Report No. 1410
February 20, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William M. Paul
Acting Chief Counsel and Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
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Re: *Report No. 1410 – Report on the Proposed Section 2010 Regulations*

Dear Messrs. Kautter, Rettig, and Paul:

I am pleased to submit our Report No. 1410 (the "Report"), commenting on the proposed regulations (the "Proposed Regulations") issued pursuant to the authority of Section 2001(g)(2) and Section 2010(c)(6) of the Internal Revenue Code of 1986, as amended (the "Code"). In 2017, Congress enacted "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act").

Among other changes to the Code, the Act amended Section 2010 of the Code to increase the basic exclusion amount available to estates of decedents dying after December 31, 2017, and before January 1, 2026. In addition, the Act added Section 2001(g)(2), which directs the Secretary of the Department of the Treasury ("Treasury") to issue regulations necessary or appropriate to carry out Section 2001 with respect to changes in the basic exclusion amount. We commend the Treasury and the Internal Revenue Service for releasing proposed regulations exercising Treasury's authority under Section 2001(g)(2) and addressing taxpayer questions regarding the effects of the temporarily increased basic exclusion amount.

The Report highlights areas of the Proposed Regulations that we believe warrant clarification, and offers specific recommendations. Our comments generally address issues raised by the sunset provisions of the Act. In particular, we recommend the following:

1. The final regulations include an example confirming that individuals do not benefit from pre-2026 inflation adjustments unless they actually make taxable gifts that use up inflation-adjusted increases to the basic exclusion amount.

2. The final regulations include an example confirming that individuals who made taxable gifts that use up a portion of the temporarily increased basic inclusion amount do not benefit from post-2025 inflation adjustments unless and until the basic exclusion amount, as adjusted, exceeds the amount of basic exclusion amount previously used by the taxpayer.

3. Consistent with existing regulations regarding the deceased spousal unused exclusion amount ("DSUE"), the final regulations confirm that DSUE inherited from a deceased spouse before 2026 will not be limited by the lower basic exclusion amount available beginning January 1, 2026.

4. The final regulations provide an explicit ordering rule determining whether the basic exclusion amount or, instead, the DSUE amount is used first for purposes of determining the amount of basic exclusion amount used prior to 2026.

5. The final regulations confirm that late allocations may be made of the amount of generation-skipping transfer tax exemption increased by the Act, including to trusts created before 2018.

6. Treasury and the Service consider further whether gifts included in a decedent's gross estate should successfully lock in the temporarily increased exclusion amount available before 2026.

We appreciate your consideration of our recommendations. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

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Report No. 1410

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE PROPOSED SECTION 2010 REGULATIONS

FEBRUARY 20, 2019

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This report (the "Report")[1] provides comments on proposed regulations (the "Proposed Regulations")[2] issued pursuant to the authority of Section 2001(g)(2) and Section 2010(c)(6) of the Internal Revenue Code of 1986, as amended (the "Code").[3] In 2017, Congress enacted "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97 (the "Act").[4] Among other changes to the Code, the Act amended Section 2010(c) to increase the basic exclusion amount available to estates of decedents dying after December 31, 2017, and before January 1, 2026.[5] In addition, the Act added Section 2001(g)(2), which directs the Secretary of the Treasury Department ("Treasury") to issue regulations necessary or appropriate to carry out Section 2001 with respect to changes in the basic exclusion amount. Treasury and the Internal Revenue Service (the "Service") requested comments on all aspects of the Proposed Regulations.

We commend Treasury and the Service for releasing proposed regulations exercising Treasury's authority under Section 2001(g)(2) and addressing taxpayer questions regarding the effects of the temporarily increased basic exclusion amount. This Report is divided into three parts. Part I summarizes the Report's principal recommendations. Part II provides background regarding the basic exclusion amount, the estate computation procedures, and the Proposed Regulations. Part III describes this Report's recommendations, including that final regulations clarify certain issues.

I. SUMMARY OF PRINCIPAL RECOMMENDATIONS

We recommend the following:

1. The final regulations include an example confirming that individuals do not benefit from pre-2026 inflation adjustments unless they actually make taxable gifts that use up inflation-adjusted increases to the basic exclusion amount.

2. The final regulations include an example confirming that individuals who made taxable gifts that use up a portion of the temporarily increased basic inclusion amount do not benefit from post-2025 inflation adjustments unless and until the basic exclusion amount, as adjusted, exceeds the amount of basic exclusion amount previously used by the taxpayer.

3. Consistent with existing regulations regarding the deceased spousal unused exclusion amount ("DSUE"), the final regulations confirm that DSUE inherited

[1] The principal authors of this Report are Austin Bramwell and Alan S. Halperin. Helpful comments were received from Steven Dean, Stephen Land, Deborah Paul and Michael Schler. The Report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-106706-18, 83 Fed. Reg. 59343 (Nov. 23, 2018).

[3] Unless otherwise indicated, all references to a "Section" shall refer to a particular section of the Code.

[4] *See* An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. 115-97, 131 Stat. 20554 (2017).

[5] The basic exclusion amount under Section 2010 is sometimes referred to by certain other names, such as "the gift and estate tax exemption," which the Report generally uses interchangeably with "basic exclusion amount."

from a deceased spouse before 2026 will not be limited by the lower basic exclusion amount available beginning on January 1, 2026.

4. The final regulations provide an explicit ordering rule determining whether the basic exclusion amount or, instead, the DSUE amount is used first for purposes of determining the amount of basic exclusion amount used prior to 2026.

5. The final regulations confirm that late allocations may be made of the amount of generation-skipping transfer ("GST") tax exemption increased by the Act, including to trusts created before 2018.

6. Treasury and the Service consider further whether gifts included in a decedent's gross estate should successfully lock in the temporarily increased exclusion amount available before 2026.

II. BACKGROUND

A. The Applicable Exclusion Amount and the Estate Tax Computation Procedures

Section 2010 effectively allows a certain amount, known as the "applicable exclusion amount," to be excluded from the total amount of wealth transfers subject to estate tax at death. The applicable exclusion amount is equal to the sum of two component amounts: a "basic exclusion amount" available to all estates of decedents,[6] and, in some cases where the decedent had survived a prior deceased spouse, an additional amount, known as the "deceased spousal unused exclusion amount" or "DSUE" amount.[7] Prior to 2018, the basic exclusion amount was $5 million, indexed for inflation for decedents dying in years after 2011. Under the Act, the basic exclusion amount is increased to $10 million, indexed for inflation, for decedents dying after 2017 and before 2026. After 2025, the basic exclusion amount reverts to $5 million, again indexed for inflation.

The applicable exclusion amount also applies for gift tax purposes. Pursuant to Section 2505, an individual computes gift tax by effectively excluding the applicable exclusion amount from the total amount of his or her lifetime taxable gifts.[8] Although the applicable exclusion amount is used to compute both gift tax during lifetime and estate tax at death, it is not restored or made available a second time at death. On the contrary, through a serious of computational steps set forth in Section 2001(b), lifetime gifts that use up the gift tax exclusion amount effectively reduce the exclusion amount available at death.

More particularly, under Section 2001(b)(1), estate tax is computed, first, by calculating a tentative tax on the sum of the taxable estate and the decedent's post-1976 lifetime gifts, other

[6] Except where otherwise noted, when this Report refers to "decedents" or "estates," it refers to decedents who were citizens or residents of the United States within the meaning of Section 2001, or their estates, as the case may be.

[7] *See* I.R.C. § 2010(c)(3) (prior to amendment by the Act). "Exclusion" is technically a misnomer, as Section 2010 of the Code does not exclude amounts subject to estate tax but, as discussed below in the text, allows a credit equal to an amount of tax that would be computed on the exclusion amount.

[8] *See* I.R.C. § 2505(a).

than those included in the gross estate.[9] This first step causes exclusion amount used up during lifetime to reduce the exclusion amount that remains available at death. For example, if a decedent made taxable gifts that used up $5 million of exclusion and died in 2017 with a taxable estate of $10 million, the $5 million of taxable gifts would be added to the estate tax computation base under Section 2001(b)(1). When estate tax due is computed, the $5 million that is added in this first step in the computation effectively offsets the applicable exclusion amount that is available under Section 2010.

In some cases, a decedent, having made taxable gifts in excess of the applicable exclusion amount, may have paid or been liable for gift tax during lifetime. Gifts on which gift tax was payable are still added under Section 2001(b)(1) to the amount on which a tentative estate tax is computed. At the same time, to prevent a double tax on those gifts, Section 2001(b)(2) provides that gift tax payable is subtracted from the tentative tax computed under Section 2001(b)(1). The gift tax payable for this purpose is computed using the rates in effect at death.[10] Thus, if an individual paid gift tax during lifetime at a rate higher than the estate tax rate applicable at death, his or her estate does not recoup the full amount of gift tax paid. Rather, under Section 2001(b)(2), the estate only subtracts the gift tax that would have been payable if the lower rates applicable at death had applied at the time of the gifts.[11]

Once estate tax is computed in accordance with procedures under Section 2001(b), credits are then subtracted to reach the amount of estate tax owed. Under Section 2010, the applicable exclusion amount is used to derive a credit known as the "applicable credit amount." The applicable credit amount is equal to an amount of tax computed on the applicable exclusion amount. Through the subtraction of the applicable credit amount, cumulative wealth transfers, whether made during lifetime in the form of taxable gifts or at death, are effectively shielded from estate tax to the extent of the applicable exclusion amount.

B. Claw-back Concern

The Act's temporary doubling of the basic exclusion amount, when combined with the Section 2001(b) estate tax computation procedures, created the potential that an estate of an individual who takes advantage of the increased basic exclusion amount available through 2025, and dies after the increased amount expires in 2026, effectively would be taxed on gifts that had previously been shielded from tax by the increased amount. For example, an individual may make taxable gifts using up $10 million of exclusion available before 2026, and die in 2026 with a taxable estate of $5 million. In that case, the $10 million of taxable gifts are added to the estate tax computation base under Section 2001(b)(1). The basic exclusion amount in 2026, however, will only be $5 million (ignoring inflation adjustments). Thus, the $10 million added to the computation base might not only offset the $5 million basic exclusion amount available in 2026

[9] Even though a gift of property during lifetime is complete for gift tax purposes, the property may still be pulled back into the decedent's gross estate at death for estate tax purposes, such as under one of the estate tax "string" provisions of Sections 2035 through 2039 and Section 2042. When a tentative tax is computed under Section 2001(b)(1), only lifetime gifts that pass outside the gross estate are added to the computation base; gifts that are pulled back into the gross estate (and therefore included in the taxable estate already) are not added.

[10] I.R.C. § 2001(g)(1).

[11] *See Estate of Smith v. Comm'r*, 94 T.C. 872 (1990).

but exceed it by $5 million. As a result, an estate tax could potentially be due on the difference between the basic exclusion amount available at the time of the gift and the lower exclusion amount available at death.

Section 2001(b)(2), as discussed, allows the equivalent of a credit for gift taxes payable during lifetime. If gift tax is computed using the exclusion amount available at the time of the gifts, no Section 2001(b)(2) credit-equivalent would be available in the foregoing example, as the decedent's $10 million in gifts made before 2026 were fully protected by the temporarily increased exclusion amount. The $10 million of taxable gifts, though shielded from gift tax by the temporarily increased exclusion amount, effectively would become subject to estate tax to the extent of the $5 million excess.

C. Congress' Response to the Potential for Claw Back Tax

Congress, apparently aware of the potential for a "claw back" tax on gifts that use up the increased basic exclusion amount available before 2026, responded by simultaneously enacting a conforming amendment in section 11061(b) of the Act. Under this amendment, new subsection (2) was added to Section 2001(g) of the Code. Section 2001(g)(2) directs the Secretary to prescribe regulations necessary or appropriate to carry out Section 2001 "with respect to any difference between. . . the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and . . . the basic exclusion amount under such section applicable with respect to any gifts made by the decedent."

According to the Joint Committee on Taxation's General Explanation of Public Law 115-97 (the "Bluebook"), the intent of Section 2001(g)(2) is to authorize the Treasury to eliminate the threat of claw back by regulation. The Bluebook states in particular:

> It is intended that such regulations will address in particular the computation of the estate tax where (1) a decedent dies in a year in which the basic exclusion amount is lower than the basic exclusion amount that was in effect when the decedent made taxable gifts during his or her life, and (2) such taxable gifts exceeded the basic exclusion amount in effect at the time of the decedent's death. Because the increase in the basic exclusion amount does not apply for estates of decedents dying after December 31, 2025, it is expected that this guidance will prevent the estate tax computation under section 2001(g) from recapturing, or ''clawing back,'' all or a portion of the benefit of the increased basic exclusion amount used to offset gift tax for certain decedents who make taxable gifts between January 1, 2018, and December 31, 2025, and die after December 31, 2025.[12]

D. Proposed Regulations

Consistent with the intent of Section 2001(g)(2), the Proposed Regulations would prevent gifts that take advantage of the temporarily increased exclusion amount from being subject to

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[12] Section 2001(g)(2) authorizes regulations "to carry out this section," that is, Section 2001, whereas the Proposed Regulations are issued under Section 2010. Treasury and the Service could have achieved a similar result by issuing regulations interpreting Section 2001(b)(2), which allows the equivalent of a credit for gift taxes payable on post-1976 gifts. We believe that the approach of the Proposed Regulations is not only elegant but is clearly within Treasury's authority under Section 2001(g)(2) and Section 2010(c)(6).

estate tax if the donor dies on or after January 1, 2026. The Proposed Regulations accomplish this result through a new special computation of the basic exclusion amount.[13] Under this special rule, the basic exclusion amount is equal to the greater of the basic exclusion amount applicable at the time of the decedent's death and basic exclusion amount applied toward the decedent's taxable lifetime gifts.[14] The result achieved by the Proposed Regulations prevents a claw back tax at the decedent's death. In addition, taxpayers who take advantage of the increased basic exclusion amount and die after 2025 achieve results that are similar to those afforded to taxpayers who also take advantage of the increased basic exclusion amount but die prior to January 1, 2026.

III. RECOMMENDATIONS

We appreciate the government's efforts to issue regulatory guidance on the effect of the Act's changes to Section 2010. Our comments below address a number of specific issues raised by the Act or the Proposed Regulations that are not expressly resolved by the Proposed Regulations.

A. Confirmation of Effect of Inflation Adjustments before 2026

Historically, individuals who failed to use up inflation-adjusted increases in the basic exclusion amount were still able to take advantage of those increases in later years. For example, the basic exclusion amount increased from $5 million in 2011 to $5,490,000 in 2017. The estate of an individual who made a $5 million taxable gift in 2011 and died in 2017 would be able to exclude an additional $490,000 from estate tax at death, due to the post-2011 inflation adjustments. Inflation adjustments, in other words, did not expire if they went unused.

Under the Proposed Regulations, by contrast, inflation adjustments through 2025 are lost if not used before 2026. Suppose, for example, that an individual makes a taxable gift of $10

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[13] Prop. Reg. § 20.2010-1(c).

[14] REG-106706-18, 83 Fed. Reg. 59343 (Nov. 23, 2018). Under the Proposed Regulations, a taxpayer who dies on January 1, 2026, with taxable estate of $6 million, having made lifetime gifts of $10 million between January 1, 2018 and December 31, 2025, would not be at risk of claw back*:

Combined taxable lifetime gifts and taxable estate:	$16,000,000
Tentative tax on taxable lifetime gifts and taxable estate ($16,000,000 x 40%):	$ 6,400,000
Tentative tax payable on lifetime gifts, taking into account the basic exclusion amount available at the time of the gift:	$ 0
Tentative tax on the basic exclusion amount **previously applied to lifetime gifts** ($10 million x 40%):	$ 4,000,000
Estate tax payable ($6,400,000 - $0 - $4,000,000):	$ 2,400,000

The estate tax is, in effect, calculated with respect to $6 million, the amount by which the taxpayer's aggregate taxable gifts and taxable estate exceeds the increased basic exclusion amount used by the taxpayer during his or her lifetime. The effective tax rate on that excess is 40%, the maximum marginal estate tax rate.

* For simplicity, this calculation assumes a tax rate of 40% and does not take into account inflation adjustments on the basic exclusion amount.

million in 2018, the exclusion amount increases to $12.5 million by 2025, and the individual dies in 2026 having made no further taxable gifts. Under the Proposed Regulations, the $10 million gift in 2018 successfully locks in the temporarily increased exclusion amount, unadjusted for inflation. Nevertheless, the individual's estate loses the benefit of the $2.5 million in inflation adjustments from 2019 through 2025.

We believe that this result is correct. According to the Bluebook, Congress intended to prevent a tax at death on gifts that have been shielded from gift tax by the increased exclusion amount available. Although individuals who do use up all inflation adjustments through 2025 will be able to protect more wealth transfers from tax than others who do not use up every dollar of increase, there is no indication that Congress intended to permit individuals to lock in an amount of exclusion greater than the amount they actually used. The rule of the Proposed Regulations, we believe, carries out Congress' intent.

Nevertheless, we recommend that the final regulations include an example illustrating the effect of unused inflation adjustments prior to 2026. The Proposed Regulations include only one example, which, likely for the sake of simplicity, does not illustrate the effect of inflation adjustments. To confirm the correct result, and to avoid any doubt, we recommend that the final regulations include an example showing that the exclusion amount available at death can be no higher than the greater of the amount of exclusion that was actually used prior to 2026 and the post-2025 basic exclusion amount, notwithstanding any unused inflation adjustments through 2025.

B. Confirmation of Effect of Inflation Adjustments after 2025

Under the Proposed Regulations, an individual who locks in the higher exclusion amount available prior to 2026 would not thereafter benefit from inflation adjustments on the post-2025 basic exclusion amount. Suppose, for example, that a decedent dies in 2027 having used up $8 million of exclusion before 2026. In 2027, the year of death, the basic exclusion amount increases from $7 million in 2026 to $7.1 million. Under the Proposed Regulations, although the basic exclusion amount increases by $100,000 in 2027, the exclusion amount available to the decedent's estate does not increase; rather, it remains capped at $8 million. Thus, the estate is not able to use the $100,000 increase in the basic exclusion amount.

By contrast, suppose instead that the decedent dies in 2035 when the basic exclusion amount has increased to $8.1 million. In that case, because the basic exclusion amount has exceeded the exclusion amount previously used, the decedent's estate may benefit from inflation adjustments. In other words, the "greater of" calculation under the Proposed Regulations implies that a taxpayer taking advantage of the increased basic exclusion amount under the Act is not able to use inflation adjustments until the basic exclusion amount, as adjusted for inflation, exceeds the amount of previously sheltered gifts.

We believe that denying post-2025 inflation adjustments to individuals who used up the temporarily increased exclusion amount is a fair outcome. The results will put taxpayers who do not take advantage of the increased basic exclusion amount in the same position they were in prior to the Act, without giving an additional benefit to taxpayers who do take advantage of the increased basic exclusion amount. As discussed previously, however, the example in the Proposed Regulations ignores the effect of inflation adjustments. To eliminate any doubt, we suggest that the final regulations include an example confirming that inflation adjustments only make a difference once the basic exclusion amount, as adjusted for inflation, exceeds the exclusion amount used up during lifetime.[15]

C. Preservation of the Deceased Spousal Unused Exclusion Amount

Section 2010(c) permits a surviving spouse to inherit the unused exclusion of the deceased spouse. More specifically, if a deceased spouse's executor makes an election to "port" the deceased spouse's unused exclusion amount to the surviving spouse, then the surviving spouse's applicable exclusion amount is equal to his or her basic exclusion amount *plus* the amount, known as the "DSUE" amount, inherited from the deceased spouse.[16] The DSUE amount is equal to the lesser of two amounts.[17] The first limitation is the basic exclusion amount. The second limitation is equal to the deceased spouse's applicable exclusion amount, less the sum of the deceased spouse's taxable estate and post-1976 taxable gifts (other than those included in the gross estate).

For example, if a spouse dies in 2019 with a taxable estate of $1.4 million, when the basic exclusion amount is $11.4 million, and the deceased spouse made no taxable gifts during his or her lifetime, the surviving spouse would, if the deceased spouse's executors make the portability election, inherit the unused portion of the deceases spouse's exclusion amount, or $10 million. The surviving spouse would then have a total applicable exclusion amount of $21.4 million, which is equal to the $11.4 million of basic exclusion amount, plus the $10 million of inherited exclusion.

Under the Act, however, the basic exclusion amount reverts to $5 million in 2026, plus inflation adjustments. The DSUE amount, meanwhile, is limited by Section 2010(c)(4)(A) to the basic exclusion amount. Thus, it is unclear under the Act whether DSUE inherited between January 1, 2018, and December 31, 2025, will be reduced on January 1, 2026, to the post 2025-basic exclusion amount. If the DSUE amount is in fact reduced, then, in the example, not only would the surviving spouse's own basic exclusion amount drop to $5 million in 2026 (plus inflation adjustments), but so would the DSUE amount. The total applicable exclusion amount would drop from over $20 million to $10 million, plus inflation adjustments.

The Proposed Regulations do not expressly address the effect on DSUE of a drop in the basic exclusion amount. Nevertheless, we believe that, even if the final regulations remain silent, the DSUE amount inherited from a spouse dying before 2026 would not be decreased after

[15] We do not believe that there is a need for an example or additional regulations in the gift tax context. As the preamble to the Proposed Regulations explains, under Section 2505(a), the credit amount allowed for gift tax purposes is equal to the applicable credit amount available for the calendar year of the donor's gifts, less credit used up in prior years. (As the preamble also explains, a claw back of gift tax on gifts made while the exclusion amount was higher is prevented by Section 2502(a)(2), which computes gift tax by subtracting a hypothetical tax, without credits, on prior year gifts.) Consequently, if an individual who used up the temporarily increased exclusion amount makes additional taxable gifts after 2025, the gift tax credit would be reduced to zero, and gift tax would be due. Inflation adjustments would not protect further taxable gifts from tax until the applicable credit amount for the year of the gifts exceeds the credit previously used up.

[16] *See* I.R.C §§ 2010(c)(3) and 2010(c)(4). The exclusion amount inherited from a deceased spouse is referred to as the deceased spousal unused exclusion amount, or "DSUE". DSUE elections are only available to the estates of citizens and residents of the United States. See 26 C.F.R. 2010-2(a)(5).

[17] I.R.C § 2010(c)(4).

2025. Although Section 2010(c)(4)(A) does not specify whether the DSUE amount is limited to the basic exclusion amount in effect on the death of the first or the second spouse to die, regulations interpret the first DSUE limitation to be the basic exclusion amount in effect in the year that the first spouse dies.[18] This regulation predates the Act and may implicitly have been ratified by Congress when it enacted a temporary increase in the basic exclusion amount. In any event, under the regulation, a surviving spouse who inherits exclusion from a spouse dying after 2017 and before 2026, including the temporarily increased basic exclusion amount, would not have the DSUE limited after 2025 by the then lower basic exclusion amount.

Further, we believe it would be consistent with Congressional policy if the increased DSUE amount that can be inherited by spouses of decedents dying between January 1, 2018 and December 31, 2025, were preserved. In enacting the portability provisions, Congress intended to simplify estate planning by allowing a deceased spouse to provide for the survivor without the need for complex dispositive formulas and trusts designed to use up the deceased spouse's exclusion amount.[19] This goal would be frustrated if portability planning put the surviving spouse at risk of losing an amount inherited from the first spouse to die. To avoid that risk, a couple might instead opt to have the first decedent create a trust for the survivor that is designed to use up the first decedent's exclusion amount in full at the first decedent's death. So that married couples may instead choose to rely on portability without risk of losing their combined exclusion amounts, we recommend that Treasury and the Service confirm – such as in the preamble to the final regulations or other informal guidance – that the DSUE amount is limited, in accordance with Treas. Reg. § 20.2010-2(c)(1), to the basic exclusion amount in effect at the first decedent's death rather than the basic exclusion amount in effect at the survivor's death.

D. Order of Basic Exclusion Amount and Deceased Spousal Unused Exclusion

If a surviving spouse has inherited DSUE, the amount of basic exclusion amount that he or she can effectively preserve by making taxable gifts depends on whether those gifts first use up the DSUE amount or instead use up the basic exclusion amount. Take, for example, a surviving spouse who inherits $5 million of DSUE, makes a gift of $10 million in 2025 and dies in 2026 when the basic exclusion amount (ignoring inflation adjustments) is $5 million. If the gift uses up $10 million of the surviving spouse's basic exclusion amount, then the surviving spouse's estate still will be able to shield the DSUE amount of $5 million from estate tax. A total amount of $15 million of wealth transfers – that is, $10 million transferred by gift in 2025 and $5 million at death – is protected from tax.

If instead the $10 million gift is deemed to use up $5 million of DSUE first, followed by $5 million of basic exclusion amount, then, under the Proposed Regulations, the surviving spouse's estate will not be able to shield any further amounts from estate tax. The reason is that

[18] *See* 26 C.F.R. 20.2010-2(c)(1); *see also*, 77 Fed. Reg. 36153 (June 18, 2012) (stating that "[t]he temporary regulations in § 20.2010-2T(c)(1)(i) confirm that the term 'basic exclusion amount' referred to in section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed.")

[19] *See* Joint Committee on Taxation "Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform" ("JCX-23-08") at 9 ("Proponents of portability between spouses of unused exemption generally argue that it eliminates the need for inefficient and costly tax planning and results in similarly situated taxpayers being treated equally.")

the $5 million of basic exclusion amount used by the gift does not exceed the $5 million basic exclusion amount that (ignoring inflation adjustments) is available after 2025. Thus, the surviving spouse's estate is limited to $5 million of basic exclusion amount, all of which is effectively offset in the estate tax computation procedures by the gift made in 2025. A total amount of $10 million of wealth transfers – that is, the $10 million transferred by gift in 2025 – is shielded from tax.

If DSUE is used first, then, in order to preserve the increased basic exclusion amount available through 2025, the surviving spouse would need to make taxable gifts before 2026 of $15 million. Only after first making $10 million of taxable gifts would the surviving spouse begin to lock in the temporarily increased exclusion amount. Whether gifts by a surviving spouse successfully preserve the increased basic exclusion amount under the Act depends, in short, on whether gifts first use up the DSUE amount or the basic exclusion amount.

The Proposed Regulations may have been drafted on the assumption that an ordering rule already exists. In particular, Prop. Reg. § 20.2010-1(c) provides that an increased basic exclusion amount is available only "[i]f the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), *to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3)*, exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax . . . ." (Emphasis added.) The italicized language, by stipulating the applicable credit amount for gift purposes must be "based solely on the basic exclusion amount" and not also on the DSUE amount, may take for granted that, when a taxable gift is made during lifetime that uses up the donor's applicable exclusion amount, it is possible to determine which portion of the amount is attributable to the basic exclusion amount and which portion is attributable to the DSUE amount. In other words, the Proposed Regulations may be assuming that there is an ordering rule.

Indeed, there is an ordering rule in the gift tax regulations. Treas. Reg. § 25.2505-2(b) provides that a "surviving spouse will be considered to apply [the] DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount." This gift tax ordering rule works in tandem with other provisions of the portability regulations that add to a surviving spouse's applicable exclusion amount any DSUE that had been inherited from a prior deceased spouse and applied against taxable gifts prior to the death of a second deceased spouse.[20] Because a taxpayer may only use DSUE inherited from his or her last deceased spouse,[21] the ordering rule, combined with the calculation rule that adds taxable gifts using up DSUE inherited from a prior deceased spouse, protects a surviving spouse who uses inherited DSUE after his or her first spouse's death from losing the portion of DSUE that had already been used prior to the death of the second spouse.[22] If the Proposed Regulations rely on the same ordering rule, then surviving spouses must first use up DSUE before they can begin to use up basic exclusion amount and lock in the temporarily increased exclusion amount under the Act.

[20] Treas. Reg. §§ 20.2010-3(b)(1)(ii), 25.2505-2(c)(1).

[21] *See* I.R.C. § 2010(c)(4)(B)(i).

[22] Under Section 2010(c)(4), a taxpayer can only use the DSUE of his or her last surviving spouse. If he or she remarries and survives his or her second spouse, he or she will lose the unused DSUE from his or her first spouse.

It is not clear, however that the Proposed Regulations intend to incorporate the ordering rule of the portability regulations. The Proposed Regulations do not refer to Treas. Reg. § 25.2505-2(b) explicitly. Moreover, the portability regulations use a different idiom in distinguishing between gifts that use up the DSUE amount and gifts that use up the basic exclusion amount. Treas. Reg. § 25.2505-2(b) states that a surviving spouse is "considered to apply [the] DSUE amount." The Proposed Regulations, by contrast, refer to the computation of credits "based solely on the basic exclusion amount." Indeed, the Proposed Regulations' focus on the computation of credits based on the basic exclusion amount suggests that the DSUE amount available at the time a decedent made taxable gifts should, if anything, be *ignored* in determining what basic exclusion amount is available at death. The effect of ignoring DSUE amount would be that taxable gifts use up the basic exclusion amount first, thereby reversing the ordering rule of Treas. Reg. § 25.2505-2(b) and making it easier for surviving spouses to take advantage of the temporarily increased basic exclusion amount.

In the final regulations, Treasury and the Service should clarify and make explicit which ordering rule is intended. We recognize that allowing the surviving spouse to apply his or her basic exclusion amount prior to the DSUE would make it easier for surviving spouses to maximize the utility of the increased basic exclusion amount. Nevertheless, we believe it would be administratively difficult to adopt an ordering rule that runs contrary to existing regulations. On balance, we believe that there should be consistent ordering rules with regard to the use of DSUE and the basic exclusion amount applicable to the portability regulations and the temporary expanded basic exclusion amount.

E. Late Allocation of GST Tax Exemption

Section 2601 imposes generation-skipping transfer or "GST" tax on transfers to grandchildren and other "skip persons" who are two or more generations below the transferor.[23] Under Section 2631(a), every individual may allocate an amount, known as the "GST exemption," to any property of which he or she is the transferor. GST exemption may be timely allocated as of the date of the initial gift of property, or, in the case of a trust, it may be allocated late. For example, if an individual funded a trust in 1990 but did not allocate GST exemption, he or she may allocate GST exemption at any later time during the donor's lifetime or by the donor's executors up until the date for filing the donor's estate tax return.[24] The effect of allocation of GST exemption, through a series of interlocking defined terms and formulas, is to reduce the GST tax rate, often to as little as zero percent.[25]

The GST exemption amount is defined to be equal to the basic exclusion amount. Consequently, the GST exemption amount was automatically increased by the Act's temporary increase in the basic exclusion amount.[26] The significant increase in the GST exemption has

[23] *See* I.R.C. §§ 2601; 2613; 2651(d).

[24] I.R.C. § 2631(a).

[25] I.R.C. §§ 2641-2642.

[26] I.R.C. § 2631(c).

caused some to question whether a late allocation of the increased amount may be made to trusts created when the GST exemption amount was less.

It has long been accepted that an individual may make a late allocation of increases in GST exemption, at least to the extent due to inflation.[27] Further, the ability to make late allocation of increased GST exemption follows from the language of Section 2631(a), which permits an individual to allocate the GST exemption amount to "any property with respect to which [an] individual is the transferor." "Any property" includes property transferred in previous years. Thus, as the amount of GST exemption increases, it should be possible to allocate it to previously existing trusts.

Finally, the Bluebook has provided the following example confirming that the increased GST exemption may be allocated to trusts created in prior years when the GST exemption amount was less:

> For example, assume that on March 15, 2016, T gave property with a value of $6,000,000 to a trust for the benefit of T's descendants (Trust A) and T's entire then-remaining generation skipping transfer tax exemption of $5,400,000 was allocated to trust A on a timely filed 2016 gift tax return. As of the date of the 2016 gift, Trust A has an inclusion ratio of 0.100 [1 - ($5,400,000/$6,000,000)]. On July 1, 2018, when the property in Trust A has a fair market value of $7 million, T files a gift tax return and allocates $700,000 of generation-skipping transfer tax exemption to Trust A, reducing Trust A's inclusion ratio from 0.100 to zero [1 - (($700,000 + (90% x $7 million)) / $7 million))], effective on July 1, 2018. Absent additional contributions to Trust A, the generation-skipping transfer tax on taxable distributions from, or a taxable termination with respect to, Trust A on or after July 1, 2018, is determined using an inclusion ratio of zero.

In this example, an individual was able to make a late allocation of the increased GST exemption and therefore achieve (through a zero "inclusion ratio") a GST tax rate of zero for a previously created the trust. Though the Bluebook may be helpful in interpreting the Act, we acknowledge that the Bluebook is not a definitive statement of the law.[28] To avoid any doubt, therefore, we recommend that the Treasury and the Service provide additional guidance confirming that late allocations of the increased GST exemption may be made.

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[27] Joint Committee on Taxation, 105th Cong., 2d Sess., "General Explanation of Tax Legislation Enacted in 1998: Part Two: Internal Revenue Service Restructuring and Reform Act of 1998" (Nov. 24, 1998) states:

> With respect to existing trusts, transferors are permitted to make a late allocation of any additional GST exemption amount attributable to indexing adjustments in accordance with the present-law rules applicable to late allocations as set forth in sections 2632 and 2642, and the regulations promulgated thereunder. For example, assume an individual transferred $2 million to a trust in 1995, and allocated his entire $1 million GST exemption to the trust at that time (resulting in an inclusion ratio of .50). Assume further that in 2001, the GST exemption has increased to $1,100,000 as the result of indexing, and that the value of the trust assets is now $3 million. If the individual is still alive in 2001, he is permitted to make a late allocation of $100,000 of GST exemption to the trust, resulting in a new inclusion ratio of 1 – (($1,500,000+100,000)/$3,000,000), or .467.

[28] *See United States v. Woods*, 571 U.S. 31, 47-48 (2013).

F. Preservation of Basic Exclusion Amount for Gifts Pulled Back into Estate

The estate and gift tax system makes it possible for a completed gift to have occurred during lifetime even though the property transferred is pulled back into the transferor's gross estate at death. For example, an individual may make a gift of a remainder interest in property while retaining a life estate.[29] Despite the completed gift of the remainder, under Section 2036(a)(1), the entire value of the property will be included in the individual's gross estate at death as a result of the retained right to income and enjoyment of the property.[30]

The Proposed Regulations, in allowing a higher basic exclusion amount to a decedent whose taxable gifts used up the temporarily increased exclusion amount available before 2026, do not distinguish between gifts that pass outside of the gross estate and those that do not. On the contrary, under the Proposed Regulations, the only condition that must be satisfied in order to lock in the temporarily increased exclusion amount is that gifts use up an amount of basic exclusion that is greater than the amount available at death. Whether those gifts are included in the gross estate at death is irrelevant, under the Proposed Regulations.

This result may well have been intentional. Nevertheless, we wish to bring to the Treasury's and the Service's attention that it would permit individuals to make relatively painless taxable gifts that lock in the increased exclusion amount, even though they retain beneficial access to the transferred property. A gift of a remainder, subject to a retained life estate, is a good example. By making a gift of a remainder interest, an individual can use up the temporarily increased exclusion amount while retaining the income and enjoyment of the property. That Section 2036(a)(1) will cause the property to be included in the gross estate does not, under the Proposed Regulations, prevent the gift from locking in the increased exclusion amount.

Moreover, special valuation rules under chapter 14 of the Code, originally enacted to curb valuation abuses, can be used to increase the amount of a taxable gift artificially, thereby making it easier to lock in the increased exclusion amount. Suppose, for example, that a father makes a gift to his daughter of a remainder interest in a $10 million residence, while retaining a life estate. Under Section 2702(a), the retained life estate is valued at zero and the value of the gift is equal to the entire $10 million value of the residence. Thus, the gift of the remainder, though in economic terms less valuable than the undivided residence, successfully uses up $10 million of exclusion available before 2026. The father thereafter may continue to use and enjoy the residence for his lifetime, yet still, under the Proposed Regulations, cause $10 million of wealth to be shielded by the increased exclusion amount under the Act.

We recommend that Treasury and the Service consider proposing rules that would create exceptions to the favorable rule of the Proposed Regulations in the case of gifts that are included

[29] *See* Treas. Reg. 25.2511-1(e). If the gift of the remainder is made to a member of the transferor's family within the meaning of Section 2704(c)(2), the retained value of the life estate will be ignored for gift tax valuation purposes. I.R.C. § 2702(a).

[30] So that the property does not count twice against applicable exclusion amount (and is not double taxed), the lifetime gift of the remainder is purged from the estate tax computation base under the Section 2001(b) estate tax computation procedures and the exclusion amount used up by the gift is effectively restored.

in the gross estate. Under this approach, if a decedent made a gift of property before 2026 and the gift is included in the gross estate, any increased basic exclusion amount used up by the gift is not preserved at death. As the gift would be purged from the estate tax computation base under Section 2001(b), there is no concern about claw back of tax. Further, the property would be subject to the estate tax lien[31] and the decedent's executor would normally have a right to recover the share of estate taxes attributable to the property.[32]

That said, Treasury and the Service may not have sufficient tools to prevent all possible planning to lock in the increased exclusion amount artificially. Deathbed planning, for example, might successfully eliminate, just before death, any rights or powers that would otherwise trigger gross estate inclusion.[33] An artificial taxable gift also could be made by making a gift of common interests in a partnership or corporation, while retaining preferred interests that intentionally run afoul of the valuation rules of Section 2701 and thereby trigger a larger taxable gift. The common interests would not be pulled back into the gross estate, yet the donor still would have the right to earnings and income of the entity through the retention of preferred interests.[34]

Given the difficulties of the problem, if Treasury and the Service wish to limit the benefits of locking in temporarily increased exclusion amount, we recommend that the Treasury and Service study the problem further. Final regulations could reserve space for future regulations and seek comments on this issue.

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[31] I.R.C. § 6324(a)(1).

[32] *See*, *e.g.*, New York's Estates, Powers, and Trusts Law 2-1.8(e); *see also* I.R.C. § 2207B.

[33] Section 2035(a) provides that if a decedent, within three years of death, relinquished certain rights or powers over transferred property that otherwise would have caused gross estate inclusion, then the property is pulled back into the gross estate. The requirement of affirmative relinquishment, however, could be avoided by giving a third party the power to eliminate the donor's gross estate inclusion strings just before death.

[34] Treas. Reg. § 25.2701-5 provides rules to mitigate double taxation if a transfer had previously run afoul of Section 2701's valuation rules, and the holder of the Section-2701-triggering retained interest makes a subsequent transfer of that interest. In general, under these rules, the initial transferor or his or her estate may, for gift or estate tax computation purposes, reduce the value of the prior Section 2701 transfer so that it is not counted twice in the tax base. If an individual makes a Section 2701 transfer before 2026, however, the effect of the mitigation rules would be to free up, as a shield against tax on future wealth transfers, an amount of exclusion equal to the amount of any temporarily increased exclusion used up by the Section 2701 transfer. In other words, any increased basic exclusion amount used up by a Section 2701 transfer would be effectively preserved after 2025. To prevent the mitigation rules from having this effect, Treasury and the Service could propose an amendment to Treas. Reg. § 25.2701-5(b). The amendment would provide that the amount of reduction in the value of any prior Section 2701 transfer would not include the difference between the amount of basic exclusion amount used up by the initial Section 2701 transfer and the amount of basic exclusion amount available at the time of the subsequent transfer of the Section 2701 interest. That is, the amount of the temporarily increased exclusion used up by the initial Section 2701 transfer would be subtracted from the reduction amount.