;

2. An index (for years between the base year and the particular year);

3. The number of beneficiaries in the particular year.

To allow for a change in the mix of Medicaid beneficiaries over time, the cap would be calculated using the specific spending per beneficiary and number of beneficiaries in four subgroups: the aged, individuals with disabilities, non-disabled adults, and non-disabled children. Once the cap is calculated, it is multiplied by the federal medical assistance percentage (FMAP) to calculate the maximum federal spending per beneficiary in that state.

The per capita cap becomes effective in FY 1997.

Spending

Payments for DSH, State Fraud Control units survey and certification, save Medicare premiums and cost-sharing, payments to IHS and other Indian health providers, and the VFC program would be excluded from the cap.

Most administrative costs would be included in the base year calculation.

The base year would be adjusted for disallowances and prior period adjustments.

Beneficiaries

Beneficiaries are full-year equivalent individuals enrolled in Medicaid. All beneficiaries except QMBs (those qualified Medicare beneficiaries below 100 percent of poverty for whom Medicaid pays all Medicare premiums, coinsurance, and deductibles), would be subject to the cap.

Index

Growth in spending per beneficiary would be indexed using an inflation-based index -- the five year rolling average of nominal gross domestic product (GDP) per capita adjusted with a plus or minus factor to meet budgetary targets, such that the amount of savings from the limits and the DSH program restructuring equals $54 billion over the 7 year period.

ENFORCEMENT

The cap would be enforced on an aggregate state level, based on the sum of subgroup caps for each of the beneficiary enrollment categories. The current reporting requirements would be modified in order to implement the per capita cap.

Spending projections for the upcoming quarter would be disaggregated by beneficiary group.

Expenditure, reports would be changed to include enrollment data and to cross-walk expenditure and beneficiary categories.

The current system for reconciling actual and allowed spending would be used. Quarterly grants would be adjusted as they are currently to reflect updated information as it becomes available. The cap would be enforced on an annual basis, so that quarterly grant adjustments would only be interim steps.

Under a per capita cap, a quarterly grant process similar to that used to announce DSH allotments would be used.

STATE FLEXIBILITY PROVISIONS

States would be given increased flexibility in how to manage their Medicaid programs.

Provider Payment

The Boren Amendment would be repealed. It would be replaced, in the case of nursing home payments only, with a set of notification provisions that would assure that adequate public notice and comments was provided to state residents.

Provide reasonable opportunities for all citizens to appeal and obtain a hearing on State actions;

HHS would conduct a study to investigate the relationship between quality, access and provider payment to address the need for adequate access of Medicaid beneficiaries.

Repeal other special federal payment requirements. Federal requirements payment for obstetrical and pediatric services would be repealed.

Repeal requirement for States to pay for private insurance when cost-effective States would have the option to purchase group insurance and negotiate their own payment rate.

Delivery systems

Allow States to mandate enrollment in certain types of managed care delivery systems as State plan option, without the need for Federal waivers. States would continue to be required to offer Medicaid enrollees a choice of plan or delivery system except in rural areas where choice of plan could be limited. Choice of providers within plan would be maintained in rural areas. Special provisions would be made for the inclusion of Indian health providers and Native Americans in managed care systems.

Modify managed care quality of care requirements by repealing the 75/25 enrollment composition rule and the independent external review requirement, while adding a provision that States would develop a quality improvement strategy, consistent with Federal standards, to ensure that the managed care providers maintain reasonable access and quality health care.

Allow states to provide home and community based services as state plan option, without the need for Federal waivers.

Administration

Repeal physician qualification requirements.

Repeal Federally-mandated administrative requirements, but retain States' authority to establish similar requirements.

Re-engineer the Medicaid Management Information System (MMIS) requirements to retain the required use of standardized claims formats, standardized HCFA reporting requirements

Eligibility Expansions and Simplification

Allow States to expand or simplify eligibility by making modest eligibility changes within certain parameters under a simplified and expedited procedure with limited Federal involvement.

Federal matching would remain limited by the aggregate limit, which would be based on current law eligibility and be constrained to the lower of the aggregate cap for current eligibles or projected State spending below the cap. Parameters for these simplified eligibility changes could be specified as either within a certain percentage of the Federal poverty level (e.g., 150 percent), or within a certain threshold level of enrollee expansion (e.g., 30 percent).

FEDERAL OVERSIGHT PROVISIONS

Eligibility

Retain current mandatory and optional eligibility groups, including AFDC and SSI cash and non-cash groups, poverty level children and pregnant women, medically needy, and QMB/SLMB. (note: SLMBs are those "selected low-income Medicare beneficiaries" -- below 110 percent of federal poverty -- that as a condition of participation in the Medicaid program we currently require states to pay Medicare the premiums for.

Retain spousal impoverishment provisions.

Services

Retain the requirement that states continue to offer all Medicaid mandatory services.

Payment

Retain the prohibition on copayments that are more than nominal or other cost-sharing burdens on recipients unless they are reasonably related to income.

Retain requirement for Federal matching as well as DSH payment requirements both from the 1987 and 1991 laws, and per hospital limits included in OBRA 93.

Quality

Retain quality of care provisions, such as OBRA-87 nursing home reform provisions, and an uncapped funding for the State survey and certification activities.

Continue requirements for beneficiary protections and retain the administrative provisions that require States to ensure quality of care:

- Use a single State agency to administer or supervise the administration of the plan;
- Provide reasonable opportunities for all citizens to appeal and obtain a hearing on State actions;
- Submit proposed program changes to public review and comment;
- Safeguard information about recipients.

Retain current fraud and abuse provisions, and retain an uncapped funding for the State Fraud Control Units.

Modify requirements related to State contracts with health plans to maintain State and Federal oversight on managed care as follows:

States must develop an overall quality improvement strategy, including plan standards, monitoring strategies, and data analysis;

States must collect and analyze patient data from contracting health plans [or States may require plans to report certain information from the plans patient data];

Current Demonstration Waivers

All States would be subject to the per capita limits, including those with Statewide demonstration programs. The same per capita growth rates would apply to all States.

Enrollment Base: The proposal would permit implemented demonstration States to choose between two approaches for maintaining their eligibility expansion: (1) Including demonstration eligibles in their enrollment base for calculating their aggregate limit; or (2) Calculating their aggregate limit off of current law eligibles, and expanding enrollment in a budget-neutral manner within this cap.

REDUCING AND RE-TARGETING MEDICAID DISPROPORTIONATE SHARE HOSPITAL PAYMENTS

The policy objective is to reduce and re-target the amount of Federal Medicaid Disproportionate Share Hospital (DSH) payments made by states to hospitals serving large low-income and uninsured populations to be consistent with the President's balanced budget proposal.

Reducing Payments

Most states would have their 1995 federal DSH payments reduced by 35 percent by 1998; spending would then be maintained at the 1998 levels.

Very high DSH states (with DSH payments greater than 35 percent of non-DSH spending in FY 1995) would receive a 75 percent reduction, and very low DSH states (1995 DSH spending that is less than 5 percent of non-DSH spending) would receive a 10 percent reduction.

<u>Special pool:</u> to ease the transition to the streamlined DSH program, two special, 100 percent federally funded pools would be established.

> Pool for undocumented persons' medical care: a 100 percent federal pool would be allocated among the 15 states with the largest number of undocumented persons in proportion to the state's share of the total number of undocumented persons.
>
> Pool for states with large Medicaid shortfalls and unsponsored care burdens: a 100 percent federal pool would be allocated equally among the ten states with the highest percentage of Medicaid shortfall and unsponsored care as measured by the American Hospital Association (AHA, November, 1992).

COMPARISON OF ADMINISTRATION MEDICAID REFORM PROPOSAL WITH FLEXIBILITY REFORMS DESIRED BY THE GOVERNORS

Our Alternative Medicaid Reform Proposal significantly increases State flexibility in Medicaid program administration. At the same time, it achieves Federal Medicaid savings through the use of per capita caps which protect States against eligible population growth due to demographic changes, economic downturns, and other uncontrollable events. Finally, the level of savings proposed by the alternative is substantially less than a third of what the Republicans are seeking. Thus, States would have the flexibility to tailor their Medicaid programs to meet local needs without the substantial funding losses and financial risks inherent in the Republican block grant proposals.

The State flexibility of the alternative plan is illustrated by the fact that many of the Medicaid flexibility proposals requested by the States over the past several years are included explicitly in the plan. The following chart reflects items requested by the National Governor's Association in its 1993 summary of State Recommendations for Statutory Change and its Medicaid Policy adopted in January 1995.

Attached find some tables comparing NGA Medicaid Proposals and the Administration's alternative proposal.

Flexibility Proposals Contained in the Alternative Medicaid Proposal

NGA Medicaid Proposals	Alternative Proposal
1. Allow states greater flexibility to establish managed care networks:	Addressed. States may implement managed care programs without obtaining waivers from HCFA.
• States should be able to establish networks through the state plan process rather than through the freedom of choice waiver process. (NGA93, NGA95)	Included.
• Eliminate the 75/25 rule for capitated health plans participating in the Medicaid program (NGA93, NGA95)	Included.
• Under a freedom of choice waiver, permit states to restrict Medicaid recipients in a rural area to a single HMO if there is only one HMO available. (NGA93)	Included.
2. OBRA87 Nursing home reform modifications:	Addressed.
• Eliminate restrictions on training sites for nurse aides. (NGA93)	Eliminates prohibition on providing nurse-aide training in rural nursing homes
3. States should have the ability to turn home and community based waivers into permanent site plan amendments once the waiver has been proven effective. (NGA93, NGA95)	Addressed. States may establish home and community-based services without waivers (subject to CBO scoring).
4. Promote cost control and efficiency -- i.e., encourage states to continue innovations in provider payment methods. (NGA95)	Addressed. Permits states to implement managed care programs without waivers.
5. Give states greater leeway in containing the cost of hospital and long-term care through the Boren Amendment. (NGA93, NGA95)	Addressed. Boren amendment is repealed for hospitals and nursing homes.
6. Provider Qualifications	Addressed.
• Repeal provision establishing minimum qualifications for physicians who serve pregnant women and children. (NGA93)	Included.

• Repeal the annual reporting requirements for OB and pediatric care. (NGA93)	Included.
7. Allow states to pay Medicaid rates for those services provided to recipients for whom the state has purchased cost-effective group health insurance. (NGA93)	Addressed. States will have the option to purchase group health insurance and pay Medicaid rates.
8. Once a state has demonstrated through the waiver process that the program is effective and efficient, other states should have the opportunity to make that program a part of their state plan as an optional services without having to submit a waiver. (NGA93)	Addressed. Managed care and home and community-based care no longer require waivers.
9. Simplify eligibility by collapsing existing categories and optional groups where appropriate. (NGA93)	Addressed. To allow for eligibility simplification and eligibility expansion, states would have the option of covering individuals up to 150% of poverty, or expanding overall coverage by 30%, as long as the expansion is "budget neutral" (subject to CBO scoring). Current coverage would be maintained.
10. Personal care should be an optional service that can be delivered or provided by other providers besides home health agencies. (NGA93)	Affirms current law that personal care services can be delivered by providers other than home health agencies.
11. OBRA87 enforcement: the determination of deficiencies require a form of scope and severity index to assure that limited state resources are directed to the enforcement of the most egregious deficiencies. (NGA93)	Affirms current law to allow the targeting of state enforcement resources.

12. Impose no unilateral caps for federal spending on Medicaid entitlement.	Addressed. In contrast with the Republican block grant proposal, the alternative per capita proposal provides states with protections for enrollment increases due to population changes and economic conditions. Disproportionate share payments (DSH) would be reduced and restructured. Entities eligible for DSH payment should be expanded to include FQHCs, RHCs and other outpatient providers. The alternative proposal would also include new payments to a number of states with high numbers of undocumented immigrants and high level of uncompensated care.