Estate Tax Changes Past, Present, and Future

Charting the rates,
Planning for mates,
Watching the states,
Handling the waits,
And predicting the fates
Of the effective dates.

May 2022

Parts 25-29 are from Washington Update: Pending and Potential Administrative and Legislative Changes (May 2022).

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Introduction

This outline is a selective and evolving review of the history of the modern federal estate tax. It originated during the attempts to repeal the estate tax in President Clinton's second term and accelerated with the one-year (2010) "repeal" enacted in 2001. **A discussion of *recent, pending, and proposed* developments begins with Part 25.**

1. Past Reminiscences

a. The World War I Era

(1) In the Revenue Act of September 8, 1916, as the United States was on the brink of entering World War I, Congress enacted the current estate tax, imposed at rates of 1 percent to 10 percent on taxable estates over $50,000. In the Act of March 3, 1917, the rates were generally increased by half, to levels of 1½ percent to 15 percent. In explaining the Senate bill, which would have doubled rates to 2 percent-20 percent, the Finance Committee said:

> *Such a tax, when used as an emergency measure, is necessarily unequal in operation.* Only if continued at the same rate for many years – the period of a generation – does it become equal for all persons in like situation. *If levied as a war tax, that is, as a temporary emergency measure, it falls only upon the estates of those who happen to die during the period of the emergency.* Particularly is it to be remembered that perhaps a majority of those dying during the war and leaving estates to be taxed will be soldiers and sailors dying in defense of our country. *On the other hand, as a permanent measure, such a tax, even at the rates already fixed by existing law, trenches in considerable degree on a sphere which should be reserved to the States.*

S. Rep. No. 103, 65th Cong., 1st Sess. 14 (1917) (emphasis added).

(2) In its version of the Revenue Act of 1926, when the gross rates ranged from 1 percent to 20 percent, the House of Representatives raised the state death tax credit to 80 percent of the basic tax, while the Senate version would have repealed the estate tax. In support of repeal, the Finance Committee quoted the excerpts from its 1917 report that are italicized above. S. Rep. No. 52, 69th Cong., 1st Sess. 8 (1926). In short, the Finance Committee of 1917 and 1926 seems to have cited the same arguments in support of doubling the tax and in support of repealing the tax! The 1926 House-Senate conference, of course, accepted the House approach.

b. The Kennedy-Johnson Studies and the Nixon Administration

On **February 5, 1969**, less than two weeks after the inauguration of President Nixon, Congress published a multi-volume Treasury Department work titled "Tax Reform Studies and Proposals," reflecting work that had been overseen by Assistant Secretary of the Treasury for Tax Policy Stanley Surrey during the Kennedy and Johnson Administrations. It included a number of estate and gift tax proposals. The following list of the estate and gift tax proposals gives the date each proposal was eventually enacted in some form:

(1) Taxation of appreciation at death or at the time of gifts (carryover basis enacted in 1976, repealed in 1980, and enacted again in 2001, effective only for 2010).

(2) Unification of the gift and estate taxes.

  (a) Same rates (1976).

  (b) Same base – tax-inclusive (1976, for gifts within three years of death).

  (c) Single exemption (1976 – until 2004).

  (d) Abolition of the "gifts in contemplation of death" rule (1976).

(3) Unlimited marital deduction, including income interests (1981).

(4) Repeal of the exclusion of interests in qualified retirement plans (1984).

(5) More explicit rules governing disclaimers (1976).

(6) An "orphan exclusion" equal to the amount of the gift tax annual exclusion multiplied by the number of years by which the orphan is under 21 (roughly in 1976 – repealed in 1981).

(7) Tightening of the deduction rules for transfers to charity (1969).

(8) More rational allocation of deductions between estate tax and income tax returns (in part by the "*Hubert* regulations," Reg. §§20.2013-4(b)(3), 20.2055-3(b) & 20.2056(b)-4(d), in 1999).

(9) Tax on generation-skipping transfers (1976 and 1986).

(10) Liberalized extended payment of estate taxes (section 6166) (1976).

(11) Discontinuance of "flower bonds" redeemable at par to pay estate tax (last issued 1971, last matured 1998).

c. **The Ford Administration**

"Blueprints for Basic Tax Reform" was published by the Treasury Department **January 17, 1977**, during the last week of the Ford Administration. In the context of proposing a comprehensive model of income taxation that depended on a dramatically (and at points esoterically) broader tax base, "Blueprints" assumed that transfers by gift or at death would be recognition events. Such capital gains, whether by gift, at death, or otherwise, would be fully taxed at ordinary income rates, with adjustments to the basis of corporate stock for retained earnings and to the basis of all assets for general price inflation. Pre-enactment gain would be excluded, following the precedent of the "carryover basis at death" rules that were enacted in 1976. "Blueprints" was not embraced by the incoming Carter Administration.

d. **The Reagan Administration**

(1) "Tax Reform for Fairness, Simplicity, and Economic Growth" ("Treasury I") (see **www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-v1-1984.pdf** and **www.treasury.gov/resource-center/tax-policy/Documents/Report-Tax-Reform-v2-1984.pdf**) was published by Treasury on November 27, 1984, just three weeks after President Reagan's landslide reelection. Treasury I included the following (at vol. 2, pp. 373-405):

(a) Imposition of gift tax, like the estate tax, on a "tax-inclusive" basis.

(b) Imposition of tax only once, when beneficial enjoyment ceases, ignoring retained powers (a proposal that kindled an "easy to complete"/"hard to complete" debate).

(c) Treatment of all powers of appointment as general powers of appointment if the holder could benefit from them, without regard to complicating concepts such as "ascertainable standards" and "adverse interests."

(d) Valuation of fractional interests in an asset at their pro rata share of the value of the asset owned or previously transferred by the transferor or the transferor's spouse.

(e) A simplified GST tax (compared to the GST tax enacted in 1976) with a $1 million exemption and a flat rate (in this proposal equal to 80 percent of the top estate tax rate).

(f) Elimination of the phase-out of the credit for tax on prior transfers from a member of the same or a younger generation.

(g) Expansion of section 6166 deferral of the payment of estate tax to all cases where the estate lacks sufficient cash or marketable assets, whether or not it holds an interest in a business. Liquidity would be reevaluated annually on an "if you have it send it in" basis (or at least send in 75 percent of it).

(h) Conversion of the IRD deduction under section 691(c) to a basis adjustment.

(i) Replacement of the separate rate schedule for calculating the maximum state death tax credit with a maximum credit equal to a flat 5 percent of the taxable estate. This would have resulted in a substantially smaller state death tax credit in most cases.

(j) Repeal of section 303, which provides for exchange treatment of stock redemptions to pay certain taxes and funeral and administration expenses.

(2) "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" was published by the White House on **May 29, 1985**. It was popularly called "Treasury II" or "White House I" or sometimes "Regan II" in reference to the fact that Donald T. Regan was the Secretary of the Treasury who signed the transmittal letter for "Treasury I" and had become the White House chief of staff by May 1985. Based generally on Treasury I, it was the rough model for the Tax Reform Act of 1986. It contained no transfer tax proposals.

(a) Ultimately, the Tax Reform Act of 1986 (Public Law 99-514) did enact a supposedly simpler GST tax (but at a rate equal to 100 percent, not 80 percent, of the top estate tax rate).

(b) In the Omnibus Budget Reconciliation Act of 1987 ("OBRA") (Public Law 100-203), the House of Representatives added a repeal of the state death tax credit, a rule valuing interests in family-owned entities at their pro rata share of the total value of all interests in the entity of the same class, and rules regarding "disproportionate" transfers of appreciation in estate freeze transactions. H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1041-44. The House-Senate conference retained only the estate freeze rules, as section 2036(c) (which in turn was repealed in 1990 and replaced with the supposedly more workable rules of chapter 14).

(c) The other transfer tax suggestions of Treasury I have not been enacted.

e. **The Clinton Administration**

(1) The Clinton Administration's budget proposals for fiscal year 1999 included a proposal to "eliminate non-business valuation discounts," described as follows:

> The proposal would eliminate valuation discounts except as they apply to active businesses. Interests in entities would be required to be valued for transfer tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds readily marketable assets (including cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets, non-income producing property such as art or collectibles, commodities, options and swaps) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as part of the active business (*i.e.*, not subject to the limits on valuation discounts). No inference is intended as to the propriety of these discounts under present law.

General Explanations of the Administration's Revenue Proposals (Feb. 1998) at 129.

(a) The Clinton Administration's budget proposals for fiscal year 2000 and fiscal year 2001 repeated this proposal, except that "readily marketable assets" was changed to "non-business assets" and "the propriety of these discounts under present law" was changed to "whether these discounts are allowable under current law."

(b) This proposal was reduced to legislative language in section 276 of H.R. 3874, 106th Cong., 2d Sess., introduced on March 9, 2000, by the Ranking Democrat on the House Ways and Means Committee, Rep. Charles Rangel of New York. This bill would have added a new section 2031(d) to the Code, the general rule of which read as follows:

> (d) Valuation Rules for Certain Transfers of Nonbusiness Assets—For purposes of this chapter and chapter 12—
>
> (1) In General—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092 [*see* Reg. §1.1092(d)-1(a) & (b)]), the value of such interest shall be determined by taking into account
>
> (A) the value of such interest's proportionate share of the nonbusiness assets of such entity (and no valuation discount shall be allowed with respect to such nonbusiness assets), plus
>
> (B) the value of such entity determined without regard to the value taken into account under subparagraph (A).

(c) A slightly different articulation of this rule appeared in section 303 of H.R. 1264, 107th Cong., 1st Sess., introduced by Rep. Rangel on March 26, 2001, partly as an alternative to the Republican proposals that became the 2001 Tax Act, which would have added a new section 2031(d) to the Code, to read as follows:

> (d) Valuation Rules for Certain Transfers of Nonbusiness Assets—For purposes of this chapter and chapter 12—
>
> > (1) In General—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092)—
> >
> > > (A) the value of any nonbusiness assets held by the entity shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
> > >
> > > (B) the nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

Rep. Rangel's 2001 bill would also have added a new section 2031(e) to the Code, to read as follows:

> (e) Limitation on Minority Discounts—For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity if the transferee and members of the family (as defined in section 2032A(e)(2)) of the transferee have control of such entity.

Identical statutory language for new sections 2031(d) and (e) appeared in H.R. 5008, 107th Cong., 2d Sess. §3 (introduced June 24, 2002, by Rep. Earl Pomeroy (D-North Dakota)), H.R. 1577, 109th Cong., 1st Sess. §4 (introduced April 12, 2005, by Rep. Pomeroy), and H.R. 4242, 110th Cong., 1st Sess. §4 (introduced November 15, 2007, by Rep. Pomeroy).

(d) Clinton Administration proposals inevitably experienced a bit of a revival after Democrats took control of the Congress and White House. Democratic staff members publicly referred to them as a possible model for legislative drafting. This is perhaps reflected in H.R. 436, the 2009 version of Rep. Pomeroy's bill, discussed in Part 6.a below.

(e) The same Clinton Administration's proposed budgets also recommended the repeal of the personal residence exception from section 2702.

(2) The "Death Tax Elimination Act of 2000" (H.R. 8) was passed in 2000 by large majorities in Congress, including 59 Senators, but it was vetoed by President Clinton. H.R. 8 would have –

(a) reduced the top rate from 55 percent to 40.5 percent in nine annual steps from 2001 through 2009,

(b) converted the "unified credit" to an exemption, thereby allowing the exemption to be applied to the top marginal rate rather than to the lower rates as the credit is,

(c) eliminated the 5 percent surtax that resulted in the 60 percent "bubble" for taxable estates larger than $10 million,

(d) repealed the estate tax, gift tax, and generation-skipping transfer tax (GST tax), beginning in 2010, and

(e) replaced the estate, gift, and GST taxes with a carryover basis regime, beginning in 2010.

2. The Turbulence Created by the 2001 Tax Act

a. The Phase In and Out of the 2001 Tax Act

The changes to the estate, gift, and GST taxes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") are summarized as follows:

<table>
<tr><th colspan="11">Year-by-Year Summary of the Changes Made by the 2001 Tax Act</th></tr>
<tr><th></th><th>2001</th><th>2002</th><th>2003</th><th>2004</th><th>2005</th><th>2006</th><th>2007</th><th>2008</th><th>2009</th><th>2010</th></tr>
<tr><td colspan="10">Estate Tax</td><td rowspan="11">Not applicable. Replaced with carryover basis.</td></tr>
<tr><td>Exclusion</td><td>$675,000</td><td colspan="2">$1 million</td><td colspan="2">$1.5 million</td><td colspan="2">$2 million</td><td colspan="2">$3.5 million</td></tr>
<tr><td>Lowest rate</td><td>37%</td><td colspan="2">41%</td><td colspan="2">45%</td><td rowspan="2">46%</td><td colspan="3" rowspan="2">45%</td></tr>
<tr><td>Top rate</td><td>55%</td><td>50%</td><td>49%</td><td>48%</td><td>47%</td></tr>
<tr><td>5% bubble</td><td>Yes</td><td colspan="8">No</td></tr>
<tr><td>QFOBI</td><td colspan="3">Yes</td><td colspan="6">No</td></tr>
<tr><td>State tax credit</td><td>100%</td><td>75%</td><td>50%</td><td>25%</td><td colspan="5">None. State taxes are deductible.</td></tr>
<tr><td colspan="10">GST Tax</td></tr>
<tr><td>Exemption</td><td>$1.06 million</td><td>$1.1 million</td><td>$1.12 million</td><td colspan="2">$1.5 million</td><td colspan="2">$2 million</td><td colspan="2">$3.5 million</td></tr>
<tr><td>Rate</td><td>55%</td><td>50%</td><td>49%</td><td>48%</td><td>47%</td><td>46%</td><td colspan="3">45%</td></tr>
<tr><td colspan="10">Gift Tax</td></tr>
<tr><td>Exclusion</td><td>$675,000</td><td colspan="9">$1 million</td></tr>
<tr><td>Lowest rate</td><td>37%</td><td colspan="8">41%</td><td rowspan="2">35%</td></tr>
<tr><td>Top rate</td><td>55%</td><td>50%</td><td>49%</td><td>48%</td><td>47%</td><td>46%</td><td colspan="3">45%</td></tr>
<tr><td>5% bubble</td><td>Yes</td><td colspan="9">No</td></tr>
</table>

b. The Gift Tax

(1) The gift tax was not repealed, but was left in place, reportedly to discourage indiscriminate transfers of income-producing or appreciated assets from one taxpayer to another to avoid or reduce income tax liabilities.

(2) Consistent with that objective, the gift tax rate in 2010 was reduced to 35 percent, which was the top long-term income tax rate enacted by the 2001 Tax Act, but the gift tax exemption was capped at $1 million, which was thought to better serve the income tax objectives of the gift tax in a post-estate tax world.

c. The State Death Tax Credit

(1) The federal credit for state death taxes was repealed, and that has produced dramatically different results from state-to-state, depending on the existence and structure of state estate taxes. In a strictly "coupled" state, where the state tax is tied to whatever the federal credit is from time to time, there is no state tax because there is no federal credit.

(2) In a "decoupled" state, where the state tax typically is tied to the federal credit in effect at some point before 2002, there is a state tax. Section 2058 allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. Federal Form 706 now accommodates the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes. The "tentative taxable estate" in effect *is* the taxable estate for calculating the state tax (but not the federal tax) in such a state.

(3) The following table shows the resulting marginal rates on the largest estates, including the results under the 2010 Tax Act and the American Taxpayer Relief Act of 2012, discussed below):

Top Marginal Estate Tax Rates			
	Federal	**State**	**Total**
2009			
"Coupled" State	45%	0	45%
"Decoupled" State with Deduction	38.8%	13.8%	52.6%
"Decoupled" State, No Deduction	37.8%	16%	53.8%
2010-2012			
"Coupled" State	35%	0	35%
"Decoupled" State with Deduction	30.2%	13.8%	44.0%
"Decoupled" State, No Deduction	29.4%	16%	45.4%
2013 and Beyond			
"Coupled" State	40%	0	40%
"Decoupled" State with Deduction	34.5%	13.8%	48.3%
"Decoupled" State, No Deduction	33.6%	16%	49.6%

(4) The landscape is further complicated by other departures from the federal model in various jurisdictions, such as jurisdictions that decoupled their tax systems after 2001 not only from the federal credit for state death taxes but also from the phased increases in the federal unified credit, so that the state exemption is less than the federal exemption. In January 2012, only Delaware, Hawaii, and North Carolina had exemptions and filing thresholds equal to the federal exclusion amount. (Delaware and North Carolina repealed their estate taxes, effective 2018 and 2013, respectively.) By 2020, none of the states that retain an estate tax were known to match the federal exemption.

d. **Carryover Basis**

(1) For 2010, the 2001 Tax Act added carryover basis rules that would change the way executors and beneficiaries determine the income tax basis of property acquired from a decedent, which is used to calculate gain or loss upon sale of the property and in some cases to calculate depreciation deductions. Instead of a basis equal to the value on the date of death (or "alternate valuation date," generally six months after death), the basis was to be the value on the date of death or the decedent's basis in the property, *whichever is less*.

(2) As somewhat of a substitute for the estate tax exemption, each decedent's estate was allowed $1.3 million of basis increase (increased by the decedent's capital loss and net operating loss carryovers and by the capital loss that would have been recognized if the decedent's loss assets had been sold for their fair market value immediately before the decedent's death), which the executor could allocate to individual assets to eliminate up to $1.3 million of that unrealized appreciation. The executor was able to allocate an additional $3 million of basis increase to any assets passing to a surviving spouse, either outright or in certain kinds of trusts.

e. **Three Shall Nots and One Had Never Been**

(1) Not Really Repeal

(a) Section 2210(a) stated that "this [estate tax] chapter shall not apply to the estates of decedents dying after December 31, 2009."

(b) Section 1014(f) stated that "[t]his section [providing for a stepped-up basis at death for appreciated assets] shall not apply with respect to decedents dying after December 31, 2009."

(c) Section 2664 stated that "[t]his [GST tax] chapter shall not apply to generation-skipping transfers after December 31, 2009." It was the entire chapter that did not apply, not just the tax. All definitions, exemptions, rules, etc. were inapplicable. But the GST tax chapter was inapplicable only in the case of generation-skipping transfers.

(2) Watching a Byrd at Sunset

(a) It was well known that the "repeal" of the federal estate tax took effect in 2010, for only one year. In 2011, the 2001 Tax Act was to "sunset" and the estate tax law return to where it would have been without the enactment of the 2001 Tax Act – namely the former 55 percent rate (with a 60 percent "bubble"), a credit for state death taxes, and the $1 million exemption that would have been reached in 2006 under the phased in changes made by the Taxpayer Relief Act of 1997.

(b) Specifically, section 901(a) of the 2001 Tax Act stated:

> Sec. 901. Sunset of Provisions of Act.
>
> (a) In General.—All provisions of, and amendments made by, this Act shall not apply—
>
> (1) to taxable, plan, or limitation years beginning after December 31, 2010, or
>
> (2) in the case of title V, to estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010.
>
> (b) Application of Certain Laws.—The Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described in subsection (a) as if the provisions and amendments described in subsection (a) had never been enacted.

(c) Section 901 was the only section in the ninth and last title of the 2001 Tax Act, titled "Compliance with Congressional Budget Act."

i. The Congressional Budget Act of 1974 (2 U.S.C. §621 *et seq.*) prescribes the procedures by which Congress adopts spending and tax priorities in a budget resolution and implements those priorities in a streamlined process of budget reconciliation. In a rule added in 1985 and amended in 1990, sponsored by the late Senator Robert Byrd (D-West Virginia) (and hence known as the "Byrd Rule"), section 313 of the Budget Act (2 U.S.C. §644) makes "extraneous" provisions in budget reconciliation subject to a point of order in the Senate. "Extraneous" is defined to include the reduction of net revenues in years beyond the period provided for in the budget resolution. Since the 2001 budget resolution generally covered 10 years, a net reduction of taxes beyond the tenth year would have been ruled out of order.

ii. A point of order under the Byrd Rule can be waived by a vote of 60 Senators (just as a Senate filibuster against general legislation can be broken by a vote of 60 Senators). H.R. 1836, which became the 2001 Tax Act, originally passed the Senate, on May 23, 2001, by a vote of 62-38 (while the conference report on the 2001 Tax Act passed the Senate on May 26, 2001, by a vote of only 58-33). H.R. 1836, however, garnered 62 votes only with a "sunset" provision in it. The Senate was not asked to vote on a non-sunsetting repeal, and presumably the votes were just not there. In the Senate consideration of H.R. 1836, amendments to eliminate the estate tax repeal were defeated by votes of 43-56 and 42-57. Even an amendment to preserve the estate tax only for estates greater than $100 million was defeated by a vote of 48-51.

(d) The "as if … had never been enacted" language of section 901(b) of the 2001 Tax Act attracted a lot of attention and created a lot of speculation and exasperation. This was particularly true in the context of the GST tax. It is safe to surmise that members of Congress in 2001 did not think about how this language might affect estate planning in 2010 and 2011. Indeed, it is unlikely that they expected the 2001 Tax Act changes to still be in effect without modification and permanence by 2010. It is certain that the "had never been enacted" language was not cobbled together just to torment estate planners nine years later. Indeed, as of 2001, it was not unprecedented repeal, override, or sunset language.

i. Similar language had been used, ironically, in the 1980 repeal of the original 1976 carryover basis regime. Section 401(b) of the Crude Oil Windfall Profit Tax Act of 1980 (Public Law 96-223) stated:

> Except to the extent necessary to carry out subsection (d) [which allowed executors of decedents dying from January 1, 1977, to November 6, 1978, to *elect* the 1976 carryover basis regime, despite its repeal], the Internal Revenue Code of 1954 shall be applied and administered as if the provisions repealed by subsection (a), and the amendments made by those provisions, had not been enacted.

ii. In a different context, the words "if the Revenue Act of 1948 had not been enacted" appear in section 1014(b)(7) itself.

3. Republican-Led Efforts to Repeal or Reform (2001-2006)

a. Early Efforts After 2001 To Make Repeal Permanent

(1) In the consideration of H.R. 2646, the Farm Security and Rural Investment Act of 2002, which President Bush signed on May 13, 2002, the Senate added an expression of the "sense of the Senate" that the estate tax repeal should be made permanent. Even though such an expression had no statutory or other binding effect whatsoever, it garnered only 56 votes, with 42 votes opposed, although the two Senators not voting (Senators Bennett of Utah and Domenici of New Mexico) were Republicans who had supported the repeal of the estate tax in the past.

(2) As part of an agreement reached to facilitate consideration of certain tax provisions of the 2002 energy bill (H.R. 4), the leadership of the Senate agreed to allow consideration of a proposal to remove the "sunset" feature of the estate and GST tax repeal, so that the repeal scheduled under the 2001 Tax Act to take effect in 2010 would no longer be scheduled to sunset on January 1, 2011 – making the repeal, in effect, permanent. The vote was promised by the end of June 2002.

(a) The repeal measure the Republican leadership agreed to consider would only make the repeal of the estate and GST taxes in 2010 permanent for the years 2011 and beyond. Until 2010, the rates would fall and the unified credit would rise, on the schedule enacted in 2001. The gift tax unified credit would continue to be limited, so as to shelter gifts only up to $1 million, and after 2009 the gift tax would continue in effect, with a 35 percent rate. The state death tax credit would be phased out by 2005, and carryover basis would be enacted as a permanent replacement for the estate tax, beginning in 2010.

(b) This permanent repeal measure involved a suspension of the budget reconciliation rules under which the 2001 Tax Act was crafted, and therefore it required the vote of 60 Senators – the same 60-vote requirement that contributed prominently to the odd results in the 2001 Tax Act in the first place.

(c) The vote was held on June 12, 2002. The vote was 54-44, and the measure therefore failed. (The two Senators not voting supported repeal.)

(d) Before voting on permanent repeal, the Senate took up alternatives offered by Democratic Senators, including accelerated increases in the unified credit (which failed by a vote of 38-60) and expansion of qualified family-owned business interest (QFOBI) relief (which failed by a vote of 44-54).

b. Reports of Compromise Efforts

(1) The October 22, 2003, *Washington Post* reported that Senator Jon Kyl (R-Arizona), an important member of the Senate Committee on Finance who had been a major player in actively advocating permanent repeal of the estate tax, was at that time considering abandoning that position in exchange for an increase in the estate tax exemption to $15 million per person and a decrease in

the estate tax rate, above that exemption, to 15 percent, the then current income tax rate on capital gains.

(2) The *Post* report was silent as to what, if anything, Senator Kyl would do about the gift and GST taxes, about adjustment of basis at death, and about state death taxes. The *Post* also reported that Senator Kyl's proposal had gained the interest of several Democratic Senators and the support of several important lobbyists. The article implied that the impetus for Senator Kyl's proposal was the growth of the deficit and the risk that if a Democrat were elected President in 2004 permanent repeal or substantial reduction of the estate tax would be a dead letter.

(3) Then, on October 23, 2003, one day after the *Post* report, Senator Kyl repudiated the article. As if to leave no doubt, on the same day Senator Kyl introduced S.J. Res. 20, to express "the sense of the Congress that the number of years during which the death tax … is repealed [that is, 2010] should be extended, pending the permanent repeal of the death tax."

c. **The 2004 Election**

(1) After his reelection in 2004, President Bush referred to the "political capital" that he had earned and intended to "spend." He also made it clear that one of the centerpieces of his domestic agenda was to make permanent the tax cuts enacted in 2001 and 2003, including the repeal of the estate and GST taxes.

(2) Also in the 2004 election, the Republicans maintained control of the House and gained four seats in the Senate. Fifty-five was more Republicans than there had been in the Senate since Herbert Hoover was President. This gain in the Senate immediately triggered a lot of speculation about the new votes that might be available for permanent repeal of the estate tax.

(3) Extrapolating from the 59 Senate votes for H.R. 8 (which President Clinton vetoed) in 2000, the 58 votes for the 2001 Tax Act, and especially the 54 votes for the up-or-down repeal vote in June 2002 (with two absent Senators expressing support for repeal), some observers attempted to predict the likely votes for repeal in light of the intervening personnel changes. *See*, *e.g.*, M.A. Sullivan, "60-Vote Majority at Hand for Estate Tax Repeal," Tax Notes, Nov. 29, 2004, at 1174.

(4) Some also cited the intangible effect of the "Daschle factor" – the likelihood that Democrats in "red states" carried by President Bush, especially those up for reelection in 2006, would have second thoughts about opposing the supposedly popular repeal of the estate tax. *Id.*

(5) It is harder still to evaluate the intangible factor of weighing votes rather than counting them. A vote in 2000 for a measure everyone knew President Clinton would veto, a vote in 2001 for a repeal for only one year nine years in the future, and a vote in 2002 where the counting had already been done were not necessarily indicative of how lawmakers would vote on a measure with a realistic chance of success, when it is actually necessary for them to take responsibility for their actions (as the 2006 votes were to show).

d. **The Final Push for Repeal or Compromise**

(1) The permanent repeal of the federal estate tax was placed before the Senate when, by a more or less bipartisan vote of 272-162 on April 13, 2005, the House passed the 109th Congress's version of H.R. 8 (the "Death Tax Repeal Permanency Act of 2005") to eliminate the 2011 "sunset" that limits repeal to just the year 2010.

(2) At the end of July 2005, just before the August recess, Senate Majority Leader Bill Frist of Tennessee filed a motion of "cloture" on H.R. 8, basically the Senate form of "calling the question," which requires approval of 60 Senators. When the Senate was scheduled to reconvene on September 6, the day after Labor Day, there was only one matter that might have been ahead of that cloture motion, a cloture motion on the "Native Hawaiian Government Reorganization Act of 2005."

(3) Meanwhile, with full repeal lacking 60 votes, compromise efforts continued. The idea of a 15 percent rate, mentioned in the October 22, 2003, *Washington Post*, although quite a departure from the top 55 percent rate of just a few years ago and even the 45 percent top rate achieved in

2007, had proved remarkably durable, and it remained the target rate openly discussed by Senator Kyl and others as the compromise discussions reached a public crescendo. In contrast, the $15 million exemption level reported in October 2003 was elusive. Following the 2004 elections, the most often mentioned aspiration was an exemption of $10 million. In mid-July (2005), $8 million was mentioned in the press, and by the end of July it was $3.5 million.

(4) By Labor Day, the pressures of dealing with Hurricane Katrina had become too much for the Senate, and the estate tax vote was postponed.

(a) Opponents of repeal of the estate tax asked how Congress could possibly consider huge tax cuts for the nation's wealthiest families when multitudes on the Gulf Coast had been left with nothing.

(b) Supporters of repeal asserted that more than ever the economy needed stability in tax policy, especially regarding the taxation of saving and investment that would be so important in the Gulf Coast rebuilding effort.

(5) On May 2, 2006, a "Summit for Permanent Death Tax Repeal" convened at the National Press Club in Washington. It was sponsored by the Family Business Estate Tax Coalition, and participants included Senator Jon Kyl (R-Arizona) (who retired from the Senate in 2013), Ways and Means Committee Member Congressman Kenny Hulshof (R-Missouri) (who retired from Congress and ran, unsuccessfully, for Governor of Missouri in 2008), and Al Hubbard, Assistant to the President for Economic Policy and Director of the National Economic Council. The consensus at the Summit was to support a compromise of a 15 percent rate, a $5 million exemption (indexed for inflation), and continued stepped-up basis for appreciated assets, all effective January 1, 2010.

(6) On June 8, 2006, the Senate considered a cloture motion to take up H.R. 8, which the House had passed in April 2005, thus returning the debate to the posture that had been expected before the hurricanes of late August 2005. The motion was only to take up H.R. 8, not necessarily to approve it but possibly to amend it with something like Senator Kyl's 15 percent/$5 million proposal.

(a) Prior to the vote, however, Senator Kyl had floated the suggestion that he would agree to a second rate of, say, 30 percent, imposed on taxable estates over, say, $30 million. That made it unlikely that the last few necessary Democratic votes would support a 15 percent rate that did not include a 30 percent super-rate.

(b) The vote was 57-41 in favor of cloture, three votes short of the necessary 60. (The two Senators who did not vote would have voted no.)

e. **PETRA**

On June 22, 2006, by a vote of 269-156, the House of Representatives passed a new bill, H.R. 5638, called the "Permanent Estate Tax Relief Act of 2006" ("PETRA").

(1) PETRA, effective January 1, 2010, would have provided

(a) a $5 million exemption equivalent (indexed for inflation after 2010),

(b) an initial rate tied to the top income tax rate on general capital gains under section 1(h)(1)(C) (then 15 percent, but returning to 20 percent in 2011 in the absence of further legislation),

(c) a rate equal to double that rate on taxable estates over $25 million (not indexed),

(d) gift tax exemptions and rates re-conformed to the estate tax (rather than a special exemption of $1 million and a special rate of 35 percent as in 2010),

(e) repeal of the deduction for state death taxes (which itself replaced the phased-out credit for state death taxes in 2005),

(f) retention of a stepped-up basis at death for appreciated assets, and

(g) repeal of the 2011 "sunset" for the other transfer tax provisions of the 2001 Tax Act.

(2) PETRA would also have provided a mechanism for a surviving spouse's estate and gift (but not GST) exemptions to be increased (but no more than doubled) by the amount of the exemption that was not used by that spouse's predeceased spouse.

(a) This in effect would have allowed a surviving spouse an exemption of up to $10 million (in 2010 and thereafter), indexed for inflation, if the first spouse to die did not use any exemption – if, for example, the estate of the first spouse to die were left entirely to the surviving spouse.

(b) This treatment would have to be elected on a timely estate tax return of the first spouse to die, and the Internal Revenue Service would have been authorized to reexamine that return at the time the surviving spouse died, no matter how much time had passed, for the purpose of determining the exemption available to the surviving spouse (but not for the purpose of changing the tax with respect to the first return).

(c) The $25 million level for the higher rate would not have been transferable between spouses.

(3) In addition, PETRA included a relief provision for the timber industry, widely viewed as an effort to attract the votes of Senators from timber-growing states.

(4) The Bush Administration, despite its official commitment to full and permanent repeal of the estate tax, announced on June 22 that it supported PETRA "as a constructive step toward full repeal of the death tax."

(5) On June 27, Senator Frist announced that PETRA would not be brought to the Senate floor before the Fourth of July recess.

f. **ETETRA**

On July 29, 2006, by a somewhat less enthusiastic and less bipartisan vote of 230-180, the House of Representatives passed still another bill, H.R. 5970, called the "Estate Tax and Extension of Tax Relief Act of 2006" ("ETETRA").

(1) ETETRA modified PETRA by

(a) phasing in the $5 million exemption equivalent in $250,000 annual increments from $3.75 million in 2010 (up from $3.5 million in 2009) to $5 million in 2015,

(b) delinking the top estate tax rate (but not the initial 15 percent rate) from the capital gains tax rate,

(c) phasing in the top 30 percent rate in 2 percent annual increments from 40 percent in 2010 (down from 45 percent in 2009) to 30 percent in 2015,

(d) extending the indexing for inflation (after 2015) to the $25 million bracket amount, and

(e) removing the "miscellaneous" provisions of the 2001 Tax Act from the repeal of the sunset, meaning that they again would be scheduled to expire in 2011.

(2) In addition to the estate tax provisions and the timber relief provision, ETETRA included two-year "extenders" of the research credit and other expiring provisions, an increase in the minimum wage to $7.25 per hour by June 1, 2009, and a number of other tax changes not related to the estate tax. The estate tax provisions, extenders, and minimum wage increase were popularly referred to as

(3) On August 3, the Senate cloture motion to take up consideration of H.R. 5970 failed by a vote of 56-42. Senator Frist changed his vote to no only to preserve his right to request reconsideration later in the year, and Senator Baucus (D-Montana), who was expected to vote yes, was absent because of the recent death of his nephew in Iraq, thus suggesting that the total votes for cloture might have been 58. The only Senator to change from his June 8 vote was Senator Byrd (D-West Virginia).

g. **Adjournment**

(1) After recessing for the November 7 elections and returning for a "lame duck" session, the 109th Congress adjourned without enacting ETETRA-like changes or any other significant changes to the estate, gift, and GST taxes.

(2) Congress did, however, enact a number of the extenders that had been in ETETRA, but without estate tax changes, without an increase in the minimum wage (which was postponed to 2007), and without even the relief provisions for the timber industry that had originated in PETRA.

h. **What Might Have Been**

(1) We will probably never know how the Senate would have voted just after Labor Day in 2005, if Katrina had not intervened. But it is clear that **even before Republicans lost control of Congress to the Democrats in the 2006 election**, the effort for total repeal had simply lost too much traction to have a meaningful chance of recovery. Consider the following:

(2) In October 2003, Senator Kyl was publicly insisting on full and permanent repeal and denying rumors of compromise, but by the end of 2004 his push for a 15 percent rate instead of full repeal was a matter of general knowledge. Even before the June 8 cloture vote, it was understood in the Senate that Senator Kyl would accept a 30 percent rate for the largest estates – an understanding that later was reflected in PETRA and ETETRA. Once willingness to compromise in this way is conceded, it is very hard to credibly reassert a "purist" position.

(3) As late as April 21, 2005, a letter from Majority Leader Frist called on his Republican colleagues to "end the death tax forever," but by summer he was leading the effort to bring ETETRA to a vote, with its 15 percent and 30 percent rates.

(4) The Bush Administration's official position had been to favor full and permanent repeal, but the White House called PETRA "a constructive step toward full repeal of the death tax." Again, once a compromise effort is dignified in that way, it can become, in effect, the new agenda.

(5) The opposition to repeal – indeed even the opposition to substantial reduction – has been resolute and deep, as indicated by the failure of the ETETRA "sweeteners" to change more than one Senator's vote.

(6) Meanwhile, the support for total repeal was diluted both by years of frustrations and by the realization that carryover basis would be a very unwelcome substitute.

(7) Unlike 2001, when large budget surpluses were forecast, a climate of large budget deficits fuels the unease of politicians and voters with "tax cuts for the rich."

4. "Options" Presented by the Joint Committee Staff (2005)

On January 27, 2005, the Staff of the Joint Committee on Taxation published a 430-page Report titled Options to Improve Tax Compliance and Reform Tax Expenditures (JCS-02-05), as requested in February 2004 by Chairman Grassley and Ranking Member Baucus of the Senate Finance Committee. Under the heading of Estate and Gift Taxation, it presented five proposals estimated to raise revenue by $4.2-4.7 billion over 10 years.

a. **Perpetual Dynasty Trusts**

(1) The first proposal is labeled "Limit Perpetual Dynasty Trusts (secs. 2631 and 2632)." The purpose of this proposal is described as follows:

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

(2) The proposal would prohibit the allocation of GST exemption to a "perpetual dynasty trust" that is subject either to no rule against perpetuities or a significantly relaxed rule against perpetuities. If an exempt trust were moved to a state that had repealed the rule against perpetuities, the

inclusion ratio of the trust would be changed to one. (Presumably this latter rule would apply only if the relocation of the trust produced a change in the governing law, and a similar rule would also apply if the situs state changed its governing law.)

(3) The details, not disclosed in the Report, would have been important.

(a) For example, the proposal states that it would apply in a state that relaxes its rule against perpetuities to permit the creation of interests for individuals more than three generations younger than the transferor. Presumably, the statutory language would not be harsher than a classical rule against perpetuities, which easily allows transfers to great-great-grandchildren.

(b) Likewise, rather than an outright prohibition on allocation of GST exemption, as the proposal says, it seems more appropriate to simply limit allocation of the transferor's GST exemption to a one-time use (permitting a tax-free transfer to grandchildren) and then allow the allocation of GST exemption, again for one-time use, by members of each successive generation also.

(c) An overall objective of tax-neutrality among jurisdictions would be salutary, but elusive.

b. **Valuation Discounts**

(1) The second proposal is labeled "Determine Certain Valuation Discounts More Accurately for Federal Estate and Gift Tax Purposes (secs. 2031, 2512, and 2624)." The purpose of this proposal is described as follows:

> The proposal responds to the frequent use of family limited partnerships ("FLPs") and LLCs to create minority and marketability discounts. … The proposal seeks to curb the use of this strategy frequently employed to manufacture discounts that do not reflect the economics of the transfers during life and after death.

(2) The proposal would determine valuation discounts for transfers of interests in entities by applying aggregation rules and a look-through rule. The aggregation rules are what the Report calls a "basic aggregation rule" and a "transferee aggregation rule."

(a) The basic aggregation rule would value a transferred interest at its pro rata share of the value of the entire interest owned by the transferor before the transfer. For example, a transferred 20 percent interest would be valued at one-fourth the value of an 80 percent interest if the transferor owned an 80 percent interest and at one-half the value of a 40 percent interest if the transferor owned a 40 percent interest.

(b) The transferee aggregation rule would take into account the interest already owned by the transferee before the transfer, if the transferor does not own a controlling interest. For example, if a person who owns an 80 percent interest transfers a 40 percent interest by gift and the other 40 percent interest at death to the same transferee, the gifted 40 percent interest would be valued at one-half the value of the 80 percent interest originally owned by the donor and the bequeathed 40 percent interest would be valued at one-half of the value of the 80 percent interest ultimately owned by the donee/legatee.

(c) Interests of spouses would be aggregated with the interests of transferors and transferees. The proposal explicitly (and wisely) rejects any broader family attribution rule "because it is not correct to assume that individuals always will cooperate with one another merely because they are related."

(3) The look-through rule would require the portion of an interest in an entity represented by marketable assets to be valued at its pro rata share of the value of the marketable assets, if those marketable assets represent at least one-third of the value of the assets of the entity.

(4) The proposal takes a measured approach which appears designed to avoid the uncertain and overbroad reach of previous legislative proposals. Nevertheless, the successive focus on what the transferor originally owned and on what the transferee ends up with – in contrast, for example, to the simple aggregation with the *transferor's* previous transfers – could produce some curious results.

(a) Transferors with multiple transferees – *e.g.*, parents with two or more children – would apparently have more opportunities to use valuation discounts than transferors with only one transferee.

(b) Transfers over time could apparently be treated more leniently than transfers at one time.

(c) The results illustrated in the examples, based on the assumption that a majority (*i.e.*, more than 50 percent) represents control, would apparently be easier to avoid in an entity like a limited partnership or LLC, where a 99 percent interest is often a noncontrolling interest.

(d) Testing valuation discounts ultimately against what the transferee ends up with would encourage successive transfers (retransfers) or transfers split, for example, between a child and a trust for that child's descendants.

c. **Lapsing Crummey Powers**

(1) The third proposal is labeled "Curtail the Use of Lapsing Trust Powers to Inflate the Gift Tax Annual Exclusion Amount (sec. 2503)." The purpose of this proposal is described as follows:

> Recent arrangements involving Crummey powers [*i.e.*, lapsing powers of withdrawal from a trust] have extended the "present interest" concept far beyond what the Congress likely contemplated in enacting the gift tax annual exclusion, resulting in significant erosion of the transfer-tax base.

(2) The proposal offers three options for curbing the use of lapsing Crummey powers.

(a) Limit Crummey powers to "direct, noncontingent beneficiar[ies] of the trust." This would repudiate the broad use of Crummey powers sustained in *Cristofani v. Commissioner*, 97 T.C. 74 (1991).

(b) Limit Crummey powers to powers that never lapse. As the proposal acknowledges, "[t]his option effectively eliminates Crummey powers as a tax planning tool."

(c) Limit Crummey powers to cases where "(1) there is no arrangement or understanding to the effect that the powers will not be exercised; and (2) there exists at the time of the creation of such powers a meaningful possibility that they will be exercised. This option requires a facts-and-circumstances analysis of every Crummey power."

(3) Again curiously, the proposal does not explore the possibility of making "tax-vesting" (includibility in the powerholder's gross estate), rather than actual non-lapsing, the test, even though a tax-vesting test is already used for trusts for minors under section 2503(c) and for all GST tax purposes under section 2642(c)(2).

(4) Indeed, if lapsing Crummey powers were ever eliminated, Congress might at the same time recognize the desirability of allowing section 2503(c) trusts to extend beyond age 21, even for life, subject to a tax-vesting requirement patterned after section 2642(c)(2).

(5) The proposal is silent about its possible application to lapsing rights of withdrawal at age 21 to qualify a trust under section 2503(c), although the principles seem to be the same.

d. **Consistent Basis**

(1) The fourth proposal is labeled "Provide Reporting for a Consistent Basis Between the Estate Tax Valuation and the Basis in the Hands of the Heir (sec. 1014)." The idea is that an heir will be required to use as the income tax basis the same value that is used for estate tax purposes, with the supposedly noncontroversial objective of consistency. To implement this rule, the executor would be required to report the basis to each recipient of property and to the IRS.

(2) A form of this proposal was enacted in 2015. See Part 29.b below.

e. **529 Plans**

(1) The fifth and final proposal is labeled "Modify Transfer Tax Provisions Applicable to Section 529 Qualified Tuition Accounts (sec. 529)." This proposal would essentially subject 529 plans to the transfer tax rules that are generally applicable.

(2) An exception is the special rule allowing the use of five annual gift tax exclusions for a single transfer, which apparently would not be changed.

5. "Middle Class" Focus Under Democratic Leadership (2007-2008)

a. The Fiscal Year 2008 Congressional Budget Resolution (March 2007)

(1) On March 21, 2007, in the context of finalizing the fiscal year 2008 budget resolution (S. Con. Res. 21), the Senate, by a vote of 97-1 (with only Senator Feingold (D-Wisconsin) opposed), approved an amendment offered by Senator Baucus (joined by Senators Mary Landrieu (D-Louisiana), Mark Pryor (D-Arkansas), Evan Bayh (D-Indiana), and Bill Nelson (D-Florida)) that in effect would make the $132 billion surplus projected for 2012 available to offset tax cuts in both 2011 and 2012, including selective extension of the tax cuts enacted in 2001 and 2003.

(2) Senator Baucus stated that under this amendment "the Senate's highest priority for any surplus should be American families." 153 Cong. Rec. S3469 (daily ed. March 21, 2007). Accordingly, the first priority Senator Baucus cited was improving children's health care coverage under the State Children's Health Insurance Program (SCHIP). Senator Baucus continued:

> Then our amendment takes the rest of the surplus and returns it to the hard-working American families who created it. Our amendment devotes the rest of the surplus to the extension and enhancement of tax relief for hard-working American families.
>
> Here are the types of tax relief about which we are talking. We are talking about making the 10-percent [income] tax bracket permanent.…
>
> We are talking about extending the child tax credit.…
>
> We are also talking about continuing the marriage penalty relief.…
>
> We are also talking about enhancing the dependent care credit.…
>
> We are talking about improving the adoption credit.…
>
> We are talking about [taking] combat pay [into account] under the earned-income tax credit, otherwise known as the EITC.…
>
> **We are talking about reforming the estate tax. We want to try to give American families certainty. We want to support America's small farmers and ranchers, and in this amendment, we have allowed room for estate tax reform that will do that.**
>
> And we talk about returning surplus revenues to hard-working American families.

(3) Senator Kent Conrad (D-North Dakota), the Chairman of the Senate Budget Committee (and a former North Dakota Tax Commissioner), responded:

> Madam President, I thank very much Senator Baucus for his leadership on this very important amendment. This amendment is to reassure all those who have benefited from the middle-class tax cuts that those tax cuts will go forward, that those children who are not now currently covered under the SCHIP legislation will have the opportunity to be covered.
>
> The Senator has also provided for small business because we have a number of provisions that are critically important to small business and, of course, to prevent the estate tax from having this bizarre outcome, which is now in the law, where the exemption would go down to $1 million from $3.5 million just two years before. That makes no sense. So the Senator provides for room in this amendment to deal with estate tax reform.
>
> The precise contours of that will be up to, obviously, the Finance Committee.

(4) In response to the ensuing discussion of several of the points he had made, Senator Baucus subsequently said (*id.* at S3470):

> There is an underlying answer to all these questions; namely, these are questions the Finance Committee is going to address and find the appropriate offsets and deal with the pay-go when it comes up at that time.

(5) After being asked specifically about the estate tax, Senator Baucus stated that the amendment "contemplates extending the estate tax provisions that are in effect in 2009 permanently."

(a) In the context of this budget resolution, of course, "permanently" meant only through 2012 (or perhaps only through 2011, since the tax from 2011 estates would generally be payable in *fiscal year* 2012, which begins October 1, 2012).

(b) The prospect of extending 2009 law through 2011 or 2012 was intriguing. It reflected some thoughtful attention to the concerns about the instability of the estate tax law, especially as 2010 approached.

(c) Moreover, by eliminating the repeal year of 2010, an extension actually picked up some revenue to offset the revenue lost in 2011 and 2012. The revenue loss in 2011 and 2012, when the exemption would increase from $1 million to $3.5 million, would be complicated by the fact that the top federal rate would go from 39 percent (net of the state death tax credit) to something like 37.8 percent, 38.8 percent, or 45 percent (as in the table in Part 2.a above).

(d) Since the revenue gain from 2010 would have been a one-time gain, it would not have been available again to mitigate revenue losses, meaning that permanent estate tax reduction would become even more expensive if this extension were enacted.

(6) On March 23, 2007, the Senate rejected a variation of Senator Kyl's proposal to direct the tax-writing committees to report an estate tax exemption of $5 million (indexed for inflation) and a top rate no higher than 35 percent. The vote was 48-51. The vote was severely partisan; no Democrat voted for it, and only one Republican (Senator Voinovich) voted against it. The four Senators who voted for cloture on H.R. 8 in June 2006 but not for Senator Kyl's March 2007 amendment were Senators Baucus, Lincoln (D-Arkansas), Bill Nelson (D-Florida), and Ben Nelson (D-Nebraska).

(7) On the same day, by a vote of 25-74, the Senate rejected an amendment offered by Senator Ben Nelson that he described as follows (*id.* at S3667 (March 23, 2007)):

> Like the Kyl amendment, our amendment will allow us to accommodate the Landrieu proposal of a $5 million [exemption] and 35 percent [rate] with a surcharge for the largest estates. Unlike the Kyl amendment, this amendment is fiscal yearly responsible and deficit neutral [that is, it will be paid for].

Only four Republicans (Senators Susan Collins and Olympia Snowe of Maine, Richard Lugar of Indiana, and George Voinovich of Ohio) voted for Senator Nelson's amendment.

(8) Thus, with only Senators Collins, Lugar, and Snowe voting for both the Kyl amendment and the Nelson amendment, it might be said that 70 Senators voted on March 23 for an exemption of $5 million and a top rate no greater than 35 percent (at least if it can be "paid for" and depending on what Senators Nelson and Landrieu meant by "a surcharge for the largest estates").

(9) The Senate approved the overall budget resolution on March 23 by a largely partisan vote of 52-47.

(10) On May 9, 2007, when the Senate was considering the appointment of Senators to the House-Senate conference on the budget resolution, Senator Kyl offered the following motion (*id.* at S5838 (May 9, 2007)):

> That the conferees on the part of the Senate on the disagreeing votes of the two Houses on the concurrent resolution S. Con. Res. 21 (the concurrent resolution on the budget for fiscal year 2008) be instructed to insist that the final conference report include the Senate position to provide for a reduction in revenues, sufficient to accommodate legislation to provide for permanent death tax relief, with a top marginal rate of no higher than 35%, a lower rate for smaller estates, and with a meaningful exemption that shields smaller estates from having to file estate tax returns, and to permanently extend other family tax relief, so that American families, including farmers and small business owners, can continue to enjoy higher after-tax levels of income, increasing standards of living, and a growing economy, as contained in the recommended levels and amounts of Title I of S. Con. Res. 21, as passed by the Senate.

(a) In explaining the motion, Senator Kyl said: "While the motion does not specify that amount, an exemption of $5 million per estate indexed for inflation is what is contemplated." *Id.* at S5839.

(b) Senator Conrad opposed the motion, on the grounds that it was not paid for and that the subject was already covered by the Baucus amendment in the Senate resolution, which he as a Senate conferee would be committed to support. *Id.*

(c) Nevertheless, Senator Kyl's motion passed by a vote of 54-41, with eight Democrats in favor and no Republicans opposed.

(d) The binding effect of such a motion to "instruct" conferees was unclear. Even provisions "sufficient to accommodate" the desired legislation would still leave the implementation up to the tax-writing committees.

(11) On May 17, 2007, the House and Senate approved the budget resolution with intriguing references to the estate tax.

(a) The provisions of the budget resolution applicable to the House of Representatives (section 303(b)(2)) permit

> one or more bills, joint resolutions, amendments, motions, or conference reports that provide for tax relief for middle-income families and taxpayers and enhanced economic equity, such as extension of the child tax credit, extension of marriage penalty relief, extension of the 10 percent individual income tax bracket, modification of the Alternative Minimum Tax, *elimination of estate taxes on all but a minute fraction of estates by reforming and substantially increasing the unified credit,* extension of the research and experimentation tax credit, extension of the deduction for State and local sales taxes, and a tax credit for school construction bonds … provided that such legislation would not increase the deficit or decrease the surplus for the total over the period of fiscal years 2007 through 2012 or the period of fiscal years 2007 through 2017.

H.R. Rep. No. 110-153, 110th Cong., 1st Sess. 27 (2007).

(b) With respect to the corresponding language of the budget resolution applicable to the Senate (section 303(a)), an overview prepared by the staff of the Senate Budget Committee stated:

> The Conference Agreement supports middle-class tax relief, including extending marriage penalty relief, the child tax credit, and the 10 percent bracket subject to the pay-as-you-go rule. It also supports reform of the estate tax to protect small businesses and family farms. House provisions include additional procedural protections to help ensure fiscal year responsibility.

(c) The proviso that the contemplated tax relief "not increase the deficit or decrease the surplus for the total over the period of fiscal years 2007 through 2012 or the period of fiscal years 2007 through 2017" – what the Senate Budget Committee's overview refers to as "procedural protections to help ensure fiscal responsibility" – could fairly be interpreted to mean that under the budget resolution the Ways and Means Committee would not include any tax relief provisions that were not "paid for" through increases of other taxes or projected budget surpluses. That would have been an especially hard standard to meet in view of the deficits that budgets needed to overcome and the commitment of Ways and Means Committee Chairman Charles Rangel (D-New York) and other Members of Congress to give priority to the very expensive task of fixing the individual alternative minimum tax (which in the 2012 Tax Act may actually have been accomplished).

b. **The Fiscal Year 2009 Congressional Budget Resolution (March 2008)**

(1) In the consideration of the fiscal year 2009 budget resolution (S. Con. Res. 70) on March 11, 2008, Senator Baucus again proposed an amendment that would make projected surpluses available for middle-class tax relief. He said, at 154 Cong. Rec. S1840 (daily ed. March 11, 2008):

> This amendment would take the surplus in the budget resolution and give it back to the hard-working American families who earned it. It would make permanent the 10-percent tax bracket. It would make permanent the child tax credit. It would make permanent the marriage penalty relief. And it would make permanent the changes to the dependent care credit. Further, it would make changes to the tax law to honor the sacrifices our men and women in uniform make for us every day. **We lower the estate tax to 2009**

levels. And it would allow middle-income taxpayers who do not itemize their deductions to nonetheless take a deduction for property taxes.

(2) Once again, Senator Conrad chimed in:

> Mr. President, I thank the chairman of the Finance Committee, Senator Baucus, for this excellent amendment. This will extend the middle-class tax cuts, the 10-percent bracket, the childcare credit, and the marriage penalty relief provisions. All those tax cuts will be extended.
>
> In addition, as I understand it, the chairman of the Finance Committee has crafted an amendment that will include significant estate tax reform because we are now in this unusual situation of where, under current law, the estate tax will go from a $3.5-million exemption per person in 2009 to no estate tax in 2010, and then in 2011, the estate tax comes back with only $1 million exemption per person. The amendment of the Senator from Montana would make certain it stays at $3.5 million and is allowed to rise with inflation.

(3) And again, Senator Baucus's amendment was approved with only Senator Feingold opposed. The vote was 99-1.

(4) On the following day, as he had in 2007, Senator Kyl offered an amendment that would provide a $5 million estate tax exemption (indexed for inflation) and a top rate of 35 percent. *Id.* at S1922 (daily ed. March 12, 2008). An alternative, "paid for," amendment offered by Senator Salazar (D-Colorado) was defeated by a vote of 38-62. *Id.* at S2044. Senator Kyl's amendment was then defeated by a vote of 50-50. *Id.*

(a) Vice President Cheney had been in the presiding officer's chair and recognized Senators Salazar and Kyl just before the vote on Senator Salazar's amendment (*id.*), but he was no longer in the Senate chamber to break the tie after the vote on Senator Kyl's amendment

(b) During the debate, Senator Kyl complained (*id.* at S1923-24):

> The American people need to understand what is really going on. Each year we pass a budget that, theoretically, allows for a reform of the estate tax, but then we don't do anything about it. And the budget itself isn't law. The budget is merely a goal, a blueprint of where we want to go for the year. If you don't follow it up with a bill, you haven't done anything. But Members here pat themselves on the back and go back home and tell their constituents that they voted to cut the estate tax. Oh, that is wonderful, people say. But it is never followed up with an actual bill.
>
> So the chairman of the Finance Committee said: Well, he would have the goal of marking up a bill this spring. He has since advised me he has no plans whatsoever for a real bill on estate tax, and said: It won't happen.

(5) Democratic Senators Landrieu and Lincoln voted for Senator Kyl's amendment, while Republican Senator Voinovich voted against it. Republican Senators Collins, Snowe, and Voinovich joined 35 Democrats, including Senators Landrieu and Lincoln, to vote for Senator Salazar's amendment. Thus, only four Senators (Collins, Landrieu, Lincoln, and Snowe) voted for both amendments, meaning that 84 Senators (including Senators Obama, Biden, and Clinton) voted for substantial estate tax relief, albeit in what were essentially "free" votes.

c. Finance Committee Hearings

On October 4, 2007, while the Senate Finance Committee was considering the tax features of an energy, conservation, and agriculture tax package titled the Heartland, Habitat, Harvest, and Horticulture Act of 2007, Senator Kyl proposed an amendment that would set the estate tax exemption at $5 million indexed for inflation, tie the estate tax rate above $5 million to the capital gains tax income tax rate (then 15 percent), and add a 30 percent bracket beginning at $25 million. (This is essentially the same as ETETRA.) Senator Kyl withdrew the amendment after Chairman Baucus promised to hold a hearing on estate tax reform "later in the year," with the goal of marking up a bill in the spring of 2008.

(1) The Finance Committee held that hearing on November 14, 2007. A manufacturer from Iowa and a rancher from Nevada advocated repeal of the estate tax or at least a substantial increase in the exemption. Warren Buffett of Berkshire Hathaway supported a progressive estate tax (with an exemption of perhaps $4 million) as necessary to prevent "plutocracy." Practitioner Conrad Teitell of Stamford, Connecticut, pointed out the caprice of the then current law and the

complexities and uncertainties faced in estate planning. Both Chairman Baucus and Ranking Member Grassley complained about the estate tax, expressed their preference for repeal, but offered a commitment to serious reform as an achievable alternative. Chairman Baucus promised more extensive hearings in 2008 with a goal of major changes in the 111th Congress (2009-2010). See **http://finance.senate.gov/library/hearings/download/?id=d92e8705-b9ee-46cf-9313-1954eba380f6**.

(2) A second hearing was held on March 12, 2008. Three professors discussed alternatives to the estate tax system, largely donee-based taxes such as inheritance taxes and inclusion of inheritances in income, as well as income taxes on gains imposed at the donor level. It was clear that the Senators in attendance (three Democrats and three Republicans at various times) were not inclined to replace the estate tax with another regime, although they obviously were aware of the coming anomaly in 2010 and 2011 and seemed interested in finding some way to avoid it. Both Democrats and Republicans expressed concern for the liquidity problems of family-owned farms and businesses. One of the witnesses was New York University School of Law Professor Lily Batchelder, who, it was announced May 17, 2010, had been appointed the Chief Tax Counsel for the Committee. See **http://finance.senate.gov/library/hearings/download/?id=74cdc8a6-010a-4faa-b820-c0d8740d5d27**.

(3) A third hearing was held on April 3, 2008. Witnesses were invited to discuss

(a) the need to clarify, modernize, simplify, and otherwise improve the rules for deferred payment of estate tax under section 6166,

(b) the "portability" of transfer tax exemptions (and exemption equivalents represented by the unified credit) from deceased spouses to surviving spouses,

(c) reunifying the estate and gift tax unified credits, and

(d) the effect of the estate tax on charitable giving.

The topics provide clues about the "targeted" relief to look for in any legislation (tied to family farms and other family businesses which had been a vocal concern of Senators, especially Democrats like Senator Lincoln). See **http://finance.senate.gov/library/hearings/download/?id=57f554d9-c027-42c2-90d7-f740010f59cd**.

6. The 111th Congress (2009-2010)

a. The First Pomeroy Bill (H.R. 436)

(1) On January 9, 2009, Rep. Earl Pomeroy (D-North Dakota) introduced H.R. 436, called the "Certain Estate Tax Relief Act of 2009." It received a great deal of attention, but the attention was probably overdone (not surprising in the atmosphere of anticipation that prevailed in January 2009). H.R. 436 was not even featured on Rep. Pomeroy's own website.

(2) H.R. 436 would freeze 2009 estate tax law – a $3.5 million exemption equivalent (with no indexing) and a 45 percent rate.

(3) H.R. 436 would also revive, effective January 1, 2010, the "phaseout of graduated rates and unified credit" of pre-2002 law, expressed as a 5 percent surtax.

(a) The pre-2002 surtax applied only to taxable estates between $10,000,000 and $17,184,000. Because of the increase in the unified credit to match a $3.5 million exemption, the surtax under H.R. 436 would apply to taxable estates from $10 million **all the way up to $41.5 million.**

(b) In other words, the marginal rate between $10 million and $41.5 million would be 50 percent (45 percent plus 5 percent), and the ultimate tax on a taxable estate of $41.5 million, calculated with the 2009 unified credit of $1,455,800, plus the 5 percent surtax on $31.5 million (the excess over $10 million), would be $18,675,000 – exactly 45 percent of $41.5 million.

(c) At least the old 5 percent surtax **used** to work that way when there was a federal credit and no deduction for state death taxes. Today, it would still work that way in "coupled" states where in effect there is no state death tax. Once again, the repeal of the state death tax credit makes the math more complicated in "decoupled" states that impose their own tax. In those states, the actual numbers will depend on the structure of the state tax.

(d) Regardless of the stature or future of H.R. 436 in general, the revival of the surtax idea might gain traction in a revenue-minded and middle-class-focused congressional environment. No idea ever fades away completely.

(e) If a surtax like this were enacted, it would be one more reason to be careful in providing blanket general powers of appointment in trusts subject to the GST tax, because at least the GST tax is imposed at a flat 45 percent rate.

(4) H.R. 436 would add a new section 2031(d), generally valuing transfers of nontradable interests in entities holding nonbusiness assets as if the transferor had transferred a proportionate share of the assets themselves. If the entity holds both business and nonbusiness assets, the nonbusiness assets would be valued under this special rule and would not be taken into account in valuing the transferred interest in the entity. Meanwhile, new section 2031(e) would deny a minority discount (or discount for lack of control) in the case of any nontradable entity controlled by the transferor and the transferor's ancestors, spouse, descendants, descendants of a spouse or parent, and spouses of any such descendants. The statutory language is identical to the bills introduced by Rep. Rangel in 2001 and Rep. Pomeroy in 2002, 2005, and 2007, discussed in Part 1.e(1)(c) above. These rules would apply for both gift and estate tax purposes and would be effective on the date of enactment.

b. **The Arithmetic of the Estate Tax**

(1) Although the estate tax was not prominent in the 2008 presidential campaign, President Obama's campaign embraced making permanent the 2009 estate tax law, with a $3.5 million exemption and 45 percent rate.

(2) Freezing the federal estate tax at its 2009 level would have increased federal revenues for fiscal year 2011 – the 12 months that began October 1, 2010 – because that is when the tax would have been due with respect to decedents dying in 2010.

(3) After 2010, reversing the 2001 Tax Act "sunset" and "reducing" the federal estate tax to its 2009 level would of course have reduced federal revenues (relative to what the pre-2002 law would produce in 2011). But that reduction of federal revenue would have been of less magnitude and different composition than might sometimes be assumed, because, if the 2001 Tax Act sunset were allowed to run its course and pre-2002 law, **including the credit for state death taxes**, returned in 2011, the net federal rate on the largest estates would not increase very much.

(4) If pre-2002 law returned, at the level of a taxable estate of $3.5 million (the 2009 exemption), the net federal marginal rate would be **45.4 percent**, as it was before 2002. At a taxable estate of $3.6 million, it would drop to **44.6 percent**, and never again would be above 45 percent, the then current federal rate in states with no deductible state death tax. At a taxable estate just under $10 million, the net federal marginal rate would be **39.8 percent**. Because of the 5 percent surtax under old section 2001(c)(2), the net marginal rate would become **44.8 percent** at $10 million and then **44 percent** over $10.1 million. At a little over $17 million, the net marginal rate would fall to **39 percent**, the net rate on all taxable estates above that level. These rates compare to the 2009 net federal marginal rate on the largest estates of **45 percent** in "coupled" states, **38.8 percent** in ordinary "decoupled" states, and **37.8 percent** in "decoupled" states where the state tax itself is not allowed as a deduction in computing the state tax.

(5) Putting it another way, the following table shows the **net** federal tax paid, if Congress had not changed the law, on a small and large taxable estate (with no adjusted taxable gifts or other complexities, and no state estate tax):

Federal Estate Tax Owed			
Taxable Estate	2009	2011 (before 2010 Tax Act)	Change
$5 million	$675,000	$1,653,400	+145%
$50 million	$20.9 million	$19.7 million	-6%

(6) The upshot of all this is that a return to pre-2001 law in 2011, compared to 2009 law, would have collected more federal revenue, but mostly from estates at the low end of the range of taxable estates. The very largest estates would actually get a federal tax cut in many states. It is a bit of an oversimplification to ignore state taxes and other factors, but the prima facie effect of raising substantial revenue from the smallest taxable estates and reducing the net federal marginal rates and even the net federal tax on the estates of the richest decedents would not have fit well with popular notions of "tax cuts for the rich" versus "middle class tax relief."

c. **The Obama Administration's Fiscal Year 2010 Budget Proposal**

(1) The ambitious document announcing the Administration's proposed budget, "A New Era of Responsibility: Renewing America's Promise," was published February 26, 2009. In a summary of the adjustments to baseline projections to reflect selective (targeted) continuation of the 2001 and 2003 tax cuts, a footnote (footnote 1 to Table S-5) stated that "the estate tax is maintained at its 2009 parameters." Apparently the gift tax exemption was assumed to remain $1 million, and the exemptions were not indexed for inflation or portable between spouses.

(2) On June 11, 2009, revenue estimates from the Joint Committee on Taxation scored the 10-year cost of the Administration proposal at about 43 percent of the then current-law estimates.

d. **The Fiscal Year 2010 Congressional Budget Resolution**

(1) The House and Senate versions of the budget resolution, H. Con. Res. 85 and S. Con. Res. 13, both as proposed by the respective Budget Committees and as passed by the House and Senate respectively, allowed for 2009 estate tax law to be made permanent.

(2) On April 2, 2009, the Senate, by a vote of 51-48, approved an amendment offered by Senator Blanche Lincoln (D-Arkansas) and cosponsored by Senators Jon Kyl (R-Arizona), Ben Nelson (D-Nebraska), Chuck Grassley (R-Iowa), Mark Pryor (D-Arkansas), Pat Roberts (R-Kansas), Mary Landrieu (D-Louisiana), Michael Enzi (R-Wyoming), Susan Collins (R-Maine), and John Thune (R-South Dakota). The precise wording of Senator Lincoln's amendment is:

> The Chairman of the Senate Committee on the Budget may revise the allocations of a committee or committees, aggregates, and other appropriate levels and limits in this resolution for one or more bills, joint resolutions, amendments, motions, or conference reports that would provide for estate tax reform legislation establishing–
>
> (1) an estate tax exemption level of $5,000,000, indexed for inflation,
>
> (2) a maximum estate tax rate of 35 percent,
>
> (3) a reunification of the estate and gift credits, and
>
> (4) portability of exemption between spouses, and
>
> provided that such legislation would not increase the deficit over either the period of the total of fiscal years 2009 through 2014 or the period of the total of fiscal years 2009 through 2019.

(3) In short, Senator Lincoln's 2009 amendment had about the same effect as would have the amendment proposed by her cosponsor Senator Nelson in 2007 (see Part 5.a(7) above) and by Senator Salazar in 2008 (see Part 5.b(4) above) – that is, in Senator Nelson's words, "[l]ike the Kyl amendment, [but] fiscally responsible and deficit neutral." In an environment of extreme fiscal challenges, that effect could be very small.

(4) As if to leave no doubt about the aspirational nature of this amendment, the Senate then immediately approved, by a vote of 56-43, an amendment offered by Assistant Majority Leader Richard Durbin (D-Illinois), providing that "[i]n the Senate, it shall not be in order to consider any bill, joint resolution, amendment, motion, or conference report that would provide estate tax relief beyond $3,500,000 per person ($7,000,000 per married couple) and a graduated rate ending at less than 45 percent unless an equal amount of tax relief is provided to Americans earning less than $100,000 per year and that such relief is in addition to the amounts assumed in this budget resolution." Senator Kyl mildly opposed the Durbin amendment, but Senators Lincoln, Nelson, and Pryor themselves voted for it.

(5) On April 29, 2009, the conference report on the budget resolution was passed by votes of 233-193 in the House and 53-43 in the Senate. The Lincoln amendment was not included.

e. **The First Baucus Bill (S. 722)**

(1) Meanwhile, on March 26, 2009, Senate Finance Committee Chairman Max Baucus (D-Montana) had introduced the "Taxpayer Certainty and Relief Act of 2009" (S. 722), including Title III captioned "Permanent Estate Tax Relief."

(2) Consistent with the Obama Administration's budget proposal, S. 722 would make permanent the then current $3.5 million estate tax applicable exclusion amount and 45 percent rate. It would again fully unify the gift tax with the estate tax by providing a single exclusion amount of $3.5 million, and it would also make the cap on the reduction of value under the special use valuation provisions of section 2032A equal to the applicable exclusion amount. Beginning in 2011, it would index the applicable exclusion amount for inflation.

(3) S. 722 would also make permanent the other transfer tax changes made by the 2001 Tax Act, including the rules affecting the allocation of GST exemption. And it would provide for the "portability" of the unused gift and estate tax unified credit of a deceased spouse to the surviving spouse and the surviving spouse's estate.

(4) The portability provisions of S. 722 are identical to those in the 2006 House-passed bills, except that the iterative portability of the unified credit to spouses of spouses is prohibited.

(a) In other words, if Husband 1 dies after 2009 without using his full exclusion amount, and his widow, Wife, marries Husband 2 and then dies, Wife's estate could use her own exclusion amount plus whatever amount of Husband 1's exclusion amount was not used. Husband 2's estate could use his own exclusion amount plus whatever amount of Wife's basic exclusion amount was not used. But Husband 2's estate could not use any of Husband 1's unused exclusion amount transmitted through Wife's estate. Some commentators describe this as requiring **privity** between the spouses.

(b) Husband 2's estate could still use the unused exclusion amount of any number of his predeceased wives (and S. 722 would make that explicit), subject only to the overall limitation that the survivor's exclusion amount could be no more than doubled.

f. **The McDermott Bill (H.R. 2023)**

(1) On April 22, 2009, Rep. Jim McDermott (D-Washington), the fourth most senior Democrat on the Ways and Means Committee, introduced H.R. 2023, called the "Sensible Estate Tax Act of 2009." Virtually identical to H.R. 6499, which he had introduced in 2008, H.R. 2023, effective January 1, 2010, would provide

(a) a $2 million exemption equivalent, indexed for inflation after 2010,

(b) an initial rate of 45 percent (over $1.5 million in the tax table), a rate of 50 percent over $5 million, and a rate of 55 percent over $10 million (with these amounts also indexed for inflation after 2010),

(c) restoration of the credit for state death taxes and repeal of the deduction for state death taxes,

(d) gift tax exemptions and rates re-conformed to the estate tax,

(e) retention of a stepped-up basis at death for appreciated assets,

(f) repeal of the 2011 "sunset" for other transfer tax provisions of the 2001 Tax Act, and

(g) portability of the unified credit between spouses (as in PETRA and ETETRA, not requiring "privity" between spouses as in S. 722).

(2) The staff of the Joint Committee on Taxation estimated that H.R. 2023 would cost $202 billion over 10 years, or about 37 percent of the then current-law revenue estimates (compared to 43 percent of the then current-law estimates for the cost of the Administration proposal to make 2009 estate tax law permanent).

g. **Ways and Means Committee Engagement and the Second Pomeroy Bill**

(1) On October 22, 2009, Ways and Means Committee members Shelley Berkley (D-Nevada), Kevin Brady (R-Texas), Artur Davis (D-Alabama), and Devin Nunes (R-California) introduced H.R. 3905, called the "Estate Tax Relief Act of 2009."

(a) Under H.R. 3905, in each of the 10 years from 2010 through 2019, the estate tax applicable exclusion amount would increase by $150,000 and the top rate would decrease by 1 percent. Thus, by 2019 the exemption and rate would be $5 million and 35 percent, the levels embraced aspirationally by a majority of Senators while considering the fiscal year 2010 budget resolution (see Part 6.d above). The $5 million exemption would be indexed for inflation after 2019.

(b) In addition, the deduction for state death taxes would be reduced 10 percent per year through 2019, when it would be eliminated entirely.

(c) H.R. 3905 would abandon carryover basis and make permanent the other 2001 transfer tax changes, including the several helpful rules regarding allocation of the GST exemption. But it would not reunify the gift and estate tax exemptions or make the exemption portable between spouses.

(2) Meanwhile, on November 4, the House Small Business Committee held a hearing titled "Small Businesses and the Estate Tax: Identifying Reforms to Meet the Needs of Small Firms and Family Farmers." Three family business owners and a think tank scholar argued that if the estate tax cannot be abolished, at least there should be greater relief for family businesses and farms.

(3) On November 18, 2009, the Democratic members of the Ways and Means Committee reportedly agreed to go forward with only a one-year extension of the 2009 estate tax law but had second thoughts when Majority Leader Steny Hoyer (D-Maryland) reconvened them and urged them to embrace a permanent solution.

(4) Then on the following day (November 19), Congressman Earl Pomeroy (D-North Dakota), the Ways and Means Committee member whom Chairman Rangel had tapped to put the permanent statutory language together, introduced H.R. 4154, a very simple bill that would only freeze 2009 law, including the estate tax exemption of $3.5 million, the gift tax exemption of $1 million, the top rate of 45 percent, a stepped-up basis at death for appreciated assets, a deduction (and no credit) for state death taxes, and the special rules for conservation easements, section 6166, and allocation of GST exemption enacted in 2001.

(5) On December 3, 2009, the House passed H.R. 4154 by a vote of 225-200. Twenty-six Democrats voted against the bill. No Republican voted for it.

(a) The supporters of the bill in the floor debate focused on the need for predictability in planning and the unfairness of carryover basis.

(b) Those voting no presumably did so mainly because they would have preferred to see the estate tax permanently repealed or more significantly reduced – the House of Representatives then included over 170 members who were among the 272 votes for permanent repeal the last time that issue had come before the House in April 2005. Indeed, the opposition in the floor debate before the vote supported the Berkley-Brady bill (H.R. 3905), which would have phased in a $5 million exemption and 35 percent rate by 2019 and indexed the exemption for inflation after that. A few voting no, however, were Democrats who had expressed a preference for a higher tax, including, for example, a reduction of the exemption to $2 million and a return to a top rate of 55 percent. Other Democrats of that view voted yes.

h. **Senate Refusal To Act in 2009**

(1) H.R. 4154 reached the Senate when the Senators were preoccupied with health care reform. On December 16, 2009, Finance Committee Chairman Max Baucus (D-Montana) asked the Senate for unanimous consent to bring H.R. 4154 to the floor, approve an amendment to extend 2009 law for only two months (not permanently), and approve the bill as amended.

(2) In response, the Republican Leader, Senator Mitch McConnell (R-Kentucky), asked Senator Baucus to agree to consideration of an amendment reflecting, as Senator McConnell described it, "a permanent, portable, and unified $5 million exemption that is indexed for inflation, and a 35-percent top rate."

(a) By use of the word "permanent," of course, Senator McConnell was advocating legislation that would eliminate not just all or part of the 2010 repeal year, but also the return to a higher tax in 2011.

(b) By "portable," he was affirming the ability of a surviving spouse to use any estate tax exemption available to but not used by the first spouse to die.

(c) By "unified," Senator McConnell was supporting the increase of the $1 million gift tax exemption to be equal to the estate tax exemption, as it had been before 2004.

(d) By "indexed for inflation," he was embracing annual increases in the unified exemption with reference to increases in the consumer price index, as the GST exemption was indexed from 1999 through 2003.

(3) Portability, unification, and indexing had been approved in two bills passed by the House of Representatives in 2006 and included in S. 722 introduced by Chairman Baucus in March 2009. A $5 million exemption and 35 percent top rate, along with unification, indexing, and portability, had been part of the amendment, sponsored by Senator Blanche Lincoln (D-Arkansas) that received 51 votes in the consideration of the fiscal year 2010 Congressional Budget Resolution in April 2009. And it was the measure that 84 Senators (including then Senators Obama, Biden, Clinton, and Salazar) voted for, albeit in two separate votes, in the consideration of the fiscal year 2009 budget resolution (S. Con. Res. 70) on March 11, 2008 (described in Part 5.b(5) above).

(4) Senator Baucus objected to Senator McConnell's request, whereupon Senator McConnell objected to Senator Baucus's request, and all practical hopes of transfer tax legislation in 2009 died.

(5) In the course of the debate, Senator Baucus stated:

> Mr. President, clearly, the right public policy is to achieve continuity with respect to the estate tax. If we do not get the estate tax extended, even for a very short period of time, say, 3 months, we would clearly work to do this retroactively so when the law is changed, however it is changed, or if it is extended next year, it will have retroactive application.

i. **The "Responsible Estate Tax Act"**

(1) On June 24, 2010, a bill dubbed "the liberals' bill," the "Responsible Estate Tax Act" (S. 3533), was introduced by Senators Sanders (I-Vermont), Whitehouse (D-Rhode Island), Harkin (D-Iowa), Brown (D-Ohio), and Franken (D-Minnesota). A companion bill, H.R. 5764, was introduced in the House by Rep. Linda Sanchez (D-California) on July 15, 2010.

(2) These bills would have restored a unified credit equivalent to a $3.5 million exemption effective January 1, 2010, with a flat 39 percent rate used to calculate the pre-unified credit tax on the

amount of the taxable estate from $750,000 to $3.5 million. The tax would then be imposed at rates of 45 percent over $3.5 million, 50 percent over $10 million, 55 percent over $50 million, and 65 percent over $500 million.

(a) The 65 percent rate is cast as a 10 percent "surtax," but it has the same effect as a 65 percent rate, and it has no ceiling. It replaces the former 5 percent surtax on taxable estates over $10 million.

(b) Like the former 5 percent surtax, the 10 percent surtax would not affect the GST tax rate, which would be 55 percent as it was before 2002.

(c) There was a typo in section 3(a)(2) of S. 3533 and H.R. 5764 as introduced. This "surtax" is said to replace section 2011(c)(2). The correct reference would be section 2001(c)(2).

(3) These bills would abandon carryover basis, restore the credit for state death taxes, and make permanent the other 2001 transfer tax changes, including the rules regarding allocation of the GST exemption. But they would not reconform the gift and estate tax exemptions, index the exemption or brackets for inflation, or make the exemption portable between spouses.

(4) These bills would increase the cap on the reduction in value under the special use valuation rules of section 2032A (then $1 million) to $3 million (indexed for inflation as it has been since 1998). And they would increase the maximum exclusion from the gross estate under section 2031(c) by reason of a conservation easement from the lesser of $500,000 or 40 percent of the net value of the land to the lesser of $2 million or 60 percent of the net value of the land.

(5) Finally, S. 3533 and H.R. 5764 include the same valuation discount provisions included in the first Pomeroy bill, H.R. 436 (see Parts 6.a(4) and 1.e(1)(c) above), and statutory language implementing the Administration's revenue proposals regarding basis and GRATs.

j. **The Second "Baucus Bill"**

(1) On December 2, 2010, in a "lame duck" session, Senator Max Baucus (D-Montana), the chairman of the Senate Finance Committee, introduced an amendment to pending tax legislation titled the "Middle Class Tax Cut Act of 2010" and widely known as the "Baucus Bill."

(2) As with Senator Baucus's previous proposals, such as S. 722 he had introduced on March 26, 2009 (Part 6.e above), the amendment would permanently reinstate 2009 estate tax law, with a 45 percent rate and $3.5 million exemption, effective January 1, 2010, indexed for inflation beginning in 2011. Executors of decedents who died in 2010 would be able to elect out of the estate tax into the carryover basis regime that had been 2010 law. In a result viewed by many as "too good to be true" and thus possibly an oversight, the Baucus Bill apparently would have left a testamentary trust completely free of GST tax forever if that election were made.

(3) The December 2010 Baucus Bill also revived the idea of the "portability" of the unified credit, or "exclusion amount" or "exemption," by making the portion of the exemption not used by the last predeceased spouse available to the surviving spouse.

(4) The December 2010 Baucus Bill would have provided substantial estate tax relief *targeted* to real estate.

(a) The value of family farmland that met certain qualifications and passed to a "qualified heir" would not be subject to estate tax until it was disposed of by a qualified heir.

(b) The cap on the special use valuation reduction under section 2032A – then $1 million – would be tied to the applicable exclusion amount ($3.5 million in the Baucus Bill) and would be indexed for inflation beginning in 2011.

(c) The treatment of a disposition or severance of standing timber on qualified woodland as a recapture event under section 2032A(c)(2)(E) would be made inapplicable to a disposition or severance pursuant to a forest stewardship plan developed under the Cooperative Forestry Assistance Act of 1978, 16 U.S.C. §2103e.

(d) Certain contributions and sales of qualified conservation easements would likewise not result in recapture under section 2032A.

(e) The limitation on the exclusion from the gross estate by reason of a qualified conservation easement under section 2031(c) would be increased from $500,000 to $5 million.

(5) Finally, the December 2010 Baucus Bill also included the requirement for consistency in basis reporting and a minimum 10-year term for GRATs that were proposed in the 2009 and 2010 Administration budget proposals.

k. **The Deal Between the President and Some Congressional Leaders**

(1) On Monday, December 6, 2010, President Obama announced on national television that he and certain congressional leaders had agreed on "the framework of a deal" to permit the 2001 and 2003 income tax cuts – the so-called "Bush tax cuts" – to be extended for two years. The President reported that the agreement included a one-year 2 percent payroll tax reduction, a 13-month extension of employment benefits desired by many Democrats, and an extension of the estate tax for two years – presumably 2011 and 2012 – with a $5 million exemption and a 35 percent rate (an exemption and rate that then Senator Obama himself had voted for in the consideration of the fiscal year 2009 budget resolution on March 11, 2008, described in Part 5.b(5) above).

(2) It appears that the congressional leaders the President reached this agreement with were mostly Republicans, and the initial reactions of Republicans were supportive, even if not enthusiastic, while surprised Democrats originally reacted with skepticism or even hostility. As the days passed, Republican criticisms also emerged while more Democratic support began to be heard. In the House of Representatives in particular, the Democratic resistance was directed largely at the estate tax proposal, believed by many to be both overly generous and extraneous to the core elements of the compromise.

l. **The 2010 Tax Act**

(1) On December 9, 2010, the Senate released the text of an amendment (S. Amdt. 4753) to implement the agreement announced by President Obama. The amendment, offered by the Senate leaders, Senators Harry Reid (D-Nevada) and Mitch McConnell (R-Kentucky), to an Airport and Airway Trust Fund funding measure (H.R. 4853), was titled the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." It provided

(a) a postponement of the 2001 Tax Act sunset for two years, until December 31, 2012,

(b) an estate tax exemption of $5 million and estate tax top rate of 35 percent, beginning January 1, 2010,

(c) an opportunity for executors of 2010 estates to elect out of the estate tax into the 2010 carryover basis rules,

(d) a GST exemption of $5 million beginning January 1, 2010,

(e) a GST tax rate of zero in 2010 and 35 percent beginning January 1, 2011,

(f) a gift tax exemption of $5 million and a gift tax top rate of 35 percent, beginning January 1, 2011,

(g) indexing of the $5 million exemption for inflation, beginning in 2012, and

(h) portability of the unified credit ("exemption") from a deceased spouse to the surviving spouse, as in the December 2010 Baucus Bill, but

(i) nothing addressing GRATs, consistent basis, targeted relief for real estate, or valuation discounts, and

(j) nothing to permanently remove the shadows of "sunset" from the other changes made by the 2001 Tax Act, affecting the GST exemption (expanded deemed allocations and elections, retroactive allocations, qualified severances, determinations of value, and relief from late allocations), conservation easements, and section 6166. (All those provisions are only extended for two years.)

(2) On December 15, 2010, the Senate approved the Reid-McConnell Amendment by a vote of 81-19.

(3) On December 16, 2010, by a vote of 194-233, the House of Representatives defeated an amendment to replace the estate, gift, and GST tax changes of the bill, generally with 2009 law with an election out for 2010 estates.

(4) Early on December 17, 2010, the House approved the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 by a vote of 277-148.

(5) On December 17, 2010, President Obama signed the Act, which became Public Law 111-312.

7. The Clarified and Modified 2010-2012 Law

a. The Sunset in General

(1) Section 101(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 ("the 2010 Tax Act") simply extended the sunset in the oft-discussed section 901 of the 2001 Tax Act for two years by replacing "December 31, 2010" with "December 31, 2012." As a result, everything that was expected to expire at the end of 2010 was rescheduled to expire at the end of 2012 instead.

(2) This included the "Bush" income tax cuts that were scheduled to expire at the end of 2010 and were the main engine that drove the extraordinarily intense discussions that led to consideration of the Reid-McConnell Amendment. But, read together with section 304 of the 2010 Tax Act, it also included the *new* estate, gift, and GST tax provisions introduced by the 2010 Tax Act.

b. The Estate Tax Exemption and Rate

(1) Title III of the 2010 Tax Act, under the heading of "Temporary Estate Tax Relief," gave special attention to the estate, gift, and GST taxes, because of the unique disruption of those taxes in 2010. Section 301 reinstated the estate tax and repealed carryover basis for 2010. Section 302(a) established an estate tax applicable exclusion amount, or "exemption," of $5 million and a top estate tax rate of 35 percent, effective January 1, 2010. It also indexed that $5 million exemption for inflation, beginning in 2012, and, being found in the context of the two-year extension, also ending in 2012.

(2) The 35 percent rate, like the 2010 gift tax rate, took effect at a level of $500,000. In other words, the "progressive" rates, or "run up the brackets," occurred only below $500,000. The tax value of that run is only $19,200 (35 percent of $500,000 less the stated tax on $500,000 of $155,800).

(3) The $5 million exemption and 35 percent rate, effective even for 2010, were a bit of a surprise, and it is understandable that they attracted special attention, especially in the attempted House amendment. While the rest of the measures extending the 2001 tax cuts simply maintained the 2010 status quo through 2011 and 2012, the estate tax component of the compromise was different in two respects.

(a) First, unlike the income tax compromises, which prevented, in effect, a tax increase on January 1, 2011, the estate tax deal *was* a tax increase compared to former 2010 law but represented a tax *cut* when compared to 2009.

(b) Second, this tax cut was effective not just in 2011 and 2012, but also, in large part, retroactively in 2010.

c. The Election out of the Estate Tax into Carryover Basis for 2010 Estates

(1) Background

(a) One complication of the attempted repeal of the estate tax in 2001 (to take effect in 2010) and the way it became a reality in 2010 was the abrupt introduction of the modified carryover basis regime of section 1022, without technical corrections, without regulations or other guidance, without forms or instructions, and without much serious study at all. Discomfort with the impending carryover basis regime was a principal argument cited in 2009 by congressional supporters of legislation to make the 2009 law permanent and prevent the 2010 law enacted in 2001 from taking effect. See Part 6.g(5)(a) above. Because Congress did not act in 2009, however, the modified carryover basis regime appeared to apply to property passing from a decedent who died in 2010. Ultimately it did apply to such property if the executor elected that the estate tax not apply.

(b) Under pre-2010 and post-2010 law, and under 2010 law without an election out of estate tax, a decedent's beneficiaries inherit assets with a basis for computing depreciation and capital gains equal to the fair market value of the assets on the date of the decedent's death. This basis adjustment is typically referred to as a "basis step-up," because it is assumed that one's basis in assets is lower than the fair market value of assets on the date of death. However, the adjustment actually works in both directions, and if the fair market value of an asset on the date of death is lower than the decedent's basis, the asset's basis is stepped down for all purposes, so that the beneficiaries inherit the property with a lower basis. One historical reason for the basis adjustment rules is apparently the perceived unfairness of imposing a double tax on a beneficiary who inherited assets – first an estate tax and then a capital gains tax when the executor or beneficiary subsequently sold the asset, especially if the sale was necessary to raise money to pay the estate tax. This reasoning would not fully apply in the absence of an estate tax.

(2) The Elective 2010 Carryover Basis Regime

(a) The basic rule in 2010 under section 1022 was that a decedent's basis in appreciated property remained equal to the decedent's basis in the property if the fair market value of the property on the date of death was greater than the decedent's basis. If the fair market value of an asset on the date of death was less than the decedent's basis, the basis was stepped down to the fair market value on the date of death, just as it would have been under former law. This rule applied separately to each item of property.

(b) Under section 1022(a), carryover basis applied to "property acquired from a decedent," which was defined in section 1022(e). The definition did not cover all property the value of which would have been included in a decedent's gross estate, such as property that would have been included in the gross estate of a surviving spouse by reason of a QTIP election under section 2056(b)(7) at the first spouse's death and property that would be included in a decedent's gross estate under section 2036 solely because the decedent had been the grantor and beneficiary of a grantor retained annuity trust ("GRAT") or a qualified personal residence trust ("QPRT").

i. Section 4.01(3)(i) of Rev. Proc. 2011-41, 2011-35 I.R.B. 188, clarified that property subject to a general power of appointment defined in section 2041 (if it applied) was subject to carryover basis.

ii. In the case of a GRAT or QPRT, the basis of the assets is likely to be the decedent's basis anyway. Example 1 of Rev. Proc. 2011-41 illustrated that carryover basis would not apply to the assets of a QPRT if the grantor died during the QPRT term and those assets passed to the grantor's child. But if in that case those assets *passed to the grantor's estate* (which is common because it results in a lower taxable gift), Example 2 of Rev. Proc. 2011-41 stated that then those assets were subject to carryover basis. Presumably the rule for a GRAT would be the same (except that a reversion to the grantor's estate would not be as common).

(c) Section 6018, as applicable to the estate of a decedent who died in 2010 and whose executor elected out of the estate tax, required reporting to the IRS and to recipients of property from the decedent, if the fair market value of all property except cash acquired from the decedent exceeds $1.3 million.

i. Before the enactment of the 2010 Tax Act, the IRS released a draft Form 8939 for this purpose. But the draft indicated that the form would be heavily dependent on the instructions, and the IRS had not yet released any instructions.

ii. Section 6075(a), as applicable to the estate of a decedent who died in 2010 and whose executor elected out of the estate tax, appeared to require the report to the IRS (Form 8939) to be "filed with the return of the tax imposed by chapter 1 for the decedent's last taxable year [that is, the decedent's final 1040 due April 15, 2011] or such later date specified in regulations."

(d) In Notice 2011-66, 2011-35 I.R.B. 184, released on August 5, 2011, the IRS provided the first substantive guidance regarding carryover basis and the election. Notice 2011-76, 2011-40 I.R.B. 479, released on September 13, 2011, amplified and modified that guidance. Confirmations and clarifications provided by those Notices include the following.

i. Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, was to be used to make what Notice 2011-66 called "the Section 1022 Election" out of the estate tax, as well as to report the value and basis of property as required by section 6018 and to allocate the basis increases discussed below.

ii. Form 8939 was to have been filed on or before January 17, 2012.

iii. Notice 2011-66 had originally said November 15, 2011.

iv. Curiously, even Notice 2011-76, which announced the January 17 due date, stated that "the Treasury Department and IRS intend to confirm in regulations … that Form 8939 is due on or before November 15, 2011."

v. Perhaps even more curiously, proposed regulations released on May 8, 2015 (REG-107595-11), would have made conforming references to section 1022 in many places throughout the income tax regulations, but said nothing about the due date of Form 8939.

vi. The statute (section 301(c) of the 2010 Tax Act), however, did not prescribe a due date for the Section 1022 Election and stated only that the election "shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide."

(e) Ordinarily Form 8939 would have been filed by the executor appointed by the appropriate probate court.

i. Sometimes, however, there is no such executor, such as when all the decedent's property is held jointly or held in trust. In that case, a Form 8939, or multiple Forms 8939 as the case may be, would have been filed by the trustees or others in possession of that property (often called "statutory executors" after the definition in section 2203). Notice 2011-66 stated that if those statutory executors did not agree regarding the election, or attempted in the aggregate to allocate more basis increase than the law allowed, the IRS would notify those statutory executors that they had 90 days to resolve their differences. If the executors failed to resolve their differences within 90 days, the IRS, after considering all relevant facts and circumstances disclosed to it, would determine whether the election had been made and how the allocations should be made. As with most "facts and circumstances" judgments, it was impossible to know how the IRS might make those decisions.

ii. In support of that regime, the 2010 estate tax return (Form 706) posted on the IRS website on September 3, 2011 (the Saturday before Labor Day), and the Form 8939 posted on October 6, 2011, both included the following sentence in the declaration above the signature line: "I (executor) understand that if any other person files a Form 8939 or Form 706 (or Form 706-NA) with respect to this decedent or estate, that [*sic*] my name and address will be shared with such person, and I (executor) also hereby request [that] the IRS share with me the name and address of any other person who files a Form 8939 or Form 706 (or Form 706-NA) with respect to this decedent or estate."

(f) The IRS indicated that in general it would not grant extensions of time to file Form 8939 and would not accept a Form 8939 filed late, and that, once made, the Section 1022 Election and basis increase allocations would be irrevocable. There were four explicit exceptions, which Notice 2011-66 called "relief provisions":

i. The executor could file supplemental Forms 8939 to make additional allocations of Spousal Property Basis Increase as additional property is distributed to the surviving spouse. Each such supplemental Form 8939 must have been filed no later than 90 days after such distribution.

ii. The executor could make other changes to a timely filed Form 8939, except making or revoking a Section 1022 Election, on or before July 17, 2012 (six months after January 17). The reasons for such an amendment could have included the following:

a. **Property subject to carryover basis or eligible for basis increases had been more accurately identified.** For example, property acquired by a decedent within three years before death by gift from anyone other than the decedent's spouse did not qualify for the basis increases. Likewise, property subject to a general power of appointment was subject to carryover basis but not eligible for basis increases. Property in a QTIP trust for the benefit of a 2010 decedent was not subject to carryover basis at all. These results departed significantly from the estate tax rules with which return preparers had been familiar.

b. **Historical bases and date-of-death values had been more accurately determined.** As expected, many executors had difficulty reconstructing the decedent's bases in assets. Even the familiar estate tax concept of date-of-death fair market value may have been a challenge in 2010. Many executors and their advisors got a late start in a climate of rumors that Congress might change the rules.

c. **The decedent's tax profile had been more thoroughly studied.** For example, before 2010 many taxpayers may have had little reason to distinguish between capital assets and other assets, especially when those assets, if sold, would have produced a loss and not a gain. Even some taxpayers with loss carryovers may have had little reason to keep strict track of them. Death in 2010 may have made such tax accounting notions relevant for the first time.

d. **Equitable treatment of respective beneficiaries had been more appropriately determined.** Because the burdens of the estate tax and the income tax might not affect all beneficiaries the same way, some executors may have found it difficult both to allocate assets among beneficiaries and to allocate basis increases among assets. After January 17, more equitable approaches may have been crafted, disagreements among beneficiaries may have been addressed, or necessary court approvals may have been obtained.

iii. The IRS may grant "9100 relief" allowing an executor to amend or supplement a Form 8939 "to allocate any Basis Increase that has not previously been validly allocated," if additional assets are discovered or if assets are revalued in what Notice 2011-66 refers to as "an IRS examination or inquiry" after Form 8939 was filed. Such an audit could occur when an asset is sold many years or even decades after the Form 8939 was filed, which means that most "formula" allocations would have been ill-advised (and in any event there could have been no "protective" elections).

iv. The IRS also retained the discretion, under "9100 relief" procedures, to allow an executor to amend or supplement a Form 8939 or even to file a Form 8939 (and thus make the Section 1022 Election) late.

a. The IRS indicated in Notice 2011-66 that its standards for this relief are likely to be strict, especially when a long time has passed since January 17, 2012.

b. But this anticipated strictness may need to be balanced against one of the apparent purposes of the Section 1022 Election, which was to relieve concern for a constitutional challenge to what would otherwise have been a retroactive reinstatement of the estate tax.

c. The first such ruling to be published, Letter Ruling 201231003 (April 16, 2012), cited no facts other than "Decedent died in 2010. The executrix for Decedent's estate retained a qualified tax professional to prepare the Form 8939." The ruling request was filed January 27, 2012 (only 10 days after the missed due date), and the ruling was issued 80 days later.

d. Subsequent rulings have been similar.

(g) The executor was required to furnish the required information to each recipient, using a Schedule A to Form 8939, no more than 30 days after the original Form 8939 or any amended or supplemental Form 8939 was filed (basically, by February 16, 2012). Assets not distributed were treated as received by the executor, and the executor was required to furnish the required information to each recipient as distributions in kind were made.

(h) Notice 2011-76 confirmed other helpful relief:

i. An automatic six-month extension of time to file an estate tax return for a 2010 decedent could have been obtained by timely filing a Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. This was true whether the decedent died before December 17, 2010 (the date of enactment of the 2010 Tax Act), or on or after that date.

ii. In a break from normal procedure, a six-month extension of time to *pay* the estate tax was also automatic; Notice 2011-76 stated that the executor "is not required to substantiate … the reason." It is not clear why the Notice used the word "substantiate" and did not just say it is not necessary even to *state* a reason.

iii. But the Notice went on to state:

> The IRS will not impose late filing and late payment penalties under section 6651(a)(1) or (2) on estates of decedents who died after December 31, 2009, and before December 17, 2010, if the estate timely files Form 4768 and then files Form 706 or Form 706-NA and pays the estate tax by March 19, 2012. The IRS also will not impose late filing or late payment penalties under section 6651(a)(1) or (2) on estates of decedents who died after December 16, 2010, and before January 1, 2011, if the estate timely files Form 4768 and then files Form 706 or Form 706-NA and pays the estate tax within 15 months after the decedent's date of death.

Section 6651(a)(1) relates to the failure to file, and section 6651(a)(2) relates to the failure to pay. So not only did this statement make it clear that estates of decedents who died before December 17 and on or after that date would be treated the same, but it also addressed filing and paying with the same language. This confirms that the standard for "substantiating," or even stating, a reason for an extension of time to pay the tax was a very low standard indeed. But a timely Form 4768 had to be filed.

iv. Notice 2011-76 confirmed that tax that was paid late under such an automatic six-month extension would still, of course, bear interest.

v. Finally, Notice 2011-76 provided that if the Section 1022 Election was made and the income tax liability of someone who sold property in 2010 that had been received from the decedent was thereby increased, "reasonable cause and good faith will be presumed" and no penalty under section 6651(a)(2) or 6662(a) will be imposed. Such a taxpayer was advised to write "IR Notice 2011-76" across the top of the amended return that was required to report consistently with the Section 1022 Election. The Notice refers only to property "disposed of" and does not apply by its terms to adjustments to depreciation (although an argument for relief based on Notice 2011-76 would appear to be compelling).

(i) Rev. Proc. 2011-41, 2011-35 I.R.B. 188, also released on August 5, 2011, elaborated the rules governing the allocation of the basis increases discussed below and provided a number of other clarifications, including the following:

i. Section 4.06(1) of Rev. Proc. 2011-41 provided that the heir's holding period of property subject to the carryover basis rules includes the decedent's holding period (whether or not the executor allocates any basis increase to the property).

ii. Section 4.06(2) provided that such property generally retained the character it had in the hands of the decedent.

iii. Section 4.06(3) provided that the depreciation of property in the hands of the recipient is determined in the same way it was in the hands of the decedent, using the same depreciation method, recovery period, and convention. For example, if the decedent had been depreciating an asset over a 20-year period and died after eight years, the executor or other recipient would continue to depreciate that asset on the same schedule over the next 12 years.

iv. Section 4.06(4) clarified that a suspended loss under the passive activity loss rules was added to basis (as in a gift, not deductible as at death) immediately before death. The explanation seems to assume that a deduction and an addition to basis are more or less equivalent, but by denying a deduction that could have been taken against ordinary income, this rule could, in effect, convert capital gain to ordinary income.

v. Section 4.06(5) clarified that if appreciated property were distributed to satisfy a pecuniary bequest, the gain recognized would be limited by section 1040 to post-death appreciation (just as in other years), even if basis was less than the date-of-death value (unlike other years).

vi. Section 4.06(6) provided that if section 684 applies, so as to impose sale or exchange treatment on a transfer to a nonresident alien, the allocation of basis increases under section 1022 were deemed to occur before the application of section 684.

vii. Section 4.07 clarified that a testamentary trust that otherwise qualified as a charitable remainder trust under section 664 would still qualify if the executor made a Section 1022 Election, even though the election out of the estate tax would mean that no estate tax deduction under section 2055 was allowable, which would appear to have disqualified the trust under Reg. §1.664-1(a)(1)(iii)(*a*).

(j) Curiously, Rev. Proc. 2011-41 began by stating that "[t]his revenue procedure provides optional safe harbor guidance under section 1022…," but many observers commented that it did not provide what are typically viewed as safe harbors. The instructions to Form 8939 included the following:

> If the executor makes the Section 1022 Election and follows the provisions of section 4 of Revenue Procedure 2011-41, and takes no return position contrary to any provisions of section 4, the IRS will not challenge the taxpayer's ability to rely on the provisions of section 4 on either Form 8939 or any other return of tax.

(k) Section 7 of Rev. Proc. 2011-41 stated that the IRS expected 7,000 executors to file Form 8939.

(l) Publication 4895 generally addressed the same topics as Notices 2011-66 and 2011-76 and Rev. Proc. 2011-41, without adding much that was new.

(3) Two Statutory Basis Increases

(a) Two modifications in section 1022 lessened the harshness of the 2010 carryover basis regime.

(b) The first modification, provided by section 1022(b), was called simply a "basis increase" in the statute, but was called the "General Basis Increase" in Rev. Proc. 2011-41.

(c) The second modification, provided by section 1022(c), was an additional $3 million increase in basis for property passing to the surviving spouse, called the "Spousal Property Basis Increase."

(4) The General Basis Increase

(a) The General Basis Increase was the sum of the "Aggregate Basis Increase," which was $1.3 million, and the "Carryovers/Unrealized Losses Increase." The Carryovers/Unrealized Losses Increase in turn had two components:

i. the amount of a decedent's unused capital loss carryovers and net operating loss carryovers and

ii. "the sum of the amount of any losses that would have been allowable under section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death" (section 1022(b)(2)(C)(ii)). Section 4.02(2)(b) and Example 3 of Rev. Proc. 2011-41 made it clear that this second component of the Carryovers/Unrealized Losses Increase included *all* unrealized losses in capital assets at the moment of the decedent's death, without regard to the limitations on immediate deductibility that would apply for income tax purposes in the event of an actual sale. Thus, the amount of those unrealized losses, in effect, was available to increase the basis of appreciated assets (up to their fair market value at death).

(b) The basis increases could not increase the basis of any asset in excess of the fair market value of that asset as of the date of the decedent's death.

(c) Section 4.04(2) of Rev. Proc. 2011-41 provided that the fair market value of an undivided portion of property for this purpose was a proportionate share of the fair market value of the decedent's entire interest in that property at death. This provision applied to determine both the fair market value cap on the allocation of basis increase and, in the case of temporal or successive interests, the allocation of the basis increase itself.

i. For example, if real estate with a value of $600,000 and a basis of $300,000 was devised to three recipients in undivided one-third shares, each share was allocated $100,000 of the decedent's basis, and the executor could allocate up to $100,000 of basis increase to each one-third share – **or to just one or two of those shares**. This was true even though the resulting basis of $200,000 for an undivided one-third interest could have exceeded its fair market value as an undivided interest.

ii. But if the real estate had been devised to one person for life and then to a second person, this provision would require, in effect, an allocation of up to $300,000 of basis increase to the real estate itself, not separately to the life estate or the remainder, and the respective bases of the temporal interests would be determined under the uniform basis principles set out in Reg. §§1.1014-4 & -5. (This focus of the allocation rule on temporal interests was confirmed by the focus on temporal interests on page 8 of the instructions to Form 8939, which were posted on the IRS website on October 7, 2011.)

(d) Section 1022(d)(1)(B)(ii) provided that some property interests that were not held through simple outright ownership qualified for the General Basis Increase, including a portion of joint tenancy property, the decedent's half of community property, the surviving spouse's half of community property if the deceased spouse owned at least half of the whole community property interest, and property held in trusts that were revocable by the grantor.

(e) The General Basis Increase could not be applied to some property the value of which would have been included in the decedent's gross estate if the election out of estate tax had not been made. As noted above (Part 7.c(2)(b)), carryover basis did not apply to a QTIP trust of which the decedent was the beneficiary and may or may not have applied to a GRAT or a

QPRT of which the decedent was the grantor. If carryover basis applied, then the General Basis Increase *might* apply. For example, carryover basis would apply to a QPRT in which the grantor had a reversion in the event of death during the QPRT term, and Example 2 of Rev. Proc. 2011-41 confirmed that the General Basis Increase would also apply. In the case of property subject to the decedent's general power of appointment, section 4.01(3)(i) of Rev. Proc. 2011-41 clarified that carryover basis applied, but Code section 1022(d)(1)(B)(iii) provided that the General Basis Increase may not be allocated to that property.

(f) Property acquired by a decedent by gift within three years of the decedent's date of death from anyone other than the decedent's spouse also did not qualify for the General Basis Increase, under section 1022(d)(1)(C).

(g) A frequent question since carryover basis was enacted in 2001, and especially after it became effective at the beginning of 2010, was whether an executor may allocate basis increases to property that has already been distributed or sold. Section 4.03 of Rev. Proc. 2011-41 said yes. Example 4 of Rev. Proc. 2011-41 even acknowledged that the basis of property that had declined in value after the decedent's death and was then sold may be increased by allocation of basis increases up to date-of-death value, thus generating a loss on the sale.

(5) The Spousal Property Basis Increase

(a) The basis of property eligible for the General Basis Increase could have been increased by an additional $3 million Spousal Property Basis Increase, but not in excess of the fair market value of the property as of the date of the decedent's death, if and only if such property was transferred to the surviving spouse, outright or as "qualified terminable interest property" for the exclusive benefit of the surviving spouse.

(b) Section 1022 provided its own definition of "qualified terminable interest property" and did not simply refer to the definition of "qualified terminable interest property" contained in the estate tax marital deduction provision of section 2056. Because the QTIP *election* in section 2056(b)(7)(B)(i)(III) was omitted from section 1022(c)(5)(A), a so-called Clayton QTIP trust (*Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992); *see* Reg. §20.2056(b)-7(d)(3)(i) as amended in 1998), in which the spouse's mandatory income interest is conditioned on the executor's QTIP election, was not eligible for the Spousal Property Basis Increase. A general power of appointment marital trust that would qualify for the marital deduction for estate tax purposes would have satisfied the requirements for the Spousal Property Basis Increase, because, as under the estate tax rules, it would not have been a "terminable" interest at all.

(c) As noted above, the three-year rule did not apply to property acquired by the decedent from the decedent's spouse unless, during the three-year period, the transferor spouse acquired the property by gift or inter vivos transfer. The law when the estate tax applies (section 1014(e)) limits death-bed transfers to a spouse in order to obtain a step-up in basis when the transferred property was given back to the surviving spouse. The limitations in the carryover basis rules excluded spouses. Property transferred from a healthy spouse to a terminally ill spouse that passed back to the healthy spouse in 2010 was eligible for both the $1.3 million General Basis Increase and the $3 million Spousal Property Basis Increase.

(d) Also as noted above (Part 7.c(4)(g)), section 4.03 of Rev. Proc. 2011-41 confirmed that an executor could allocate the basis increases to property that had already been distributed or sold. With regard to the Spousal Property Basis Increase, section 4.02(3) of Rev. Proc. 2011-41 actually contemplated allocations to property already distributed to the surviving spouse as those distributions are made. (Notice 2011-66 allowed the filing of additional Forms 8939 for that purpose.) Section 4.02(3) of Rev. Proc. 2011-41 also allowed allocation of the Spousal Property Basis Increase to property that the executor had sold, but only to the extent that the applicable Form 8939 included documentation that the sale proceeds were appropriately earmarked for the surviving spouse.

(6) The Election for 2010 Estates

(a) As many expected, the 2010 Tax Act dealt with the "retroactivity" of the 2010 estate tax provisions by permitting an executor to elect out of the estate tax back into the carryover basis regime enacted for 2010 in the 2001 Tax Act. Section 301(c) of the 2010 Tax Act provided that "[s]uch election shall be made at such time and in such manner as the Secretary of the Treasury or the Secretary's delegate shall provide. Such an election once made shall be revocable only with the consent of the Secretary of the Treasury or the Secretary's delegate." It had been hoped that Form 8939 would include an opportunity to make that election or, better, that the filing of Form 8939 itself would be treated as the election. Notice 2011-66 confirmed that.

(b) The vast majority of executors did not need or want such an election, because they were perfectly satisfied with the reinstated estate tax and a stepped-up basis for appreciated assets.

i. That included executors of most estates that would not pay estate tax anyway, such as estates under $5 million (at least in states without a state estate tax), estates that passed largely to charity, and some estates that passed largely to a surviving spouse.

ii. But if the "estate" consisted, for example, of a QTIP trust of which the decedent was the beneficiary as surviving spouse and in which the assets had declined in value, plus cash and modest other assets (less than $1.3 million), then the election might have been considered in order to preserve the higher basis of the assets in the QTIP trust (because that basis would be "stepped-down" under section 1014 if the estate tax applied). In any event, in the case of any election where the decedent was the beneficiary of a QTIP trust, the executor was well-advised not to overlook the need to allocate the decedent's GST exemption to the QTIP trust on Schedule R of Form 8939, if appropriate.

iii. Executors facing only a modest estate tax might also have forgone the election, to get the benefit of the stepped-up basis.

iv. Even executors for whom the estate tax burden would have been substantial may still have considered the estate tax superior to carryover basis if basis presented unusual challenges, such as in the estate of a real estate developer.

v. Still other executors may have elected out of the estate tax to avoid estate tax controversy or uncertainty – for example, to avoid the revaluation of assets, or an assertion that the value of assets transferred during life would be taxed under section 2036, or an assertion that a limited power of appointment held by the decedent was a general power.

(c) In most estates significantly larger than $5 million, the election out of the estate tax and into carryover basis was a clear choice, because it avoided an estate tax paid sooner and at a presumably higher rate than the additional income tax that was thereby incurred on the sale of appreciated assets. This was a small percentage of 2010 estates, and therefore it was appropriate that the default outcome in the absence of an election was that the reinstated estate tax applied. As noted above, section 7 of Rev. Proc. 2011-41 stated that the IRS expected 7,000 executors to file Form 8939.

(7) Factors Influencing the Election

In any event, the following factors were among those that should have been considered in making the election between the estate tax and the carryover basis regime:

(a) Calculation and apportionment of estate tax burden.

(b) Impact of state death taxes, particularly in states with an exemption below $5 million.

(c) Likelihood that the asset will be sold before the recipient's death.

(d) Anticipated date of sale of each asset.

(e) Decedent's basis in each asset.

(f) Ability to allocate basis increases.

(g) Date of death value of each asset.

(h) Projected future value of each asset.

(i) Projected earnings from each asset.

(j) Tax character of any future gains or earnings on assets.

(k) Identity of the beneficiaries.

(l) Revenue needs of the beneficiaries.

(m) Future tax rates.

(n) Domicile of beneficiaries and personal income tax profiles.

(o) Availability of asset-specific deductions and credits, including depreciation.

(p) Impact of election on formula clauses.

(q) Potential for disagreement among beneficiaries concerning the allocation of basis.

(r) Conflicts of interest in making the election and allocating basis.

(s) Aggressiveness of positions that would have been taken if an estate tax return had been filed.

(t) Aggressiveness of positions taken and valuation discounts claimed on the decedent's previously filed gift tax returns and those gift tax returns of the decedent that would have been filed contemporaneously with the estate tax return.

(u) Whether "adequate disclosures" were made on the decedent's previously filed gift tax returns.

(v) Comparison of the expense and aggravation associated with filing the estate tax return and filing the Form 8939.

(w) The availability of binding consents or court approval.

(x) Whether a compensating equitable adjustment was appropriate, and whether it should be approved by a court.

d. **Indexing for Inflation**

(1) The indexing of the applicable exclusion amount in 2012 followed the normal indexing rules that were applicable to income tax brackets since 1993 and in various transfer tax contexts – such as the $10,000 gift tax annual exclusion, the maximum decrease in value attributable to special-use valuation under section 2032A, the amount of value on which estate tax deferred under section 6166 is payable at a special interest rate, and the former $1 million GST exemption – since 1999.

(2) The inflation adjustment was computed by comparing the average consumer price index (CPI) for the 12-month period ending on August 31 of the preceding year with the corresponding CPI for 2010. Thus, the inflation adjustment to the applicable exclusion amount in 2012 was computed by dividing the CPI for the 12 months ending August 31, 2011, by the CPI for the 12 months ending August 31, 2010.

(3) Indexing occurs in $10,000 increments, so the amount applicable in any year is a relatively round number.

(a) But, unlike the typical inflation adjustments on which the indexing is patterned, the result of the calculation is be rounded *down* to the next lowest multiple of $10,000. It is rounded to the *nearest* multiple of $10,000 and thus possibly rounded *up*. But that not make a huge difference in practice – obviously not more than $10,000 in any year.

(b) It will also need to be remembered that the calculation is repeated every year with reference to the CPI for the 12 months ending August 31, 2010. Because of the rounding rule, it will be a mistake to assume that the applicable exclusion amount for any particular year will simply be inflation-adjusted for the following year. All annual calculations were redone with reference to the 2010 baseline and then rounded to the nearest multiple of $10,000.

(4) The indexed applicable exclusion amount was $5,120,000 in 2012. Rev. Proc. 2011-52, §3.29, 2011-45 I.R.B. 701.

e. **The GST Tax**

(1) The GST tax exemption and rate remained tied to the estate tax applicable exclusion amount and top rate, just as they had been since 2004. As a result, beginning in 2011 the estate tax applicable exclusion amount, gift tax applicable exclusion amount, and GST exemption were all the same for the first time ever.

(2) The reinstatement of the estate tax for 2010 meant that once again there was an applicable exclusion amount and therefore a GST exemption for inter vivos transfers in 2010. In fact, it was $5 million.

(3) For any taxable distribution or taxable termination with respect to a trust or a "direct skip" gift in 2010, section 302(c) of the 2010 Tax Act set the 2010 GST tax rate at zero, regardless of inclusion ratios or any other calculations.

(a) This was hugely significant, addressing a number of questions that the 2001 Tax Act created for 2010 and 2011 by providing in section 2664 of the Code that the GST tax chapter "shall not apply to generation-skipping transfers after December 31, 2009" and providing in section 901(b) of the 2001 Tax Act, in relevant part, that "[t]he Internal Revenue Code of 1986 … shall be applied and administered to … [generation-skipping transfers after December 31, 2010] as if [Code section 2664] had never been enacted." For example –

i. Would it have been possible to allocate GST exemption to 2010 transfers?

ii. Would the "move down" rule of section 2653 have applied to "direct skip" transfers in trust in 2010?

iii. Could a "reverse QTIP" election under section 2652(a)(3) have been made for a transfer in 2010?

iv. Would GST exemption allocated to transfers before 2010 still have affected the inclusion ratio even to the extent that that GST exemption exceeded the indexed GST exemption that would have been available if the 2001 Tax Act "had never been enacted"?

v. Would deemed allocations of GST exemption provided for by section 2632(c), which was added by the 2001 Tax Act, still have been effective after 2010?

vi. Would elections in and out of automatic allocations, provided for by section 2632(c)(5), which was added by the 2001 Tax Act, still have been effective after 2010?

vii. Would retroactive allocations of GST exemption in the case of the death of a non-skip person, provided for by section 2632(d), which was added by the 2001 Tax Act, still have been effective after 2010?

viii. Would late allocations of GST exemption pursuant to "9100 relief" allowed by section 2642(g), which was added by the 2001 Tax Act, still have been valid after 2010?

ix. Would qualified severances under section 2642(a)(3), which was added by the 2001 Tax Act, have been respected after 2010?

(b) The technical key for answering all these questions was to allow the GST tax *chapter* to "apply" without resulting in a GST *tax*. Setting the GST tax rate at zero was the elegantly simple way to accomplish that.

(c) Because inter vivos transfers in 2010 *to trusts* that were "direct skips" – for example, where only grandchildren and not children of the donor are beneficiaries – qualified for the "move down" rule of section 2653, so that future distributions to grandchildren when the GST tax rate is not zero will not be taxed, it may be important to have affirmatively elected on the 2010 gift tax return not to permit a deemed allocation of GST exemption under section 2632(b) or (c). This was not always desirable, however, because the "move down" would permit the tax-free skip of only a generation or two, while the allocation of GST exemption would cause a long-term trust to be exempt as long as it lasts.

(d) But if the 2010 direct skip gift was made *outright* to a skip person, there were no future GST tax characteristics to protect and no conceivable reason to want GST exemption to be allocated. The IRS acknowledged this in section II.B of Notice 2011-66, which stated:

> [Reg. §26.2632-1(b)(1)(i)] provides that "… a timely filed Form 709 accompanied by payment of the GST tax (as shown on the return with respect to the direct skip) is sufficient to prevent an automatic allocation of GST exemption with respect to the transferred property." Because it is clear that a 2010 transfer not in trust to a skip person is a direct skip to which the donor would never want to allocate GST exemption, the IRS will interpret the reporting of an inter vivos direct skip not in trust occurring in 2010 on a timely filed Form 709 as constituting the payment of tax (at the rate of zero percent) and therefore as an election out of the automatic allocation of GST exemption to that direct skip. This interpretation also applies to a direct skip not in trust occurring at the close of an estate tax inclusion period (ETIP) in 2010 other than by reason of the donor's death.

The "payment of tax (at the rate of zero percent)" is certainly an odd notion, but again, like the zero rate itself, it produced the right result.

(e) The 2010 gift tax return (Form 709) that the IRS posted on its website on March 18, 2011, was consistent with this approach. In Part 3 of Schedule C, the "applicable rate" in column G was filled in as "0," and column H, which instructed "multiply col. B by col. G," was also filled in with "0." Similarly, in the 2010 estate tax return (Form 706) posted on the IRS website on September 3, 2011, line 8 of Part 2 of Schedule R, line 8 of Part 3 of Schedule R, and line 6 of Schedule R-1 all provided for the calculation of "GST tax due" by multiplying the previous line by zero. Meanwhile, the second page of Schedule R-1 (page 26 of the entire return) included the usual comprehensive instructions for trustees about the payment of the (zero) tax.

(f) Although the huge uncertainties about 2010 were eliminated, it is still a good idea to review all past transfers with generation-skipping potential and use the next gift tax return as an opportunity to affirm, clarify, modify, or make any allocations or elections with respect to the GST exemption.

(4) It was once thought that a *testamentary* generation-skipping trust created by reason of a decedent's death in 2010 might escape GST tax forever, because the property in the trust would not have been subject to estate tax, and therefore there would be no "transferor" under section 2652(a)(1)(A) and no "skip person" under section 2613(a)(1). That result was reversed by the 2010 Tax Act.

(a) In most estates for which no election back into carryover basis was made, the GST tax worked fine. The tax rate on direct skips was zero and the GST exemption allocable to trusts created at death was $5 million. If the estate was smaller than $5 million and no estate tax return was filed, the deemed allocation under section 2632(e) ordinarily worked just fine. Only when there were two or more potentially generation-skipping trusts **and** the total value of all such trusts was greater than the available GST exemption **and** it was undesirable to permit section 2632(e) to allocate that GST exemption pro rate among those trusts would an affirmative allocation have been needed.

(b) If the executor elected out of the estate tax into carryover basis, which probably occurred in the largest estates that are likely to include generation-skipping trusts, the result is the same, but the analysis is more complicated. A sentence added to the end of section 301(c) of the Reid-McConnell Amendment, which became the 2010 Tax Act, that had not appeared in the

Baucus Bill makes it clear that such an election does not affect the treatment of property placed in a generation-skipping trust as "subject to the tax imposed by chapter 11" for purposes of section 2652(a)(1)(A). Therefore, the decedent is still the "transferor," "skip persons" are still defined with reference to that transferor under section 2613, and that will govern the taxation of the trust in the future.

(c) There is no specific reference to the other important way that the GST tax rules are linked to the estate tax rules, which is the definition of the GST exemption in section 2631(c) by reference to the estate tax applicable exclusion amount in section 2010(c). But in section 302(c) the Section 1022 Election is explicitly stated to apply "with respect to chapter 11 of such Code and with respect to property acquired or passing from such decedent (within the meaning of section 1014(b) of such Code)" – in other words, with respect to the suspension of the estate tax and the imposition of carryover basis, not with respect to chapter 13 – meaning that for purposes of section 2631(c) (part of chapter 13) the $5 million applicable exclusion amount in section 2010(c) remained available.

i. This analysis was confirmed by the Joint Committee staff's explanation of the Reid-McConnell Amendment, which stated that "[t]he $5 million generation skipping transfer tax exemption is available in 2010 regardless of whether the executor of an estate of a decedent who dies in 2010 makes the election … to apply the 2010 Tax Act estate tax rules and section 1022 basis rules." Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate (JCX-55-10) at 50 n.53 (Dec. 10, 2010).

ii. This result was again confirmed in section II.D of Notice 2011-66, which stated that "references to chapter 11 in [chapter 13] will be construed as if the decedent was subject to chapter 11 even if the decedent's executor made the Section 1022 Election."

iii. Notice 2011-66, as amplified by Notice 2011-76, also confirmed that GST exemption in the case of an election out of the estate tax would be allocated on Schedule R or R-1 of Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent. The automatic allocation rules applied if the executor did not make, or timely revoked, a Section 1022 Election, or filed a Form 8939 without attaching a Schedule R or R-1. (Not surprisingly, these Schedules R and R-1 are very similar to the Schedules R and R-1 that accompany Form 706.)

(5) Because the GST exemption is tied to the estate tax, it was also indexed for inflation, beginning in 2012. For 2012 it was $5,120,000. Rev. Proc. 2011-52, §3.29, 2011-45 I.R.B. 701.

f. **Extension of Time for Performing Certain Acts**

Section 301(d) of the 2010 Tax Act provided that the due date for certain acts was no earlier than nine months after the date of enactment, which was September 17, 2011. Because that was a Saturday, those acts were due no earlier than Monday, September 19, 2011 (although care in this regard is always warranted, especially in the case of disclaimers, which are not returns required to be filed with the IRS and therefore are not clearly covered by sections 7502 and 7503, but are addressed only to the extent Reg. §25.2518-2(c)(2) applies). The acts for which the due dates were extended were

(1) filing an estate tax return with respect to the estate of a decedent who died after December 31, 2009, and before December 17, 2010,

(2) making any election on the estate tax return of a decedent who died after December 31, 2009, and before December 17, 2010,

(3) paying any estate tax with respect to the estate of a decedent who died after December 31, 2009, and before December 17, 2010,

(4) making any disclaimer of an interest in property passing by reason of the death of a decedent who died after December 31, 2009, and before December 17, 2010 (but care will still be required to ensure that the disclaimer is permitted under state law, or, if not, that section 2518(c)(3) can provide a workaround),

(5) filing a return reporting any generation-skipping transfer after December 31, 2009, and before December 17, 2010, and

(6) making any election required to be made on a return reporting any generation-skipping transfer after December 31, 2009, and before December 17, 2010.

g. **The Gift Tax (and "Clawback")**

(1) The gift tax was not changed for 2010. The exemption remained $1 million, and the rate remained 35 percent.

(2) Beginning January 1, 2011, the gift tax chapter no longer had its own unified credit ("determined as if the applicable exclusion amount were $1,000,000," as section 2505(a)(1) provided for gifts from 2002 through 2009) or its own rate schedule. It is once again the same as the estate tax unified credit and rates.

(a) This was introduced in section 302(b)(1) of the 2010 Tax Act under the heading "Restoration of unified credit against gift tax." It is awkward to refer to a "unified" credit since 2004, when the estate tax exemption increased to $1.5 million but the gift tax exemption remained at $1 million, although the credits were still "unified" in the sense that the credit used affected the credit available both for future gifts and for estate tax purposes.

(b) Under the 2010 Tax Act, the estate and gift tax calculations will again be identical and, in that sense, once again "unified."

(c) Beginning in 2012, the gift tax exemption is therefore indexed for inflation, because it will be identical to the indexed estate tax exemption.

(3) There was a surge in gift-giving in 2011 and 2012.

(a) For many donors, a $5.12 million lifetime exemption in 2012, $10.24 million for a married couple, was enough to accomplish estate planning objectives with simple gifts, outright or, more likely for larger gifts, in trust. Because the GST exemption was also $5.12 million, those trusts could be generation-skipping or even perpetual, without any gift or GST tax paid.

(b) In other cases, more creative use of the gift tax exemption was desirable. Just as the former $1 million exemption could be leveraged, so could the $5 million indexed exemption, except there was five times as much of it. The basic techniques for leveraging the gift tax exemption did not change and included life insurance, installment sales, AFR loans (including forgiveness), GRATs, QPRTs, and the use of entity-based valuation discounts as in closely held businesses and family limited partnerships.

(c) In all these cases, growth in the value of asset following the gift would escape estate tax. And any gift tax paid escapes estate tax if the donor survives for three years after the gift, which reduced the 35 percent gift tax rate to an estate-tax-equivalent rate (or "net gift" or "tax-exclusive" rate) of about 26 percent (0.35 ÷ 1.35). (The tax-exclusive rate corresponding to a 40 percent rate is 28.57 percent (0.4 ÷ 1.4).

(d) The interest in making gifts in 2012, of course, was fueled by the concern that the large gift tax exemption might not survive into future years, either because Congress would not act and it fell to a $1 million level on January 1, 2012, or because Congress might choose to "deunify" the estate and gift tax exemption again. Married donors could resolve the tension between the desire to use the gift tax exemption while it is available and the desire to save it for future use by forgoing gift-splitting, using the high 2012 exemption of the donor spouse and saving even $1 million of the exemption for future use by the non-donor spouse.

(4) The possibility of a surge in gifts followed by a return to a $1 million applicable exclusion amount in 2013 (*e.g.*, if Congress had not acted) also created concerns that some of the gift tax saving would be "recaptured" or "clawed back" by an increased estate tax at death. This concern about "clawback" arose from the provision of former section 2001(b)(2) (which was scheduled to be revived in 2013) that after calculating a tentative tax on the sum of the taxable estate and adjusted taxable gifts there is subtracted "the aggregate amount of tax which would have been payable under chapter 12 [*i.e.*, gift tax] with respect to gifts made by the decedent after December 31, 1976, if the provisions of subsection (c) (as in effect at the decedent's death) [which deals only with tax rates] had been applicable at the time of such gifts."

(a) For a gift in 2011 and death in 2013, for example (if there had been no change in law), this amount would have tended to be *greater* than the gift tax actually paid, because it would have been calculated on the higher rates in effect in 2013.

(b) But this amount would have tended to be *smaller* than the amount of the tentative tax attributable to the adjusted taxable gifts, because it appears that it would have been calculated using the larger unified credit resulting from using the 2011 applicable exclusion amount. Section 2001(b)(2) expressly requires a substitution only of the *rates* in section 2001(c) in reconstructing the hypothetical gift tax payable, not a substitution of the *applicable exclusion amount* in section 2010(c).

(c) Because the adjustment under section 2001(b)(2) is a *reduction* of the estate tax, a *reduction* of that *reduction* by using the 2011 applicable exclusion amount will result in an *increase* in the resulting estate tax. The estate tax (plus the gift tax paid, if any) would ordinarily not be as high as it would have been if the gift had not been made, but it could result in an effective tax on the taxable estate greater than 55 percent.

(5) The clawback can be illustrated this way:

(a) Assume an unmarried individual who has never before made a taxable gift makes a $5,000,000 taxable gift in 2011. The "tentative tax" under sections 2502(a)(1) and 2001(c) would be $155,800 plus 35 percent of the excess of the taxable gift over $500,000, or $1,730,800. The unified credit under sections 2505(a) and 2010(c) would be the same ($1,730,800), and the tax payable would be zero.

(b) Assume that the applicable exclusion amount had returned to $1 million in 2013 and the individual dies in 2013 with a taxable estate of $5,000,000 and, of course, "adjusted taxable gifts" (the 2011 taxable gift) of $5,000,000. The "tentative [estate] tax" computed under section 2001(b)(1) on the sum of those two amounts would be $1,290,800 plus 55 percent of the excess (of $10,000,000) over $3,000,000, or $5,140,800.

(c) The estate tax unified credit would return to its pre-2002 level of $345,800.

(d) In calculating the hypothetical gift tax to subtract under section 2001(b)(2), the "tentative [gift] tax" that would have been computed under sections 2502(a)(1) and 2001(c) in 2011 using 2013 rates would likewise be $1,290,800 plus 55 percent of the excess (of $5,000,000 in this case) over $3,000,000, or $2,390,800.

i. If the net estate tax were computed without regard to the unified credit in either 2011 or 2013, it would be $5,140,800 (¶b) less $2,390,800 (¶d), or $2,750,000. Because $2,750,000 is exactly 55 percent (the 2013 marginal rate) of $5,000,000 (the taxable estate), **this is intuitively the right answer**.

ii. But using the 2011 unified credit of $1,730,800, the section 2001(b)(2) reduction would be $2,390,800-$1,730,800 or $660,000, and the estate tax would be $5,140,800-$660,000-$345,800 (unified credit) or $4,135,000.

iii. If the 2011 unified credit were recalculated using 2013 rates (but the 2011 applicable exclusion amount), it would also be $1,290,800 plus 55 percent of the excess (of $5,000,000) over $3,000,000, or $2,390,800. The section 2001(b)(2) reduction would be zero, and the estate tax would be $5,140,800-$345,800 (unified credit) or $4,795,000. **(Thus, the cost of clawback would be $4,795,000-$2,750,000, or $2,045,000.)**

iv. If the 2011 unified credit were recalculated using both 2013 rates *and the 2013 applicable exclusion amount of $1,000,000*, it would be $345,800. In that case, the section 2001(b)(2) reduction would be $2,390,800-$345,800 or $2,045,000, and the estate tax would be $5,140,800-$2,045,000-$345,800 (unified credit) or $2,750,000.

(e) If the gift had not been made, and the estate tax were computed only on a taxable estate of $10,000,000, it would be $5,140,800-$345,800 (unified credit) or $4,795,000 (the same as in clause iii above). On the other hand, if the 2011 taxable gift of $5,000,000 had been made under 2013 (or 2001) law, a gift tax of $2,045,000 would actually have been paid, and, together with the estate tax (computed under clause iv above) of $2,750,000, the total taxes would *also* be $4,795,000, confirming that in a static tax structure the computation works right (although if the donor survived for three years the total tax would be reduced by excluding the gift tax paid from the taxable estate).

(f) But if the estate tax were simply 55 percent of the taxable estate of $5,000,000, which is intuitively what it ought to be to preserve the benefit of the lower tax at the time of the gift, the estate tax would be $2,750,000. Indeed, if the donor died in 2012 instead of 2013, the "tentative [estate] tax" computed on $10,000,000 would be $155,800 plus 35 percent of the excess of $10,000,000 over $500,000, or $3,480,800; there would be no reduction for gift tax paid, and after the unified credit of $1,730,800 the estate tax would be $1,750,000, which is simply *35* percent of $5,000,000.

(g) This intuitively correct estate tax of $2,750,000 is less than the amount computed in clause iii above (which is the clawback), but identical to the amount computed in clause iv, suggesting that the solution to the clawback problem might be to simply take the approach illustrated in clause iv.

(h) This intuitive view of the estate tax (and thus the approach illustrated in clause iv) are supported by legislative history. The wording of section 2001(b)(2) was intended "to prevent the change in rates from having a retroactive effect to gifts made prior to" the phase-in of the lower rates enacted by the Economic Recovery Tax Act of 1981. H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 156 (1981). This wording was occasioned by the phased lowering of *rates* in 1981; it was not needed for the phased increase in the unified credit in 1976, because the increased unified credit is applied after the section 2001(b) calculation, and therefore such increases would take care of themselves. The objective of the calculation was to tax the taxable estate consistently in the proper rate bracket – in other words, to ensure that, as in the gift tax calculation, "previous taxable gifts only affect the starting point in determining the applicable rate." H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 13 (1976). In 1976, the gift tax structure was specifically designed to provide that "the reduction for taxes previously paid is to be based upon the new unified rate schedule even though the gift tax imposed under present [*i.e.*, pre-1977] law *may have been less than this amount*." *Id.* (emphasis added). There is no reason to doubt that Congress would intend the same policy judgment again if the gift tax "may have been less" than a future estate tax and therefore no reason to suspect that Congress would have intended the "clawback" that is now causing speculation and concern.

i. That policy judgment would have been a justification for Treasury and the IRS (in forms and instructions under section 7805(c), for example) to apply the same treatment to the applicable exclusion amount in section 2010(c) as to the rates in section 2001(c); the technical justification would have been that rates and exemptions (unified credits) have always been treated together in defining the burden of the tax and therefore in determining whether a "change in rates" would have "a retroactive effect."

ii. Put another way, because the *rates* in section 2001(c) cannot be completely understood or applied apart from the brackets, applicable credit amount, and applicable exclusion amount that define their operation, regulations or other guidance (including forms and instructions) could reach this result by simply construing the reference in section 2001(b)(2) to the rates of subsection (c).

(6) Section 302(d) of the 2010 Tax Act added a new section 2001(g) to the Code intended to conform the deduction for tax attributed to adjusted taxable gifts in the calculation of the estate tax to the new gift and estate tax applicable exclusion amount and rates. Section 2001(g) read as follows:

> (g) Modifications to Gift Tax Payable to Reflect Different Tax Rates.—For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute—
>
> (1) the tax imposed by chapter 12 with respect to such gifts, and
>
> (2) the credit allowed against such tax under section 2505, including in computing—
>
> (A) the applicable credit amount under section 2505(a)(1), and
>
> (B) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).

(a) Section 2001(g) is not completely clear, in the absence of implementing forms and instructions. It appears to be well-meaning and likely intended, among other things, to prevent any untoward "recapture" or "clawback" of a gift tax exemption in the form of an increased estate tax, including the increased estate tax that would have taken effect in 2013 if Congress had not acted in the 2012 Tax Act. But section 2011(g) has two limitations:

i. Like the previous wording of section 2001(b)(2), section 2001(g) expressly requires a substitution only of the *rates* in section 2001(c) in reconstructing the hypothetical gift tax payable, not a substitution of the *applicable exclusion amount* in section 2010(c).

ii. Besides, section 2001(g) itself was scheduled to sunset in 2013 when it might have been most needed.

(b) Thus, until there were forms, instructions, or other published guidance from the Internal Revenue Service on this subject, there would always have been a certain risk in making gifts in 2011 and 2012. Of course, this became academic when the indexed applicable exclusion amount in the 2010 Tax Act was made permanent by the 2012 Tax Act.

(c) A similar addition was made to section 2505(a), relating to the treatment of previous gifts in calculating the tax on current gifts, which restores the full cumulative exemption of $1 million for 2010 in most cases.

(7) The "Sensible Estate Tax Act of 2011," H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D-Washington), would have reduced the exemption to $1 million (indexed for inflation *since 2001*) and restore the top 55 percent rate (for taxable estates over $10 million), thus presenting the potential for clawback. But section 2(c) of H.R. 3467 would have eliminated the estate tax clawback by providing that the applicable exclusion amount used to calculate the hypothetical gift tax to subtract under section 2001(b)(2) may never exceed the estate applicable exclusion amount used to compute the tentative estate tax.

(8) In what was called a "conforming amendment," section 302(e) of the 2010 Tax Act would have repealed section 2511(c), which had treated certain transfers in trust as a gift if the trust was not a grantor trust.

(9) There was a glitch in the description of the effective date of the $5 million gift tax exemption.

(a) The $5 million gift tax exemption was provided for in two ways.

i. Section 302(b)(1)(A) of the 2010 Tax Act deleted "(determined as if the applicable exclusion amount were $1,000,000)" from section 2505(a)(1) of the Code. Section

302(b)(1)(B) stated that "[t]he amendment made by this paragraph shall apply to gifts made after December 31, 2010."

ii. Section 302(b)(2) of the 2010 Tax Act stated that "[o]n and after January 1, 2011, subsection (a) of section 2502 is amended to read as such subsection would read if section 511(d) of the Economic Growth and Tax Relief Reconciliation Act of 2001 had never been enacted."

(b) While those references to an effective date of January 1, 2011, are clear enough standing alone, section 302(f) of the 2010 Tax Act states that "[e]xcept as otherwise provided in this subsection, the amendments made by this section shall apply to estates of decedents dying, generation-skipping transfers, and gifts made, after December 31, 2009." Obviously, the words "this subsection" (which are meaningless, because nothing else is provided in subsection (f)) should be "this section" (which would ratify the January 1, 2011, effective dates in section 302(b). And no one would seriously argue that the *general* effective date language in section 302(f) should override the *specific* effective date language in section 302(b).

(c) The other reference to a specific effective date in section 302 of the 2010 Tax Act (the provision for inflation adjustments "in a calendar year after 2011") is hardwired into section 2010(c)(2)(B) of the Code itself and is not affected by this glitch.

(d) A similar, but potentially more consequential, glitch appeared in section 304 of the original Reid-McConnell Amendment, which provided, nonsensically, that "[s]ection 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall apply to the amendments made by this section." Before Senate action, the word "section" was changed to "title" by unanimous consent, thereby clarifying that the estate, gift, and GST tax amendments would sunset at the end of 2012 as contemplated.

h. **Portability**

(1) Section 303 of the 2010 Tax Act included provisions for the portability of the unified credit between spouses that were identical to those in the Baucus Bill, conformed to the exclusion amount ($5 million) and effective date (January 1, 2011) of the 2010 Tax Act.

(2) Under section 2010(c)(5)(A), portability is not allowed "unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return."

(a) Such an election will keep the statute of limitations on that estate tax return open forever, but only for the purpose of determining the amount of unused exemption, not to make adjustments to that return itself. (The regular statute of limitations will prevent any adjustments to the predeceased spouse's return as such.)

(b) It is not clear why this election is required for the surviving spouse to use the unused exemption of the predeceased spouse. But such an election was in every legislative version of portability since 2006, despite criticisms. It is possible that Congress thought an election by the predeceased spouse's executor was necessary in order to keep the return open even for such a limited purpose. See also the explanation in the preamble to the June 2012 temporary regulations in Part 12.b(2)(a)i below.

(c) The IRS's August 25, 2011, draft of the 2011 estate tax return (Form 706) said nothing about portability, which fueled speculation that the "election" of portability required by section 2010(c)(5)(A) would be presumed in the case of any return for a married decedent that provides the information necessary to determine the exclusion amount that was available and the exclusion amount that was used, and therefore the amount of "deceased spousal unused exclusion amount" contemplated by section 2010(c)(4). Arguably part 4 of the August 25 draft did that, because it asked for the customary information about beneficiaries other than charity and the surviving spouse (line 5), as well as all federal gift tax returns (line 7a). (Information about taxable gifts was also collected, as usual, on lines 4 and 7 of the tax computation in Part 2.)

(d) Sure enough, the updated draft of the instructions for the 2011 return (dated September 2, 2011, but not released until a few days later) ended the speculation and, in the instructions to line 4 of Part 4 (on page 13), provided the much-anticipated, albeit labored, reassurance that "[t]he executor is considered to have elected to allow the surviving spouse to use the decedent's unused exclusion amount by filing a timely and complete Form 706." The final instructions posted on the IRS website on September 28, 2011, were the same. Those instructions went on to specify that an executor who did not wish to make the election may (1) attach a statement to that effect to the return, (2) write "No Election under Section 2010(c)(5)" across the top of the return, or (3) simply file no return, if a return is not otherwise required. Notice 2011-82, 2011-42 I.R.B. 516, released on September 29, 2011, confirmed all this.

(e) Without knowing whether portability would be made permanent, it was prudent to assume that it would be and therefore to consider an election every time a married person died (unless that person used the entire exemption, or it was very unlikely that the spouse's total estate would exceed the exemption).

i. To the extent that the smallest estates may have the most unused exemption to pass on and therefore need the election the most, it might be hard to see portability as a simplification, especially if a return that is not required for estate tax purposes is still required to make the portability election.

ii. In contrast, if the couple's combined estate is well under the exemption, there may be no reason to get involved with portability at all.

(3) Each iteration of the legislative portability proposal was more restrictive in its treatment of the vexing issue of the surviving spouse who may have succeeded to unused exemptions from more than one predeceased spouse.

(a) The House-passed "Permanent Estate Tax Relief Act of 2006" ("PETRA") (Part 3.e(2) above) and "Estate Tax and Extension of Tax Relief Act of 2006" ("ETETRA") (Part 3.f above) avoided complex tracing and anti-abuse rules by simply limiting any decedent's use of exemptions from previous spouses to the amount of that decedent's own exemption. In other words, no one could more than double the available exemption by accumulating multiple unused exemptions from previous spouses.

(b) S. 722 in March 2009 (Part 6.e(4) above) restricted portability still further by limiting the source of unused exemption to a spouse or spouses to whom the decedent had personally been married. Thus, if Husband 1 died without using his full exemption, and his widow, Wife, married Husband 2 and then died, Wife's estate could use her own exemption plus whatever amount of Husband 1's exemption had not been not used. Ultimately, Husband 2's estate could use his own exemption plus whatever amount of Wife's own exemption had not been used. But Husband 2's estate could not use any of Husband 1's unused exemption transmitted through Wife's estate. Some commentators describe this as requiring "privity" between the spouses.

(c) The December 2010 "Baucus Bill" amendment (Part 6.j(3) above) went still further by limiting portability to just one predeceased spouse, the "*last* such" deceased spouse. The 2010 Tax Act followed the December 2010 Baucus Bill in this respect.

(4) These limitations – the surviving spouse's own exemption can be no more than doubled and the increase is limited to the unused exemption from just one predeceased spouse – seem redundant (except in the case where the exemption might be reduced in the future). But the wording of the new limitation to just one predeceased spouse appeared to produce a result that was not intended.

(a) The Joint Committee Staff's Explanation included the following three examples, which did a good job of illustrating what was apparently intended:

> Example 1. – Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1), which she may use for lifetime gifts or for transfers at death.
>
> Example 2. – Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.
>
> Example 3. – Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use *Wife's deceased spousal unused exclusion amount, which is $4 million* (Wife's $7 million *applicable* exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

Technical Explanation, *supra*, at 52-53 (emphasis to Example 3 added).

(b) The problem with Example 3 is that under section 2010(c)(4)(B) the "deceased spousal unused exclusion amount" that is portable from Wife to Husband 2 is the excess of Wife's "basic exclusion amount" (which is $5 million) over the amount with respect to which Wife's tentative tax is determined under section 2001(b)(1) (which is Wife's taxable estate of $3 million). The excess of $5 million over $3 million is $2 million, not $4 million as in Example 3.

(c) Even if Wife tried to "use" Husband 1's deceased spousal unused exclusion amount by making $2 million of taxable gifts and left a taxable estate of only $1 million, the amount with respect to which Wife's tentative tax is determined under section 2001(b)(1) would still be $3 million (a $1 million taxable estate plus $2 million of adjusted taxable gifts), and her deceased spousal unused exclusion amount would still be only $2 million.

(d) The discrepancy occurred because section 2010(c)(4)(B)(i) used her $5 million *basic* exclusion amount, while Example 3 used Wife's $7 million *applicable* exclusion amount.

(e) The result in Example 3 was probably intended. When the staff of the Joint Committee on Taxation prepared its General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11, March 2011), it repeated Example 3 unchanged. *Id.* at 555.

(f) On March 23, 2011, the Joint Committee staff published an "Errata" for the General Explanation (JCX-20-11), including just two items – 24 pages of revised budget effect estimates and the following:

> On page 555, add the following footnote 1582A to the word "amount" in the next to last sentence in example 3:
>
>> The provision adds new section 2010(c)(4), which generally defines "deceased spousal unused exclusion amount" of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference

to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the provision.

Section 2(d) of the "Sensible Estate Tax Act of 2011," H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D-Washington), would have made that change.

(5) Although the last sentence of Examples 1 and 2 confirmed that portability was intended to be available for lifetime gifts as well as transfers at death, when the exclusion amount defined by the portability rules is translated into the unified credit, its use for lifetime gifts is limited by the reduction under section 2505(a)(2) by "the sum of the amounts allowable as a credit … for all preceding calendar periods." As an expansion of Examples 1 and 2, assume Wife used the entire $7 million of applicable exclusion amount she had after Example 1 to make gifts (whether before or after marrying Husband 2), and then Husband 2 died and she had an applicable exclusion amount of $6 million as in Example 2. If she then made more gifts, her allowable credit under sections 2505(a) and 2010(c)(1) would be the tentative tax on $6 million (section 2505(a)(1)) reduced by the tentative tax on the $7 million previously used (section 2010(a)(2)). In other words, she would have no allowable unified credit (except to the extent that future inflation adjustments of the exclusion amount overtake that $1 million difference). She would still have $6 million of applicable exclusion amount available at death, although its impact would be diminished by the inclusion of her $7 million gifts in "adjusted taxable gifts" under section 2001(b)(1)(B).

(6) In any event, Treasury was given broad authority to flesh out the portability rules in regulations.

(7) Notice 2011-82, 2011-42 I.R.B. 516, released on September 29, 2011, recapitulated the statutory rules regarding portability

> The Treasury Department and the Service anticipate that, as a general rule, married couples will want to ensure that the unused basic exclusion amount of the first spouse to die will be available to the surviving spouse and, thus, that the estates of most (if not all) married decedents dying after December 31, 2010, will want to make the portability election. As indicated above, because the election is to be made on a timely-filed Form 706, the Treasury Department and the Service anticipate a significant increase in the number of Forms 706 that will be filed by the estates of decedents dying after December 31, 2010, and that many of those returns will be filed by the estates of decedents whose gross estates have a value below the applicable exclusion amount.
>
> As a result, the Treasury Department and the Service believe that the procedure for making the portability election on the Form 706 should be as straightforward and uncomplicated as possible to reduce the risk of inadvertently missed elections. To that end, the Treasury Department and the Service have determined that the timely filing of a Form 706, prepared in accordance with the instructions for that form, will constitute the making of a portability election by the estate of a decedent dying after December 31, 2010.

Of course, some might have wondered if the preparation of a Form 706 in accordance with its instructions is really "straightforward and uncomplicated."

(8) Notice 2012-21, 2012-10 I.R.B. 450, released on February 17, 2012, granted a six-month extension of time to file a federal estate tax return (Form 706) to make the portability election in the case of married decedents who died in the first six months of 2011 with gross estates no greater than $5 million.

(a) Thus, the first extended returns for decedents who died January 1, 2011, and the first unextended returns for decedents who died July 1, 2011, were both due April 2, 2012 (because April 1 was a Sunday).

(b) Notice 2012-21 contained no substantive rules, but it reported that "Treasury and the Service have received comments on a variety of issues."

(9) Temporary regulations and identical proposed regulations were released on June 15, 2012, and very similar final regulations were released on June 12, 2015. See the discussion of the portability regulations and the use of portability in Part 12.b below.

i. **Comment**

(1) On December 16, 2009, when Senator Baucus asked unanimous consent that the Senate pause from its consideration of health care reform and approve an extension of 2009 transfer tax law for just two or three months, Senator McConnell asked Senator Baucus to agree to consideration of an amendment reflecting, as Senator McConnell described it, "a permanent, portable, and unified $5 million exemption that is indexed for inflation, and a 35-percent top rate." See Part 6.h(2) above. Senator Baucus objected to Senator McConnell's request, whereupon Senator McConnell objected to Senator Baucus's request, and all hopes of transfer tax legislation in 2009 died.

(2) Except for permanence, the 2010 Tax Act fulfilled Senator McConnell's request.

(3) But lack of permanence was important.

(a) Many observers, including the author of this outline, had long thought that the true congressional consensus in a stand-alone estate bill would arrive at a rate less than 45 percent and an exemption greater than $3.5 million, possibly not going quite as far as 35 percent and $5 million (although 51 Senators did in April 2009), possibly phased in to make it cost less, and possibly accompanied by some revenue raisers to make it look as if they *tried to control the cost*.

(b) But to do it all it once, without a phase-in (indeed to do it retroactively to January 1, 2010, for estate and GST tax purposes), to not even pretend to pay for it, to link it to the *income* tax cuts; to link the income tax cuts in turn to a bad economy, to insist on indexing and portability *and "unification"* at the same time, and to sunset it all in two years – just teed it up for two more years of contention.

(4) Permanence eventually was achieved, of course, in the 2012 Tax Act. See Part 10.c below.

8. The 112th Congress (2011-2012)

a. Another McDermott Bill

(1) The "Sensible Estate Tax Act of 2011," H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D-Washington), would have reduced the estate and gift tax exemptions to $1 million, effective in 2012. Quixotically, it would have indexed that amount for inflation *since 2001*, but would appear to begin that indexing in 2013, not 2012, with the result that the 2011 exemption of $5,000,000 would apparently have dropped to $1,000,000 in 2012 and then jump to about $1,340,000 in 2013 (assuming 2011 inflation rates). If indexing began in 2012, which is the likely intent, the 2012 exemption would have been about $1,310,000.

(2) H.R. 3467 would also have restored the top 55 percent rate, but for taxable estates over $10 million, and after 2012 all the rate bracket amounts would also have been indexed for inflation, which would make the 55 percent rate effective for taxable estates over about $13,430,000.

(3) As a significant tax *increase*, H.R. 3467 had no future in the Republican-led House of Representatives. But it was of foremost significance for its attention to several subsidiary technical issues and its careful and effective drafting to address those issues.

(a) Section 2(c) of H.R. 3467 would have prevented the notorious "clawback" that might otherwise operate to recapture some or all the benefit of today's large gift tax exemption if the donor dies when the estate tax exemption is lower. It would have done that by providing that the applicable exclusion amount used to calculate the hypothetical gift tax to subtract under section 2001(b)(2) may never exceed the applicable exclusion amount used to compute the tentative estate tax.

(b) Section 2(d) of H.R. 3467 would have corrected a divergence between the statutory "portability" language and the legislative history, by confirming that the legislative history reflected true congressional intent.

(c) Section 5 of H.R. 3467 would have fleshed out the statutory language implementing an Administration proposal to require the estate tax value (not the heir's after-the-fact opinion of date-of-death value) to be used as the heir's basis for income tax purposes. Specifically,

i. new sections 1014(f)(1) and 1015(f)(1) would have required the value used to determine basis in the hands of the recipient for all income tax purposes generally to be no greater than the value "as finally determined" for estate or gift tax purposes,

ii. a new section 6035 would have required each executor or donor required to file an estate or gift tax return to report to the Service and to each person receiving any interest in property from a decedent or donor the value of all such interests as reported on the estate or gift tax return "and such other information with respect to such interest as the Secretary may prescribe,"

iii. new sections 1014(f)(2) and 1015(f)(2) would have required the value used to determine basis to be no greater than the value reported on that statement if "the final value … has not been determined,"

iv. new sections 1014(f)(3) and 1015(f)(3) would have authorized Treasury by regulations to "provide exceptions" to the application of these rules,

v. new section 6035(c) would have authorized Treasury to prescribe implementing regulations, including the application of these rules to situations where no estate or gift tax return is required and "situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property," and

vi. both the failure to report under section 6035 and the failure to use a consistent basis under section 1014(f) or 1015(f) would have been subject to penalties.

The references in proposed sections 1014(f)(1) and 1015(f)(1) to the value "as finally determined" for estate or gift tax purposes allay concerns raised by a publication in September 2009 by the staff of the Joint Committee on Taxation that income tax basis might be limited to the value *reported* on an estate tax return, even if that value is increased in an estate tax audit. The exception in proposed sections 1014(f)(2) and 1015(f)(2) when "the final value … has not been determined" seems to be a necessary compromise, although it would inevitably influence the liquidation decisions of executors and heirs.

(d) This attention to technical issues at the staff level was a source of relief and reassurance at the time about any estate tax legislation Congress might entertain. Any optimism, however, was eventually to be dashed. See Part 29.b(6) below, explaining the "twists" in the legislation that was ultimately enacted in 2015.

b. **More Death Tax Repeal Permanency Bills**

(1) The "Death Tax Repeal Permanency Act of 2011" (H.R. 1259) was introduced March 30, 2011, by Congressman Kevin Brady (R-Texas). It had over 220 co-sponsors. The "Death Tax Repeal Permanency Act of 2012" (S. 2242), was introduced March 28, 2012, by Senator John Thune (R-South Dakota). It had over 35 cosponsors, all Republican.

(2) H.R. 1259 and S. 2242 would have repealed the estate and GST taxes again, effective as of the date of enactment. But they would have left the "stepped up" basis provisions of section 1014 intact without reviving carryover basis.

(3) These bills would have left the gift tax at its 2011-2012 rate (35 percent) with a $5 million lifetime exemption (non-indexed and non-portable). They would also have restored the 2001 Tax Act's enigmatic section 2511(c), providing that "except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1."

c. **Senate and House Leadership Bills**

(1) The "Middle Class Tax Cut Act," S. 3393, introduced on July 17, 2012, by Majority Leader Harry Reid (D-Nevada), would have returned the estate, gift, and GST tax law generally to 2009 levels, with a $3.5 million exemption, portable but not indexed, and a top 45 percent rate. Section 201(b) of S. 3393 included provisions apparently intended to deal with the "clawback issue," but in a manner that is more complicated and less clear than section 2(c) of H.R. 3467.

(2) The same language appeared in a draft of S. 3412, Senator Reid's "Middle Class Tax Cut Act" that passed the Senate by a partisan vote of 51-48 on July 25, but, reportedly to focus more on "middle class tax relief," the estate tax provisions were deleted from the final version of S. 3412 that was introduced on July 19. A virtually identical bill, H.R. 15, was introduced in the House on July 30 by the ranking member of the Ways and Means Committee, Rep. Sander Levin (D-Michigan).

(3) Meanwhile, the "Tax Hike Prevention Act of 2012," S. 3413, introduced on July 19 by Finance Committee Ranking Member Orrin Hatch (R-Utah) and Minority Leader Mitch McConnell (R-Kentucky) would simply extend 2012 law, including indexing and portability, through 2013. In this case, similar provisions appeared in the "Job Protection and Recession Prevention Act of 2012," title I of H.R. 8, which was introduced by Ways and Means Committee Chairman Dave Camp (R-Michigan) on July 24 and passed by the House of Representatives by a largely partisan vote of 256-171 on August 1. (H.R. 8 was destined to become the "American Taxpayer Relief Act of 2012, after a Senate amendment and House concurrence on January 1, 2013.)

9. The Climate After the 2012 Election

a. **The 113th Congress (2013-2014)**

(1) The House of Representatives: 234 Republicans (a loss of 8) and 202 Democrats.

(2) The Senate: 53 Democrats (a gain of 2), 2 Independents who caucus with the Democrats, and 45 Republicans.

b. **The "Fiscal Cliff"**

(1) Expiration of the 2001 and 2003 "Bush Tax Cuts" on January 1, 2013.

(a) The 10 percent income tax bracket eliminated.

(b) The top rate raised to 39.6 percent.

(c) The rate on qualified dividends raised from 15 percent to 39.6 percent – 43.4 percent with the 3.8 percent Medicare tax on net investment income under section 1411 if adjusted gross income, without regard to the foreign earned income exclusion, exceeds $200,000 ($250,000 in the case of a joint return and $125,000 in the case of a married person filing separately).

(d) The rate on long-term capital gains raised from 15 percent to 20 percent (23.8 percent with the 3.8 percent Medicare tax).

(e) Itemized deductions and personal exemptions again subject to phaseouts.

(f) The "marriage penalty" returned.

(g) The child tax credit cut from $1,000 to $500.

(h) The estate, gift, and GST taxes returned to 2001 levels.

(2) Perhaps 25 million or more individual taxpayers added to the alternative minimum tax roles as of January 1, <u>2012</u>.

(3) More than 60 business and individual "extenders" expired as of January 1, <u>2012</u>.

(4) End of the 2 percent payroll tax reduction.

(5) Expiration of the extension of unemployment benefits.

(6) "Sequestration" under the Budget Control Act of 2011 (enacted in August 2011).

(a) Spending cuts of $1.2 trillion over 10 years, beginning January 1, 2013.

(b) Equally divided between defense and non-defense spending.

(7) All subject to change by Congress.

c. **Factors That Affected the Ability to Compromise**

(1) The bitterness of the election versus the enormous pressures of the fiscal cliff, the debt ceiling, and the economy.

(2) The focus on "high-income" taxpayers versus the fragility of the economy (especially for the "small businesses" represented by self-employed, sole proprietorships, partnerships, and S corporations).

(3) The convenience of targeted relief (*e.g.*, for job-creating small businesses) versus the burden of additional complexity in the tax law.

(4) The pressure to enact a temporary extension versus the need for certainty and the eventual challenge of split-year rules for 2013 returns.

(5) The pressures of the 2013 filing season (2012 returns, tables, and instructions) and the 2013 withholding tables versus the clock and the calendar.

(6) The unlikelihood of a constitutional challenge to any retroactive tax <u>reduction</u> in 2013 versus the oft-forgotten predicament of the majority of states that would have seen their state estate taxes (tied to the federal state death tax credit) return on January 1, 2013, and then disappear again.

d. **Residual Discomfort with a High Estate Tax**

(1) In the House of Representatives, 207 Members of the 113th Congress are among the 272 who voted for the "Death Tax Repeal Permanency Act of 2005" (H.R. 8) in 2005 (see Part 3.d(1) above) or the 222 cosponsors of the "Death Tax Repeal Permanency Act of 2011" (H.R. 1259). Adding 47 other new Republicans (since 2005) results in 254 Members with possible no-tax or low-tax leanings.

(2) Sixty Senators in the 113th Congress are among the 84 who voted for a 35 percent rate and $5 million exemption during consideration of the fiscal year 2009 budget resolution in 2008 (see Part 5.b(5) above) or the 38 cosponsors of the "Death Tax Repeal Permanency Act of 2012" (S. 2242) (see Part 8.b(1) above). Adding five other new Republicans (since 2008) resulted in 65 Senators with possible no-tax or low-tax leanings.

(3) During the night of March 22-23, 2013, in consideration of its version of a fiscal year 2014 budget resolution, the Senate somewhat reprised its 2007 and 2008 votes. An amendment offered by Senator John Thune (R-South Dakota) allowing repeal of the estate tax in a *deficit*-neutral way was defeated on a 46-53 vote *after* an amendment offered by Senator Mark Warner (D-Virginia) allowing repeal or reduction of the estate tax in a *revenue*-neutral way was approved on an 80-19 vote.

(a) The difference, of course, is that Senator Thune's deficit-neutral repeal could be offset by reduced *spending*, not necessarily by increased revenue as in Senator Warner's revenue-neutral proposal – a big difference between Republicans and Democrats these days.

(b) Senator Warner's amendment was strange, because he spoke in favor of the estate tax while appearing to propose its repeal, stating that "I personally believe the current estate tax—with a very generous $5 million-per-person exemption, and $10 million per family; an estate tax that only applies to 3,800 families per year—is a fair part of our Tax Code." 159 Cong. Rec. S2285-86 (daily ed. March 22, 2013). But he concluded by stating that "I urge my colleagues, if we want to repeal the estate tax *and pay for it*, to vote for the Warner amendment." *Id.* (emphasis added). And when he was Governor of Virginia he vetoed the General Assembly's first effort to repeal Virginia's estate tax by "coupling" it to the repealed state death tax credit. It fell to his successor, Governor Tim Kaine, another Democrat, who also went on to the Senate (and ran for Vice President), to eventually sign the Virginia repeal into law. Apparently, Senator Warner's amendment was a simple attempt at preemption – basically to make a statement that the estate tax should not be repealed, or, by extension, further relaxed, unless it is paid for with revenue offsets.

(c) But it is likely that some of the 79 Senators who voted with Senator Warner, including all or most of the 46 Senators who voted for Senator Thune's amendment, meant to express for the record their dissatisfaction with the estate tax.

e. **Simple Math**

(1) Return to 2001 law would have resulted in a 55 percent rate that might have been unacceptable to many. But a net marginal federal rate on the largest estates of 39 percent (55 percent less the top 16 percent state death tax credit) would represent an increase of only 4 percent that might not have been worth the trouble to others. (The largest revenue pick-up might have come from the smallest taxable estates.)

(2) The 45 percent rate and $3.5 million exemption of 2009 law supported by the Administration, which once might have looked like a compromise (for example, between 2001 law and 2012 law), was beginning to look like the high-tax position. The 35 percent rate and $5 million indexed and unified exemption looked like the new compromise (for example, between 2009 law and repeal).

(3) Ironically, the "Death Tax Elimination Act of 2000" (H.R. 8), passed in 2000 by large majorities in Congress but vetoed by President Clinton (see Part 1.e(2) above), would have reduced the top rate from 55 percent to *40.5 percent* in nine annual steps from 2001 through 2009. (It would also have repealed the estate, gift, and GST taxes in 2010.)

10. The American Taxpayer Relief Act of 2012

a. **Enactment**

(1) After weeks of public and private discussions, notably between the President and the Speaker of the House, then between the Majority and Minority Leaders of the Senate, and finally between the Vice President and the Senate Minority Leader, an amendment to H.R. 8 (which had been originally passed by the House on August 1, 2012 – see Part 8.c(3) above), formally titled the "American Taxpayer Relief Act of 2012," was introduced in the Senate by Senators Reid and McConnell. The Senate debated it on New Year's Eve and passed it in the wee hours of New Year's Day by a bipartisan vote of 89-8.

(2) After a New Year's Day of suspense, the House concurred in the Senate amendment late in the day. The vote was 257-167, with about twice as many Democrats as Republicans supporting it.

(3) President Obama signed the "American Taxpayer Relief Act of 2012," Public Law 112-240 ("ATRA" or just the "2012 Tax Act"), into law on January 2, 2013.

b. **"Fiscal Cliff" Issues in General**

(1) Compare to Part 9.b above.

(2) Under the 2012 Tax Act, the 10 percent income tax bracket was permanently retained.

(3) The top rate was permanently raised from 35 percent to 39.6 percent, but only for taxable incomes over $450,000 for joint filers and $400,000 for single individuals.

(a) With the 3.8 percent "Medicare tax" on net investment income under section 1411, applicable if adjusted gross income, without regard to the foreign earned income exclusion, exceeds $200,000 ($250,000 in the case of a joint return and $125,000 in the case of a married person filing separately), the top federal rate on investment income is essentially 43.4 percent.

(b) On earned income, the net investment income tax is 0.9 percent, making the top federal rate 40.5 percent.

(4) The top rate on long-term capital gains was permanently raised from 15 percent to 20 percent (23.8 percent with the 3.8 percent Medicare tax).

(5) The top rate on qualified dividends was also permanently raised from 15 percent to 20 percent (not 39.6 percent) (also 23.8 percent with the 3.8 percent Medicare tax).

(6) Itemized deductions and personal exemptions are again subject to phaseouts, but with the threshold reset to $300,000 for joint filers and $250,000 for single individuals. (Under normal indexing the 2013 thresholds would have been about $180,000 in the case of itemized deductions and about $270,000 for joint filers and $180,000 for single individuals in the case of the personal exemption.)

(7) The annual individual alternative minimum tax "patch" was made permanent, by indexing the AMT exemption, beginning in 2012.

(8) Most of the business and individual "extenders" were extended for two years, 2012 and 2013. The biggest business extenders involve the research credit under section 41, accelerated cost recovery (depreciation) under section 168, expensing under section 179, and the active financing income exception from the current taxation of income of a controlled foreign corporation under section 953(e).

(9) Some popular credits – the American Opportunity Tax Credit, the Child Tax Credit, and the Earned Income Tax Credit – were extended for five years.

(10) The 2 percent payroll tax reduction was allowed to expire.

(11) Unemployment benefits were extended another year.

(12) Modest spending cuts were agreed to, but the issue of "sequestration" in general was postponed for two months. (The IRS, for example, announced "furlough days," originally May 24, June 14, July 5 and 22, and August 30. IR-2013-51 (May 15, 2013).)

c. **Estate Tax Provisions**

(1) The compromise in the federal estate tax was to make 2011 and 2012 law generally permanent, but with a compromise rate of 40 percent (the midpoint between the 2012 rate of 35 percent and the 2009 rate of 45 percent).

(a) A 40 percent rate produces a "tax-exclusive" gift tax rate of about 28.57 percent, if the donor survives three years after the gift.

(b) State death taxes are still deductible. As a result, the top marginal combined federal and state estate tax rate is about 48.3 percent in a state with an estate tax that follows the federal deduction under section 2058 for the state tax itself, about 49.6 percent in a state with an estate tax that does not follow that federal deduction, and of course 40 percent in a state with no state estate tax. See the table in Part 2.c(3) above. (Some states have very different tax structures.)

(2) The 2012 Tax Act makes the technical correction to the portability provisions, proposed by the staff of the Joint Committee on Taxation (see Part 7.h(4)(f) above), changing "basic exclusion amount" to "applicable exclusion amount" in section 2010(c)(4)(B)(i).

(3) Everything else about 2012 law is made permanent. All "sunsets" are removed. There no longer are any "as if … had never been enacted" provisions.

(4) In particular, the "exemption" – technically the applicable exclusion amount for estate and gift tax purposes and the GST exemption for GST tax purposes – is $5 million, permanently indexed from 2011, permanently unified (the same for gift tax purposes), and permanently portable for gift and estate (not GST) tax purposes. That made the 2012 exemption $5.12 million, with similar indexing for future years.

(5) There is no "clawback." This is addressed for gift tax purposes in the flush language to section 2505(a)(2) and to some extent for estate tax purposes in section 2001(g) (both of which are no longer sunsetted). See Part 7.g(6) above. But the real answer to the feared estate tax clawback is that the applicable exclusion amount will not go down – at least not without further congressional action that presumably would include specific provisions to prevent clawback.

(6) Estimated revenue loss over 10 years: $369 billion.

11. Following Up Those 2012 Gifts

In 2012, the gift tax lifetime exemption was $5.12 million. Before 2011, it was $1 million (decoupled from the estate tax exemption). Thus, even donors who had historically "maxed out" their use of the gift tax exemption, or even paid some gift tax, still had $4 or $4.12 million of available gift tax exemption in 2012. But on January 1, 2013, that exemption was scheduled to return to $1 million, unless Congress acted. (Congress did act, but not until January 1, 2013.) This created a "use it or lose it" attitude toward the exemption in 2012 and a surge of gifts, often hasty, ranging from $4 or $4.12 million up to $5.12 million (or $10.24 million for a married couple).

a. **Renouncing, Refocusing, Reversing, Rescinding, Reforming, Refinancing**

(1) Disclaimers.

(a) Some gifts in 2012, especially at the end of the year, were structured with explicit provisions for a disclaimer, with a redirection in the instrument of the property in the event of a disclaimer. Such disclaimers could be used within nine months after the gift (thus, in some cases, as late as September 2013) to determine the effect of a gift otherwise completed for gift tax purposes in 2012.

(b) A disclaimer or renunciation of an outright gift might cause the property to revert to the would-be donor and be treated as if the gift had never been made. But the applicable state disclaimer law needed to be consulted to see

i. if it even applies to inter vivos gifts and

ii. if it is broad enough in that case to direct that the gift passes to the children or other "heirs" of the donee (as if the donee had died).

(c) A disclaimer by a trustee was more controversial and more doubtful, although broad authority (or even direction) in the instrument creating the trust (and, thus, the instrument creating the office of the trustee) might help.

(2) QTIP trusts.

(a) Some trusts created in 2012 were designed to qualify as inter vivos QTIP trusts, with the non-donor spouse entitled to all the trust income for life within the meaning of section 2523(f)(2)(B). In some cases, the expectation was that the donor could wait to see if the 2012 gift tax exemption really was reduced in 2013, by congressional action or inaction, and then, if the exemption was reduced, simply forgo the QTIP election and make use of the donor's now-lost 2012 exemption.

(b) If the donor chose to use gift tax exemption for the 2012 trust and forwent the QTIP election, the donor's spouse, and thereby the donor's household, could have retained the income for the spouse's life, which might have been one of the objectives of making the spouse a beneficiary. Alternatively, the spouse could have disclaimed all or part of the income interest and thereby permit the trust to accumulate income and continue more efficiently as a generation-skipping trust for descendants. If the spouse disclaimed a mandatory income interest and still retained a right to income or principal in the trustee's discretion, the disclaimer is still a qualified disclaimer under the explicit exception for spouses in section 2518(b)(4)(A). But under section 2518(b)(4) and Reg. §25.2518-2(e)(2) the disclaiming spouse was not permitted to retain a testamentary power of appointment (or any power of appointment not limited by an ascertainable standard).

(c) In any event, a QTIP election for a 2012 gift had to have been made by April 15, 2013, or, if the due date of the gift tax return was extended, by October 15, 2013.

(3) Rescission or judicial construction or reformation.

(a) Much discussion of rescission of gifts that are subsequently regretted revolves around the concepts of "mistakes" of fact or law and the recent, oft-cited case of *Breakiron v. Gudonis*, 106 A.F.T.R. 2d 2010-5999 (D. Mass. 2010). There the taxpayer and his sister were the two beneficiaries of qualified personal residence trusts (QPRTs) created by their parents, following the 10-year QPRT term. The taxpayer sought to disclaim his interest, so the remainder would pass solely to his sister, and was incorrectly advised by his attorney that he could do so within nine months of the expiration of the QPRT term. Once he had made the disclaimer, he learned that it was untimely and therefore was treated as his taxable gift, resulting in a gift tax of about $2.3 million. The court likened this case to those in which courts had held that "the original transfer was defective *ab initio* because the original instrument contained a mistake." It therefore allowed a rescission of the disclaimer *nunc pro tunc*, stating that "[t]he rescission binds all parties to this action and is conclusive for federal tax purposes." (The suit was originally brought in a Massachusetts state court, naming the United States as a party. The Justice Department appeared and removed the case to the federal court.)

(b) But it would be a stretch to compare Breakiron's attorney's erroneous advice about what the deadline for a qualified disclaimer *was* to the inability of advisors in 2012 to know for sure what the gift tax exemption after 2012 *would be*. And the actual appearance of the Government in the *Breakiron* litigation was perhaps a fluke and in any event could not be assured in any other rescission action.

(4) Exchange of assets.

(a) It may be possible to fine-tune a 2012 gift if the grantor can exchange assets into the trust, such as non-income-producing assets in exchange for assets that produce income the grantor now may wish to have to live on. Such an exchange can be pursuant to a reserved power to substitute assets of equivalent value under section 675(4)(C), or can be a simple exchange with the trustee even in the absence of such a reserved power. If the trust is not a grantor trust, however, the income tax on the capital gain needs to be taken into account.

(b) There is no deadline for such exchanges.

(c) In the most serious cases of the donor's insecurity following the gift, the exchange might even be for the grantor's promissory note. But see Part 11.d(2)(c)ii below.

b. **Perfection and Implementation**

(1) Recording, obtaining transfer agents' acknowledgments, making book entries, adjusting capital accounts, etc.

(2) Opening and maintaining accounts, obtaining taxpayer identification numbers (or using the grantor's Social Security number), etc.

(3) Establishing and maintaining a businesslike administration. (Many of those trusts may have been the first trusts those clients had created.)

(4) Communicating, as appropriate, with beneficiaries.

(5) Assembling and maintaining a professional team: investment advice, property management, accounting, etc.

c. **2012 Gift Tax Returns**

(1) In general.

(a) The surge of gifts made in 2012 resulted in a surge of gift tax returns filed in 2013, which might suggest that IRS audit resources will be spread thin.

(b) On the other hand, a Joint Committee on Taxation publication published November 9, 2012, reported that in 2008, there were 38,374 estate tax returns filed, of which 17,172 showed tax due (totaling about $25 billion). Staff of the Joint Committee on Taxation, Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation (JCX-76-12) at 15, Table 3 (Nov. 9, 2012). (Gift tax returns in 2008 numbered 257,485, with 9,553 taxable, and $2.843 billion total gift tax. *Id.* at 16, Table 4.) Projections of the results if 2012 law were made permanent estimated that in 2013, there would be 9,200 estate tax returns filed, of which 3,600 would show tax due (totaling about $11 or $12 billion, say $13 billion to reflect the higher 40 percent rate). *Id.* at 40, Table A3. This 79 percent drop-off in taxable estate tax returns may well free up resources to audit gift tax returns

(c) Besides, just as techniques for gift-giving in 2012 were interesting, 2012 gift tax returns are likely to be interesting and to attract attention.

(2) Special issues with defined value gifts.

(a) It is likely that many late-2012 gifts followed the template in *Wandry v. Commissioner*, T.C. Memo. 2012-88, *nonacq.*, 2012-46 I.R.B., of assigning "a sufficient number of my Units [in an LLC] so that the fair market value of such Units for federal gift tax purposes shall be [stated dollar amounts]."

(b) The Government appealed *Wandry*, but dropped the appeal. The IRS issued a nonacquiescence, possibly signaling that it is waiting for cases with "better" facts ("better" for the IRS, "bad" facts for taxpayers). But *Wandry* itself included some facts that could have been viewed that way, and which should normally be avoided if possible, including

i. a 19-month delay for obtaining the appraisal,

ii. a description of the gifts on the gift tax returns as straightforward percentage interests without reference to the defined value formulas, and

iii. adjustments to capital accounts rather than percentage interests as the prescribed response to changes in valuation.

(c) Defined value transfers are discussed in Part 13.e below.

d. **Uses of 2012 Grantor Trusts**

(1) The use of the assets in the grantor trust to further leverage additional installment sales and similar transactions.

(a) Such sales proceed under the rather tentative but unquestioned authority of Rev. Rul. 85-13, 1985-1 C.B. 184, and Letter Ruling 9535026, and use notes with section 7872 interest rates with the approval of *Frazee v. Commissioner*, 98 T.C. 554 (1992), and *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

(b) If an advisor follows the convention of providing at least 10 percent "equity" in the structure (see Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 Est. Plan. 3, 8 (Jan. 1996)), gifts by a married couple of $10.24 million in 2012, $260,000 in 2013, and $180,000 in 2014 and 2015, for example, would have provided a $10.86 million fund that could have supported a purchase of property with a value of $97.74 million, for a total transfer of $108.6 million.

(2) The grantor's exchange of assets with 2012 grantor trusts, whether before or after such an installment sale.

(a) Short-term benefits.

i. Complete the strategic funding of a grantor trust funded in haste with cash or marketable securities.

ii. Regain liquidity.

iii. Mitigate a reluctant 2012 transfer (discussed above).

(b) Long-term benefits.

i. React to changes in value, "harvest" appreciation.

ii. Include appreciated assets in the grantor's estate, where they will receive a stepped-up basis.

(c) Issues.

i. Documentation.

ii. Verifications by the trustee "that the properties acquired and substituted by the grantor are in fact of equivalent value, and … that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries." See Rev. Rul. 2008-22, 2008-16 I.R.B. 796. This standard might well require appraisals, even, for example, of promissory notes, for which face value is typically taken for granted if an interest rate prescribed by section 7872 is used. That conformity with section 7872 does not preclude a fair market value inquiry is highlighted by the last sentence of the *Frazee* opinion, in which Judge Hamblen stated that "[w]e find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept." *Frazee v. Commissioner*, 98 T.C. 554, 590 (1992).

(3) The grantor's termination of grantor trust status by relinquishing the feature that confers grantor trust status.

e. **Calibrating the Overall Estate Plan to the 2012 Gifts**

(1) Because the 2012 gift-giving was a significant opportunity to fine-tune the donor's estate planning objectives – identification of beneficiaries, selection and succession of trustees, standards for distributions, ages and events for mandatory distributions (if any), duration, powers of appointment, and so forth – the decisions made in designing trusts in 2012 might also have been appropriate for incorporation into the donor's will, revocable trust, and other estate planning vehicles. There is nothing like irrevocability to sharpen one's focus.

(2) In any event, long-term estate planning documents should regularly be reviewed to make sure that their formulas still produce a desirable result despite the hit the credit-shelter disposition may have taken from a 2012 gift or any other significant gift, and that those formulas will work properly in a world of significant annual inflation adjustments, not to mention legislative volatility.

f. **Other Special Follow-Up of Gifts**

(1) Qualified personal residence trusts (QPRTs): Calendar the time for working out the post-QPRT term lease; monitor the grantor's occupancy.

(2) Domestic asset protection trusts (DAPTs): Observe formalities.

(3) Spousal lifetime access trusts: If "mutual," administer differently.

(4) "Donative promise gifts": Doesn't matter?

12. Otherwise Adjusting to a Permanent High-Exemption World

a. **Considerations in Making Post-2012 Taxable Gifts**

(1) Basis.

(a) The basis of property for purposes of determining gain is the donor's basis if the property is acquired by gift, but the date-of-death (or alternate valuation date) value if the property passes at death. For low basis assets, it has always been necessary to compare the estate tax saved with the additional income tax on capital gain that may be incurred.

(b) The estate tax rate is still likely to be higher than the capital gain tax rate in the typical case, but lower estate tax rates and higher capital gains tax rates have made the spread smaller. In the 2012 Tax Act, for example, the top federal estate tax rate was increased by 14.3 percent (from 35 percent to 40 percent) while the top federal general income tax rate on capital gains was increased by 33.3 percent (from 15 percent to 20 percent). As a result, there may be less priority for making leveraged transfers of appreciated assets likely to be sold soon after death.

(c) For assets subject to depreciation, this observation may be even more true, because depreciation will typically reduce taxes at ordinary, not capital gains, rates.

(d) In addition, when gift tax is paid, the gift tax is removed from the gross estate if the donor survives for three years after the date of the gift, which saves the estate tax on that tax, effectively turning the 40 percent "tax-inclusive" rate into a 28.57 percent "tax-exclusive" rate.

i. But the payment of the gift tax might also reduce the opportunity for more post-gift growth in the assets sold to pay the gift tax or into which the cash used to pay the gift tax could have been invested.

ii. On the other hand, under section 1015(d)(6), the amount of the gift tax paid is itself added to the basis of the asset given, in proportion to the appreciation in that asset.

(e) In any event, the weight given to basis must be evaluated in light of the likelihood that the asset will be sold. If the trust or other recipients are unlikely to ever sell it (like a "legacy" asset), or if it is likely to be sold during the grantor's life (like a marketable security in a managed portfolio), the basis will generally not make any difference.

(f) If the gift is made in trust, the basis can be managed during the donor's life by swapping assets in and out of the trust, perhaps pursuant to a reserved substitution power. Another person can be authorized to exercise that substitution power under a durable power of attorney. But it must be remembered that there may not be an opportunity to exercise such a power.

(2) Making gifts within the gift tax exemption, now permanently unified and increasing every year by reason of inflation, is often both easier and more beneficial than paying gift tax. And some techniques, like GRATs, use little exemption.

(3) Some valuation discounts may be more appropriate in a gift tax setting. See, *e.g.*, Rev. Rul. 93-12, 1993-1 C.B. 202.

(4) Some gifting tools, such as GRATs, valuation discounts, and grantor trusts, might be lost or limited in the future.

(5) Some gifts can be sheltered by the annual exclusion – increased to $14,000 in 2013 – or, like direct payments of tuition and medical expenses, are exempt without regard to the annual exclusion.

(6) And it is important not to overlook the GST exemption. If a gift tax or a capital gain tax must be paid if a gift is made, that short-term downside might be offset by the permanent, or very long-term, benefit of an allocation of GST exemption. This is especially pertinent in cases where prior gifts to children have used gift tax exemption, leaving the available GST exemption greater than the gift tax exemption.

b. **Portability**

(1) The 2012 Tax Act made portability permanent.

(2) Temporary regulations (T.D. 9593, 77 Fed. Reg. 36150 (June 18, 2012)) and identical proposed regulations (REG-141832-11, *id.* at 36229) were released on Friday, June 15, 2012, just barely 18 months after the enactment of the 2010 Tax Act and therefore permitted by section 7805(b)(2) to be retroactive to January 1, 2011. Public comments on the proposed regulations were invited by September 17, 2012, and a public hearing, if requested, was scheduled for October 18, 2012, but no one asked for a hearing and the hearing was cancelled. Final regulations, very similar to the

temporary and proposed regulations, were released on June 12, 2015. T.D. 9725, 80 Fed. Reg. 34279 (June 16, 2015). (Under section 7805(e)(2), the temporary regulations would have expired after three years, on June 15, 2015.)

(a) Reg. §20.2010-2(a)(1) through (4) confirm that the portability election must be made on a timely filed estate tax return of the predeceased spouse, that timeliness is determined in the usual way whether or not a return is otherwise required for estate tax purposes, that the election is deemed made by the filing of a return unless it is affirmatively repudiated, and that the election is irrevocable.

  i. With regard to the due date even when a return is not required for estate tax purposes, the preamble to the temporary and proposed regulations explained simply that a return required in order to elect portability is a required return for purposes of the due date. The preamble went on to explain that "[t]his rule will benefit the IRS as well as taxpayers choosing the benefit of portability because the records required to compute and verify the DSUE amount [which is what the regulations call the deceased spousal unused exclusion amount] are more likely to be available at the time of the death of the first deceased spouse than at the time of a subsequent transfer by the surviving spouse by gift or at death, which could occur many years later." But the regulations do not indicate how, if at all, such a return might be "audited."

  ii. While additional relaxation of the due date might be appropriate, it is clear that such relief must come from Congress.

(b) Reg. §20.2010-2(a)(6) confirms that the election may be made by an appointed executor or administrator or, if there is none, "any person in actual or constructive possession of any property of the decedent." This reflects the notion of what is often called a "statutory executor," after the definition in section 2203. Such a "non-appointed executor" could (and often will) be the surviving spouse himself or herself. The regulation adds that a portability election made by a non-appointed executor "cannot be superseded by a contrary election made by another non-appointed executor."

(c) In what is perhaps the most significant and welcome provision of the regulations, Reg. §20.2010-2(a)(7)(ii) provides special rules for reporting the value of property on an estate tax return filed to elect portability but not otherwise required for estate tax purposes (most notably a return for an estate with a value less than the basic exclusion amount).

  i. Under Reg. §20.2010-2(a)(7)(ii)(B), the value of property qualifying for a marital or charitable deduction (which does not use any unified credit anyway) need not be stated, if the executor "exercises due diligence to estimate the fair market value of the gross estate." Pending the publication of instructions to the estate tax return, the temporary and proposed regulations provided that this due diligence could be shown by provision of "the executor's best estimate, rounded to the nearest $250,000," of that value. When the instructions were published in October 2012, they included a "Table of Estimated Values" modifying this "nearest $250,000" convention only by requiring that the rounding always be *up* to the *next higher* multiple of $250,000, except for a total value greater than $5 million and less than or equal to $5.12 million (the 2012 applicable exclusion amount), which was rounded to $5.12 million. The August 2014 instructions were similar, adjusted for the 2014 exclusion amount of $5.34 million. The final regulations affirmed the reliance on the instructions for Form 706.

  ii. More rigorous valuation of marital or charitable deduction property is still needed in the case of formula bequests, partial disclaimers, partial QTIP elections, split-interest transfers, and eligibility for tax treatment that is affected by such values. As examples of such tax treatment, Reg. §20.2010-2(a)(7)(ii)(A)(*2*) cites sections 2032 and 2032A, but explicitly excludes section 1014 (under which, the preamble acknowledges, the values of all assets have an impact).

iii. Reg. §20.2010-2(a)(7)(ii)(A) requires the reporting of "only the description, ownership, and/or beneficiary of such property, along with all other information necessary to establish the right of the estate" to the marital or charitable deduction. As examples of this last requirement, Reg. §20.2010-2(a)(7)(ii)(C), *Example 1*, cites "evidence to verify the title of each jointly held asset, to confirm that [the surviving spouse] is the sole beneficiary of [a] life insurance policy and [a] survivor annuity, and to verify that the annuity is exclusively for [the surviving spouse's] life." It is possible that such evidence will actually be more in some cases than the information normally provided with an estate tax return.

iv. But it is clear that in the paradigm case of a married couple with a home, modest tangible personal property, bank account, and perhaps an investment account – all possibly jointly owned – and life insurance and retirement benefits payable to the survivor, the requirements for completing an estate tax return to elect portability were made relatively manageable, especially considering that the surviving spouse is likely to be the "non-appointed executor" with respect to all the property.

(d) Reg. §§20.2010-2(d), 20.2010-3(d), and 25.2505-2(e) reiterate, without elaboration or example, the authority of the IRS to examine returns of a decedent, after the period of limitations on assessment has run, for the limited purpose of determining the decedent's DSUE amount, if the portability election has been made. For this purpose, Reg. §20.2010-3(d) confirms that "the surviving spouse is considered to have a material interest that is affected by the return information of the deceased spouse within the meaning of section 6103(e)(3)." That means the IRS is authorized to disclose the deceased spouse's estate tax return information to the surviving spouse.

(e) In response to several comments, Reg. §20.2010-2(c)(2) provides that the computation of a predeceased spouse's DSUE amount will disregard amounts on which gift taxes were paid by the decedent because taxable gifts in that year exceeded the applicable exclusion amount but the larger *estate* tax applicable exclusion amount on the date of death exceeded the total adjusted taxable gifts.

(f) Reg. §§20.2010-3(a) and 25.2505-2(a) confirm that the DSUE amount of the last deceased spouse dying after 2010 is available both to the surviving spouse for gift tax purposes and to the surviving spouse's estate for estate tax purposes. Neither remarriage nor divorce will affect that availability, but the death of a subsequent spouse will terminate the availability of the DSUE amount from the previous last deceased spouse. This is true no matter how much DSUE amount, if any, of the previous last deceased spouse is still unused, and whether or not the new last deceased spouse has any DSUE amount or whether or not the executor of the new last deceased spouse even made a portability election.

(g) Reg. §25.2505-2(b) creates an ordering rule providing that when the surviving spouse makes a taxable gift, the DSUE amount of the last deceased spouse (at that time) is applied to the surviving spouse's taxable gifts before the surviving spouse's own basic exclusion amount. Reg. §§25.2505-2(c) and 20.2010-3(b) provide rules that retain the DSUE amounts of a previous last deceased spouse that the surviving spouse has used for previous gifts in the future calculations of either gift tax or estate tax, in order to accommodate the cumulative nature of those tax calculations. The effect of these rules is to permit a surviving spouse, by making gifts, to benefit from the DSUE amounts of more than one predeceased spouse.

(h) Reg. §20.2010-3(c)(3) provides, in general, that when property of the last deceased spouse has passed to a qualified domestic trust (QDOT) for the surviving spouse, the surviving spouse will not be able to use any of the deceased spouse's DSUE amount until the final QDOT distribution or the termination of the QDOT, typically upon the surviving spouse's death. This rule will usually prevent the surviving spouse from using any of the DSUE amount by gift. But Reg. §20.2010-3(c)(2) clarifies that the DSUE amount becomes available if and when the surviving spouse becomes a U.S. citizen.

(i) Reg. §§20.2010-3(e) and 25.2505-2(f) clarify that the estate of a nonresident who is not a U.S. citizen may not use the DSUE amount of a predeceased spouse, except to the extent allowed under a treaty.

(j) Reg. §20.2010-2(c)(3), added in the final regulations after being "reserved" in the temporary and proposed regulations, provides that eligibility for other credits, such as the credit for gift tax (section 2012), the credit for tax on prior transfers (section 2013), the credit for foreign death taxes (section 2014), and the credit for death taxes on remainders (section 2015), does not affect the computation of the DSUE amount. In other words, those credits will not help to protect the DSUE amount from being used.

(3) The 2012 Form 706 was released on October 4, 2012, after a draft had been released in August 2012. The instructions were released as a draft in September 2012 and finalized on October 12, 2012. As finalized, that Form 706 included:

(a) Part 2, Line 9b, to add the DSUE amount to the basic exclusion amount.

(b) Part 4, line 3b, asking for the identification of all prior spouses and whether the marriage ended by annulment, divorce, or death.

(c) Part 5, lines 10 and 23, for reporting the "[e]stimated value of assets subject to the special rule of Reg. section 20.2010-2T(a)(7)(ii)." See paragraph (2)(c) above. Each schedule of the return used for reporting assets (A through I), as well as Schedules M and O used for reporting transfers that qualify for the marital or charitable deduction, includes a Note referring to this special rule. (As stated above, a "Table of Estimated Values" on page 16 of the instructions modifies the "nearest $250,000" convention of the regulations only by requiring that the rounding always be *up* to the *next higher* multiple of $250,000, except for a total value greater than $5 million and less than or equal to $5.12 million (the 2012 applicable exclusion amount), which is rounded to $5.12 million.)

(d) Part 6, Section A, providing that the portability election is made "by completing and timely-filing this return" and providing a box to check to opt out of electing portability. (The instructions, on page 17, state simply that "[i]f an estate files a Form 706 but does not wish to make the portability election, the executor can opt out of the portability election by checking the box indicated in Section A of [Part 6]. If no return is required under section 6018(a), not filing Form 706 will avoid making the election.")

(e) Part 6, Section B, asking if any assets are transferred to a QDOT and advising that, if so, any DSUE calculation is only preliminary. See Part 12.b(2)(h) above.

(f) Part 6, Section C, providing for the calculation of the amount portable to the surviving spouse.

(g) Part 6, Section D, titled "DSUE Amount Received from Predeceased Spouse(s)," in two parts:

i. Part 1, for DSUE received from the last deceased spouse.

ii. Part 2, for DSUE received from other predeceased spouse(s) and "used" by the decedent – *i.e.*, when the surviving spouse makes taxable gift(s) before the last deceased spouse has died. See paragraphs (2)(f) and (g) above.

(4) A new gift tax return, Form 709, was released on November 20, 2012, after a draft had been released in September 2012. It was also consistent with the regulations, as well as the estate tax return and instructions. It included a new Schedule C, with two parts, like Part 6, Section D, of the estate tax return, for DSUE received from the last deceased spouse and DSUE received from other predeceased spouse(s) and "Applied by Donor to Lifetime Gifts." Instructions for the gift tax return, dated November 19, 2012, were released November 29, 2012.

(5) On January 27, 2014, the Internal Revenue Service published Rev. Proc. 2014-18, 2014-7 I.R.B. 513, providing a simplified method to obtain an extension of time to make the "portability"

election with respect to the estate of a decedent who died in 2011, 2012, or 2013 survived by a spouse.

(a) Noting that the IRS had granted extensions of time to make the portability election under Reg. §301.9100-3 ("9100 relief") in several letter rulings, Rev. Proc. 2014-18 provided that an executor of such a decedent who was not required to file an estate tax return for estate tax purposes and who in fact did not file an estate tax return could simply file the otherwise late estate tax return, prepared in accordance with Reg. §20.2010-2T(a)(7), **on or before December 31, 2014**, and state at the top of the return "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)."

(b) Rev. Proc. 2014-18 noted that executors who could benefit from this relief include executors of decedents who were legally married to same-sex spouses. Those executors could not have known that portability would be available for same-sex married couples until the Supreme Court decided *United States v. Windsor*, 570 U.S. 744, 133 S. Ct. 2675 (2013), on June 26, 2013, and the Service issued Rev. Rul. 2013-17, 2013-38 I.R.B. 201, on August 29, 2013. The relief provided by Rev. Rul. 2014-18, however, applied to all married persons who died in 2011, 2012, and 2013 for whom an estate tax return was not required, not just to same-sex married couples.

(c) Revenue Procedure 2014-18 provided no relief with respect to decedents who died in 2014 or later. The executors of such decedents had until at least October 1, 2014, to file estate tax returns (or claim automatic extensions) and make the portability election. If they failed to do so, Rev. Proc. 2014-18 confirmed that they may continue to seek 9100 relief.

(6) A credit shelter trust will still offer advantages over portability, especially in the largest estates, including

(a) professional management and asset protection for the surviving spouse,

(b) protection of the expectancy of children from diversion by the surviving spouse, especially in cases of second marriages and blended families, as well as remarriage of the surviving spouse,

(c) sheltering intervening appreciation and accumulated income from estate tax,

(d) preservation of the predeceased spouse's exemption even if the surviving spouse remarries, the exemption is reduced, or portability sunsets,

(e) use of the predeceased spouse's GST exemption, because portability applies only to the gift and estate taxes (although portability will apparently also be available if the first estate is placed in a QTIP trust for which a reverse-QTIP election is made, if a QTIP election in that case is not disregarded under Rev. Proc. 2001-38, 2001-24 I.R.B. 1335, discussed below),

(f) avoiding the filing of an estate tax return for the predeceased spouse's estate, if the estate is not so large as to otherwise require a return, and

(g) prevention of disclosure of the predeceased spouse's estate tax return information to the surviving spouse and the surviving spouse's representatives (see paragraph (2)(d) above).

(7) On the other hand, for many couples, portability will offer advantages, including

(a) simplicity, including relief of any concern about the titling of assets,

(b) convenience, in the case of assets like retirement benefits that are awkward in a trust,

(c) greater perceived security for the surviving spouse by accommodating an outright bequest that confers complete control over the entire estate, without the intervention of a trust,

(d) avoidance of state estate tax on the first estate in states with an estate tax and no state-only QTIP election.

(e) a second step-up in basis for appreciated assets at the surviving spouse's death (which, if the protection of a trust is still desired, could be in a QTIP-style trust, again if a QTIP election in that case is not disregarded under Rev. Proc. 2001-38), and

(f) facilitating proactive planning by the surviving spouse.

(8) There might be other approaches to address at least the basis issue, including outright distributions to the surviving spouse and "springing" or discretionary general powers of appointment. All such approaches have their own strengths and weaknesses, including the possible loss of protection of the predeceased spouse's beneficiaries, especially in the case of a second marriage.

(9) About QTIP trusts and Rev. Proc. 2001-38.

(a) Rev. Proc. 2001-38, 2001-24 I.R.B. 1335, announced circumstances in which the IRS "will disregard [a QTIP] election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The procedure stated that it "does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero." The procedure stated that it "also does not apply to elections that are stated in terms of a formula designed to reduce the estate tax to zero."

i. Thus, the paradigm case to which the procedure applied was the case where the taxable estate would have been less than the applicable exclusion amount anyway, so the estate would not be subject to federal estate tax, but the executor listed some or all of the trust property on Schedule M to the estate tax return and thus made a redundant QTIP election.

ii. Rev. Proc. 2001-38 was a relief measure. The transitional sentence between the summary of the background law and the explanation of the problem was: "The Internal Revenue Service has received requests for relief in situations where an estate made an unnecessary QTIP election."

(b) With portability made permanent in the 2012 Tax Act, an estate tax return to elect portability might be filed that is not necessary for estate tax purposes because the value of the estate is below the filing requirement. For such a return, the question arises whether a QTIP election made only to support a reverse-QTIP election for GST tax purposes or to gain a second basis step-up at the death of the surviving spouse might be treated as an election that "was not necessary to reduce the estate tax liability to zero" and therefore as "null and void."

(c) Rev. Proc. 2001-38 went on to state that "[t]o establish that an election is within the scope of this revenue procedure, the taxpayer must produce sufficient evidence to that effect. For example, the taxpayer [the surviving spouse or the surviving spouse's executor] may produce a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero."

i. That statement, the "relief" origin of Rev. Proc. 2001-38, the likelihood that a revenue procedure announcing the Service's administrative forbearance cannot negate an election clearly authorized by statute, and the unseemliness of denying the benefits of a QTIP election to smaller estates while allowing it to larger estates all suggested that a QTIP election would be respected in such a case.

ii. This view was reinforced by the explicit reference in Temporary Reg. §20.2010-2(a)(7)(ii)(A)(*4*) to QTIP elections in returns filed to elect portability but not otherwise required for estate tax purposes.

(d) Not surprisingly, when this guidance project was completed with the publication of Rev. Proc. 2016-49, 2016-42 I.R.B. 462 (Sept. 27, 2016), it retained the basic approach of Rev. Proc. 2001-38, but made it inapplicable to QTIP elections on estate tax returns filed only to elect portability. In addition to the surviving spouse's estate tax return, the procedure identifies a supplemental estate tax return for the estate of the predeceased spouse and a gift tax return for the surviving spouse as two other ways to seek relief from an unnecessary QTIP election. And the procedure withdraws a letter ruling request as a way to seek that relief. The procedure states that in requesting this relief:

> Taxpayer must identify the QTIP election that should be treated as void under this revenue procedure and provide an explanation of why the QTIP election falls within the scope of section 3.01 of this revenue procedure. The explanation should include all the relevant facts, including the value of the predeceased spouse's taxable estate without regard to the allowance of the marital deduction for the QTIP at issue compared to the applicable exclusion amount in effect for the year of the predeceased spouse's death. The explanation should state that the portability election was not made in the predeceased spouse's estate and include the relevant facts to support this statement.

(10) Rev. Proc. 2017-34, 2017-26 I.R.B. 1282, provides a simplified method to obtain an extension of time under Reg. §301.9100-3 to elect portability when an estate tax return was not required for estate tax purposes and a timely estate tax return was not filed.

(a) The extension of time is obtained by filing an estate return prepared in accordance with Reg. §20.2010-2(a)(7) and stating at the top of the return "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)." No ruling request or user fee is required.

(b) This return must be filed by the later of

i. January 2, 2018 (thus, among other things, in effect renewing the relief granted by Rev. Proc. 2014-18 described in paragraph (5) above) or

ii. the second anniversary of the decedent's death.

(c) Executors who miss that deadline may still seek 9100 relief by a ruling request, accompanied by the required user fee.

c. **Important Areas of Practice Besides Transfer Tax Planning**

(The author acknowledges with appreciation his former partner Lou Mezzullo's contribution to this list.)

(1) Identifying guardians for minor children, if and when needed.

(2) Planning for the disposition of the client's assets upon death.

(3) Asset protection planning.

(4) Planning for marital and other dissolutions.

(5) Planning for physical disability.

(6) Planning for legal incapacity.

(7) Business succession planning (without the estate tax to blame for failure of a business).

(8) Using business entities to accomplish non-tax objectives.

(9) Income tax planning.

(10) Charitable giving (for its own sake, and also because income tax considerations are still relevant and techniques such as lifetime charitable remainder trusts to facilitate diversification are not affected at all).

(11) Retirement planning.

(12) Planning for life insurance protection.

(13) Trust administration.

(14) Fiduciary litigation (perhaps more so if there is more to fight over).

(15) Planning to pay state death taxes (in many states).

(16) Planning for clients with property in more than one state, including ownership, asset protection, state taxation, and probate issues (in addition to state estate tax).

(17) Planning for children with disabilities.

(18) Planning for spendthrift children.

(19) Planning for clients who are U.S. citizens or resident aliens who own property in other countries.

(20) Planning for nonresident aliens with assets in the United States or who plan to move to the United States.

(21) Planning for clients who intend to change their citizenship.

(22) Planning to live with non-tax regulatory regimes, including Sarbanes-Oxley, the Patriot Act, HIPAA, and charitable governance reform.

(23) Planning for possible increases in the estate, gift, and GST taxes.

13. What We Learned from Those 2012 Gifts

a. Forgiveness of Past Loans

(1) This is a very simple and surprisingly popular technique, despite its perceived lack of "leverage." Often it simply confers on a prior transfer the gift treatment that would have been chosen at that time if the gift tax exemption had not been smaller. It does not even require the commitment of any assets, although sometimes a gift of cash followed by repayment in cash, while circular, is more consistent with and supportive of the bona fides of the original characterization as a loan.

(2) Forgiveness of loans followed by new loans (at a lower interest rate) may be an option, if not over-done.

(3) The "loan" that is forgiven, in whole or in part, could be the "loan" imbedded in a previous installment sale to a grantor trust.

b. Life Insurance Transactions

(1) Life insurance is an asset that historically has most strained the limits of gift tax exclusions and exemptions, in order to provide post-death liquidity. A $5.12 gift tax exemption can enable the creation of life insurance trusts to procure new life insurance, or to acquire policies from the grantor or the grantor's spouse.

(2) But many life insurance policies are not kept in force until death, and the use of gift and GST exemptions with respect to a policy that is abandoned or cashed in can be a waste of those exemptions.

(3) If a life insurance policy happens to be in trust and subject to inclusion in the gross estate under section 2035(a)(2) if the insured dies within three years of the transfer and the insured becomes terminally ill,

(a) the policy-holder might be entitled to withdraw accelerated death benefits, reducing the value of the policy that is subject to section 2035(a)(2), while the withdrawn cash is not subject to section 2035(a)(2), or

(b) alternatively, the insured's spouse, if possible, can purchase that policy from the trust.

i. The fair market value price of a policy if the insured is close to death is likely to be close to the face amount of the policy. The spouse's estate is not increased by the receipt of the proceeds, because that simply restores the purchase price the spouse paid. Meanwhile, the price paid becomes the corpus of the long-term trust, but is no longer subject to section 2035(a)(2). Assuming the trust is a grantor trust as to the purchaser's spouse, there is no gain recognized (section 1041(a)(1)) and no change in basis (section

1041(b)(2)), and therefore the transfer for value rule of section 101(a)(2) does not apply (section 101(a)(2)(A)).

ii. If the spouse cannot afford to do this, using a promissory note can work if done carefully.

c. **Qualified Personal Residence Trusts (QPRTs)**

(1) It is well known that qualified personal residence trusts (QPRTs) are more effective when the section 7520 rate is high. In 2012 the rate was very low.

(2) But, unlike a GRAT, a QPRT cannot be "zeroed-out." The unavoidable remainder (gift) value in the case of very valuable houses can be transferred in a QPRT more easily when the gift tax exemption is high.

(3) Transferring undivided interests can have the double benefit of reducing the discounted value transferred and providing a type of hedge against the mortality risk by using QPRTs of different terms.

d. **Spousal Lifetime Access Trusts (SLATs)**

(1) A frequent secondary objective in making large gifts is retaining access to the transferred funds, either because the gift is a substantial part of the donor's estate or, even in the case of very wealthy donors, … "just in case."

(2) For married couples, giving access to a spouse is often tantamount to retaining access for oneself, although there are obvious risks implicit in that assumption.

(3) It is often said that the "reciprocal trust doctrine" can be avoided, even when each spouse creates a trust in which the other spouse has an interest, by making the trusts different. *See Estate of Levy v. Commissioner*, T.C. Memo. 1983-453 (reciprocal trust doctrine did not apply to trusts created by spouses that benefited each other because the wife had a broad lifetime limited power to appoint trust assets to anyone other than herself, her creditors, her estate, or the creditors of her estate, while the husband had no such power).

(4) But it is hard to deny that the safest way to avoid the reciprocal trust risk is for only one spouse to create such a trust. (This was especially true when there was not much time left in 2012 for the creation of two trusts to be separated by much time.)

(5) Gift-splitting, if the non-donor spouse has an interest in the trust, is complicated. A right to distributions subject to an ascertainable standard might be ignored if it is unlikely to be exercised, but that is factual and subjective. A 5 percent withdrawal right might be valued like a unitrust right, significantly reducing the amount of the trust that is eligible for gift-splitting. An independent trustee's unlimited discretion would be a problem without an easy solution or limitation. *See* Reg. §25.2513-1(b)(4); Rev. Rul. 56-439, 1956-2 C.B. 605; *Robertson v. Commissioner*, 26 T.C. 246 (1956), *acq.*, 1956-2 C.B. 8; *Falk v. Commissioner*, T.C. Memo. 1965-22; *Wang v. Commissioner*, T.C. Memo. 1972-143.

e. **Using Defined Value Transfers**

(1) The use of "defined value clauses" or "value definition formulas" received both attention and an arguable boost from the 2012 Tax Court decision in *Wandry v. Commissioner*, T.C. Memo. 2012-88, *nonacq.*, 2012-46 I.R.B.

(2) Background.

(a) Just as in the days when one could drive into a gas station and ask for "five dollars' worth of regular," without specifying the number of gallons, there is an intuitive notion that a donor ought to be able to make a gift of any stated amount expressed in the form of "such interest in X Partnership … as has a fair market value of $13,000," which the IRS approved in Technical Advice Memorandum 8611004 (Nov. 15, 1985).

(b) In *Knight v. Commissioner*, 115 T.C. 506 (2000), the Tax Court disregarded the use of such a technique to transfer "that number of limited partnership units in [a partnership] which is equal in value, on the effective date of this transfer, to $600,000." As a result, the court redetermined the value subject to gift tax. It was generally believed, however, that the result in *Knight* could have been avoided if the taxpayers had acted more consistently and carefully. Despite the apparent attempt to make a defined value gift, the gifts shown on the gift tax return were stated merely as percentage interests in the partnership (two 22.3 percent interests on each return). Moreover, the taxpayers contended in court that such interests were actually worth *less* than the "defined" value.

(c) Field Service Advice 200122011 (Feb. 20, 2001) addressed, negatively, the facts generally known to be those at issue in *McCord v. Commissioner*, 120 T.C. 358 (2003) (reviewed by the Court), in which the taxpayers had given limited partnership interests in amounts equal to the donors' remaining GST exemption to GST-exempt trusts for their sons, a fixed dollar amount in excess of those GST exemptions to their sons directly, and any remaining value to two charities. The IRS refused to respect the valuation clauses, citing *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), a case with unusual facts in which the court found a provision in a document of transfer that "the excess property hereby transferred which is deemed by [a] court to be subject to gift tax ... shall automatically be deemed not to be included in the conveyance" to be contrary to public policy because it would discourage the collection of tax, would require the courts to rule on a moot issue, and would seek to allow what in effect would be an impermissible declaratory judgment. The IRS acknowledged that the approach in question was not identical to the valuation clause in *Procter*, because it used a "formula" clause that defined how much was given to each donee, while *Procter* involved a so-called "savings" clause that required a gift to be "unwound" in the event it was found to be taxable. Nevertheless, the IRS believed the principles of *Procter* were applicable, because both types of clauses would recharacterize the transaction in a manner that would render any adjustment nontaxable.

(d) Technical Advice Memoranda 200245053 (July 31, 2002) and 200337012 (May 6, 2003) took the IRS discomfort with defined value clauses to the next level.

(e) When *McCord* itself was decided by the Tax Court, the court essentially avoided the formula issue by dwelling on the fact that the assignment document had used only the term "fair market value" not "fair market value as determined for federal gift tax purposes."

(f) In *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), the Court of Appeals for the Fifth Circuit reversed the Tax Court totally, scolded the Tax Court majority soundly, and remanded the case to the Tax Court to enter judgment for the taxpayers. The court said that "although the Commissioner relied on several theories before the Tax Court, including … violation-of-public policy [the *Procter* attack], … he has not advanced any of those theories on appeal. Accordingly, the Commissioner has waived them." But, in the view of many, the Fifth Circuit said other things that are hard to understand unless the court was comfortable with the use of defined value clauses in that case.

(g) *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), addressed the use of value formulas in the different context of a disclaimer of a testamentary transfer. The decedent's will left her entire estate to her daughter, with the proviso that anything her daughter disclaimed would pass to a charitable lead trust and a charitable foundation. The daughter disclaimed a fractional portion of the estate, with reference to values "finally determined for federal estate tax purposes." Noting that phrase, the Tax Court, without dissent, rejected the Service's *Procter* argument and upheld the disclaimer to the extent of the portion that passed to the foundation. (The court found an unrelated technical problem with the disclaimer to the extent of the portion that passed to the charitable lead trust.) In a pithy eight-page opinion, the Eighth Circuit affirmed. 586 F.3d 1061 (8th Cir. 2009).

(h) In *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, the Tax Court upheld gifts and sales to grantor trusts, both defined by dollar amounts "as finally determined for federal gift tax purposes," with the excess directed to two charitable community foundations.

Elaborating on its *Christiansen* decision, the court stated that "[t]he distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter*. … A shorthand for this distinction is that savings clauses are void, but formula clauses are fine." The court also noted that the Code and Regulations explicitly allow valuation formula clauses, for example to define the payout from a charitable remainder annuity trust or a grantor retained annuity trust, to define marital deduction or credit shelter bequests, and to allocate GST exemption. The court expressed disbelief that Congress and Treasury would allow such valuation formulas if there were a well-established public policy against them. On appeal, the Government did not press the "public policy" *Procter* argument, and the Ninth Circuit affirmed the taxpayer-friendly decision. 653 F.3d 1012 (9th Cir. 2011).

(i) *Hendrix v. Commissioner*, T.C. Memo. 2011-133, was the fourth case to approve the use of a defined value clause, with the excess going to charity. The court emphasized the size and sophistication of the charity, the early participation of the charity and its counsel in crafting the transaction, and the charity's engagement of its own independent appraiser. *Hendrix* was appealable to the Fifth Circuit, and the court also relied heavily on *McCord*.

(3) In *Wandry v. Commissioner*, T.C. Memo. 2012-88, the donors, husband and wife, each defined their gifts as follows:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows: [Here each donor listed children and grandchildren with corresponding dollar amounts.]
>
> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date.…

(4) The court stressed the now familiar "distinction between a 'savings clause', which a taxpayer may not use to avoid the tax imposed by section 2501, and a 'formula clause', which is valid. … A savings clause is void because it creates a donor that tries 'to take property back'. … On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value'."

(5) The Tax Court then compared the Wandrys' gifts with the facts in *Petter* and determined that the Wandrys' gifts complied. Most interesting, the court said (emphasis added):

> It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back". Rather, the gift documents correct the *allocation* of Norseman membership units among petitioners and the donees because the [appraisal] report understated Norseman's value. The clauses at issue are valid formula clauses.

(6) This is a fascinating comparison, because it equates the rights of the charitable foundations in *Petter* that were the "pourover" recipients of any value in excess of the stated values with the rights of the children and grandchildren in *Wandry* who were the primary recipients of the stated values themselves. In a way, the facts of *Wandry* were the reverse of the facts in *Petter*.

(a) The effect of the increased value in *Petter* was an **increase** in what the charitable foundations received, whereas the effect of the increased value in *Wandry* was a **decrease** in what the donees received. The real analogs in *Wandry* to the charitable foundations in *Petter* were **the donors themselves**, who experienced an **increase** in what they **retained** as a result of the increases in value on audit.

(b) It is also telling that in the court's words the effect of the language in the gift documents was to "correct the *allocation* of Norseman membership units among petitioners and the donees because the [appraisal] report understated Norseman's value." Until *Wandry*, many observers had believed that the courts had approved not "formula transfers" but "formula allocations" of a clearly fixed transfer. In fact, the *Wandry* court used a variation of the word "allocate" five times to describe the determination of what was transferred and what was retained. But the "allocation" was between the donees and the original donors. "Allocation" to the donors looks a lot like *retention* by the donors, if not a way to "take property back," and thus the court might be suggesting that the time-honored distinction between "formula transfers" and "formula allocations" might not be so crucial after all. But it is a cause for concern that the court did not acknowledge that tension, but continued to use "allocation" language to justify what in economic effect defined what was *transferred* by the donors, not merely how the transferred property was allocated among donees. Again, though, the overall context and thrust of the court's analysis was that the donors had not sought "to take property back," but had merely defined what was given on the date of the gift.

(7) Thus, there was now a taxpayer victory in a case that did not involve a "pourover" to charity of any excess value. The court concluded by again acknowledging the absence of a charity and saying that "[i]n *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative." Thus, *Wandry* appeared to bless a simpler fact pattern that more closely conforms to the common sense "five dollars' worth of regular" approach that many observers, apparently even the IRS in 1985, have thought should work.

(8) The IRS issued a nonacquiescence in *Wandry* on November 9, 2012. AOD 2012-004, 2012-46 I.R.B.

(a) The Action on Decision took the view that "on the date of the gift the taxpayers relinquished all dominion and control over the fixed percentage interests" because "[t]he final determination of value for federal gift tax purposes is an occurrence beyond the taxpayers' control." It went on to say that "[i]n Petter, there was no possibility that the transferred property would return to the donor, and thus, the court had no need to consider the extent to which the gift was complete."

(b) Although the nonacquiescence could signal that the IRS is waiting for cases with "better" facts ("better" for the IRS, "bad" facts for taxpayers), *Wandry* itself included some facts that could have been viewed that way, including a 19-month delay for obtaining the appraisal, a description of the gifts on the gift tax returns as straightforward percentage interests without reference to the defined value formulas, and adjustments to capital accounts rather than percentage interests as the prescribed response to changes in valuation.

(9) The fairest summary of *Wandry* is that it was undeniably significant for extending the scope of the decided cases beyond the context of a charitable pourover. But unlike the charitable cases, where the weight of case law had accumulated behind defined value clauses with a "pourover" to a charity that has actively monitored and participated in the transaction, *Wandry* did not represent a consistent body of Tax Court and appellate court jurisprudence, and, as even the charitable cases showed, the IRS did not approve of the defined value technique. Because it was also fair to speculate that many year-end 2012 gifts followed the pattern of a "*Wandry* formula," we should not have been surprised to see future cases involving *Wandry* types of defined value transfers, but the flood of cases has not materialized.

(10) In *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013) and *Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013), the Tax Court was asked to consider a sale by Donald Woelbing, who owned the majority of the voting and nonvoting stock of Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products.

(a) In 2006 Mr. Woelbing sold all his nonvoting stock for a promissory note with a principal amount of $59 million (the appraised value of the stock) and interest at the applicable federal rate (AFR). The purchaser was a trust that owned insurance policies under a split-dollar arrangement with the company. Two of Mr. Woelbing's sons, who were beneficiaries of the trust, gave their personal guarantees, apparently for 10 percent of the purchase price.

(b) The sale agreement provided for the number of shares sold to be adjusted if the IRS or a court revalued the stock.

(c) In its notice of deficiency, the IRS basically ignored the note, treating it as subject to section 2702, essentially treating it as equity rather than debt. The IRS also doubled the value of the stock to about $117 million. These changes produced substantial gift tax deficiencies.

(d) The IRS ignored the note for estate tax purposes too, but included the value of the stock, then asserted to be about $162 million, in Mr. Woelbing's gross estate under sections 2036 and 2038.

(e) The IRS also asserted gift and estate tax negligence and substantial underpayment penalties.

(f) The case was settled, and stipulated decisions were entered on March 25 and 28, 2016, finding no additional gift taxes due with respect to either Mr. or Mrs. Woelbing and no additional estate tax due with respect to Mr. Woelbing's estate. It was informally reported that an agreed upward valuation adjustment in the settlement was reflected in an agreed downward adjustment in the number of shares Mr. Woelbing transferred in the 2006 sale, much as the defined value clause contemplated. In that case, the value of those shares would have been included in his gross estate, would have qualified for a marital deduction, and thus presumably would increase the size of Mrs. Woelbing's gross estate and increase the amount of estate tax owed by her estate. The settlement with the IRS probably included her executors' agreement to make or accept those changes to her estate tax return.

(11) Tax Court petitions in another pair of "defined value" cases, *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16), were filed October 11, 2016. H.A. True III is the son of the late H.A. True Jr. and, as his father's executor, he had been the petitioner in *Estate of True v. Commissioner*, T.C. Memo. 2001-167, which involved buy-sell agreements, promissory notes, and interest rates.

(a) In the 2016 case, Mr. True made gifts of interests in a family business to one of his daughters and made sales of the business interests to all of his children and a trust. The transfers were valued on the basis of an appraisal from a recognized reputable national appraisal firm. The transfers to his children were subject to a "transfer agreement" with a defined value/price adjustment provision. He and his wife made the split-gift election, so any gift was treated as made one-half by each of them, which accounted for their separate Tax Court petitions.

(b) A gift of units in the family business was made to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests is determined for federal gift tax purposes to be worth more than the anticipated $34,044,838 amount of the gift, "(i) the ownership interest gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift."

(c) Sales of business interests were made to that daughter, the other two children, and a trust. According to the petition, the transfer agreement for the sales to his children "provided that if it is determined for federal gift tax purposes that the interests sold were undervalued …, the purchase price would be increased to reflect the finally-determined fair market values."

(d) The IRS asserted a gift tax deficiency of $16,591,418 for each of the taxpayers. The taxpayers argued that their valuations were correct, but if the transferred interests were determined to have a higher value, no gift should result because of the price adjustment provisions in the transfer agreement.

(e) The cases were settled in July 2018. According to the stipulated decisions, the agreed gift tax deficiency for each taxpayer was $2,004,321, less than one-eighth of the deficiencies the IRS had asserted. This probably means that either

i. the IRS on reflection found the appraisal to be much more persuasive after all,

ii. the IRS agreed to allow the taxpayers to increase the purchase prices as the transfer agreements provided and exacted corresponding side-agreements from the taxpayers as it probably did in *Woelbing*, which would ultimately increase the taxpayers' gross estates, or

iii. some combination of those two.

14. The 3.8 Percent Medicare Tax on Trusts and Estates

a. Section 1411(a)(2), enacted by the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152) in connection with the Patient Protection and Affordable Care Act (Public Law 111-148), imposes a 3.8 percent tax (sometimes called the "Medicare Tax" or "Medicare Surtax") on the *undistributed* net investment income of an estate or trust, or, if lesser, on the adjusted gross income of the estate or trust less the amount at which the highest income tax bracket begins – $11,950 for 2013, with indexing for future years. And all or virtually all income of many trusts *will* be investment income.

b. Because this new tax took effect for taxable years beginning after December 31, 2012, executors of the estates of decedents who died before the end of 2012 could have elected a fiscal year ending November 30, thereby exempting the income in the first 11 months of 2013 from the new tax. Those executors and the trustees of qualified revocable trusts could have also elected under section 645 to treat the trust as a part of the estate for federal income tax purposes.

c. Investment income does not include income derived from a trade or business that is not a "passive activity" under section 469 (and is not trading in financial instruments or in commodities within the meaning of section 475(e)(2)). Therefore, the new tax provides an additional reason to avoid the treatment of a business as a "passive activity."

(1) Section 469(c)(1) defines "passive activity" as "the conduct of any trade or business … in which the taxpayer does not materially participate." Section 469(h)(1) defines material participation as involvement in the operations of the activity on a "regular, continuous, and substantial" basis.

(2) There are no regulations specifically applying the "passive activity" rules to the unique circumstances of estates and trusts.

(a) Reg. §1.469-8 is titled "Application of section 469 to trust, estates, and their beneficiaries" but is "reserved." Similarly, Reg. §1.469-5T(g) is titled "Material participation of trusts and estates" and is also "reserved."

(b) Since section 469 was added by the Tax Reform Act of 1986, the details of application of that section to trusts and estates, as a practical matter and out of necessity, have been developed largely by the accountants who prepare returns and financial statements.

(c) Before 2012, this ad hoc approach generally mattered only for activities that produced losses that section 469 made nondeductible (along with other narrow rules that incorporate "passive activity" status as a test or trigger, such as the special amortization rules involved in Technical Advice Memorandum 201317010, discussed below).

(3) In *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003), a federal district judge held that "common sense" and the notion of the "trust" as the "taxpayer" dictate that "material participation" in the context of a trust be determined with reference to the individuals who conduct the business of the trust on behalf of the trust, not just the trustee as the IRS had argued, although, alternatively, the court also found that the activities of the trustee alone were sufficiently "regular, continuous, and substantial."

(4) In Technical Advice Memorandum 200733023 (date not given, released August 17, 2007), the IRS rejected the reasoning of the *Mattie K. Carter* court and, citing a 1986 committee report, reasoned that it was appropriate to look only to the activities of the trust's fiduciaries, not its employees. The IRS also concluded that "special trustees," who performed a number of tasks

related to the trust's business but were powerless to commit the trust to a course of action without the approval of the trustees, were not "fiduciaries" for this purpose.

(5) Chief Counsel Advice 201244017 (issued Aug. 3, 2012; released Nov. 2, 2012) took the position that

> a trust cannot meet the qualifying tests of 469(c)(7)(B) because those tests are intended to apply only to individuals. Only individuals are capable of performing "personal services" …, and the statute specifically states that the personal services must be performed by the taxpayer.

(6) The IRS took a similar view in Technical Advice Memorandum 201317010 (Jan. 18, 2013). The IRS agreed that a "special trustee" was a fiduciary of the trust, but only as to his insubstantial time spent in voting the stock of two S corporations or in considering sales of stock of those corporations (although one could question what else a trustee does with stock), not as to his presumably regular, continuous, and substantial time spent as president of one of the corporations. The technical advice memorandum referred to him as "an employee" of the company and did not identify circumstances in which his fiduciary duties to the other trust beneficiaries as special trustee (or even if he had been a regular trustee) would cause his services as president of the company to be performed in his role as trustee with serious regard to those fiduciary duties.

(7) Final regulations addressing many issues under section 1411 were issued on November 26, 2013, but did not address the issue of material participation in the context of trusts. The preamble (T.D. 9644) candidly acknowledged Treasury's sympathy with the problems of material participation and the difficulty of dealing with those problems, which it described as "very complex." The preamble to proposed regulations published on December 2, 2013, cited the preamble to the 2013 final regulations and deferred the issue of material participation by estates and trusts, including QSSTs, which it said "is more appropriately addressed under section 469."

(8) In *Frank Aragona Trust, Paul Aragona, Executive Trustee v. Commissioner*, 142 T.C. 165 (2014), the Tax Court (Judge Morrison) rejected an IRS argument that for purposes of the passive loss rules of section 469 itself a trust in effect could never materially participate in a trade or business.

    (a) The court held that a trust operating a real estate business could avoid the per se characterization of a real estate business as passive under section 469(c)(2), as could a natural person, if, as provided in section 469(c)(7)(B), "(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates." The court also held that the trust in this case materially participated in the business because some of its co-trustees materially participated to the extent required by section 469(c)(7)(B). Therefore, the trust could fully deduct its expenses, including trustee fees.

    (b) The IRS had argued that the activities of trustees who were also employees of the business could be treated only as the activities of employees and not the activities of trustees. The court rejected that notion in part because "[t]he trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary."

    (c) Because section 1411 refers to section 469, this decision shed encouraging light on the determination of "material participation" with respect to trusts for purposes of the 3.8 percent net investment income tax.

(9) "Guidance regarding material participation by trusts and estates for purposes of §469" was placed on the Treasury-IRS 2014-2015 Priority Guidance Plan, published August 26, 2014, under the heading of "General Tax Issues." It was dropped from the 2017-2018 Priority Guidance Plan.

d. The new 3.8 percent tax is imposed on trusts at the relatively low income level where the trust is taxed at the highest marginal rate, but it is imposed on individuals only at an income level over $200,000 ($250,000 for a joint return and $125,000 for a married person filing separately, all unindexed), and the top regular income tax rate, also applicable to trusts at a relatively low level of taxable income, is otherwise not reached for individuals until an income level much higher. As a result, the difference between the trust's marginal rate and the marginal rate of its beneficiaries can be very great, especially at the lowest income levels of the beneficiaries. (State income taxes might increase this effect.) Therefore, because the undistributed net income and adjusted gross income of a trust are both reduced by distributions under sections 651 and 661, it will sometimes be possible to reduce the overall income tax by making such distributions.

(1) Of course, a trustee will have to be satisfied that the applicable distribution standard (such as "support") justifies a distribution solely for the purpose of minimizing overall income tax liability.

(2) In addition, a trustee may have to balance that income tax benefit against purposes of the trust that dictate that income be accumulated for future needs or future generations.

(3) Drafting can determine the extent to which distributions for tax reasons are encouraged or even permitted.

15. Further 2013-2014 Developments

a. The Deal That Reopened the Federal Government October 16, 2013

(1) Funded the federal government by a continuing resolution through January 15, 2014.

(a) A "continuing resolution" meant that the "sequestration" cuts that took effect in January 2013 would continue.

(b) The January 15, 2014, deadline coincided with the next scheduled round of $21 billion of "sequestration" cuts, including Medicare cuts.

(2) Postponed enforcement of any debt limit until February 7, 2014.

(a) Until February 7, 2014, the debt limit could be raised by presidential action, unless Congress disapproved. Meanwhile, the Secretary of the Treasury was authorized to use "extraordinary measures" to meet obligations.

(b) A "clean" one-year extension was approved in February 2014.

(3) Required a House-Senate budget conference to report by December 13, 2013.

(4) Required verification that individuals receiving subsidies for health insurance purchased on exchanges under the Patient Protection and Affordable Care Act meet the prescribed income limits.

(a) The Secretary of Health and Human Services was required to report to Congress on verification measures by January 1, 2014. (She did so on December 31, 2013.)

(b) In addition, the Inspector General of the Department of Health and Human Services was required to report to Congress on the effectiveness of measures to prevent fraud under the Patient Protection and Affordable Care Act.

b. The December 2013 Budget Deal

(1) The "regular order" budget conference mandated by the October 2013 deal was chaired by Congressman Ryan and Senator Murray. The deal they achieved (H.J. Res. 59) was approved by the House on December 12 and by the Senate on December 18, and President Obama signed it on December 26.

(2) Spending was set at $1.012 trillion for fiscal year 2014 (splitting the difference between the Democratic goal of $1.058 trillion and the Republican goal of $967 billion) and $1.014 trillion for fiscal year 2015.

(3) To raise revenue, part of the sequester cuts were extended into 2022 and 2023, including cuts for Medicare providers, and various fees, including airline security fees, were increased over the next 10 years. Other savings come from reduced contributions to federal pensions, divided equally between military retirees and civilian workers hired after 2013.

(4) The deal did not include any significant tax provisions, but it created a relatively peaceful environment in which to possibly make some progress behind the scenes on tax reform or other initiatives in 2014 and 2015.

c. **Reintroduction of the McDermott Bill**

On February 14, 2014, Congressman Jim McDermott (D-Washington) introduced the "Sensible Estate Tax Act of 2014" (H.R. 4061), similar to H.R. 3467 that he had introduced in 2011. See Part 8.a above.

d. **Talk of "Tax Reform" in General**

(1) While talk of "tax reform" or sometimes "fundamental tax reform" never really ceases, the possibilities for 2014 originally seemed to be a bit more serious than usual.

(a) This optimism was encouraged by the well-known commitment and cooperation of Senate Finance Committee Chairman Max Baucus (D-Montana) and House Ways and Means Committee Chairman Dave Camp (R-Michigan). Senator Baucus released three working drafts during the week of November 18, 2013, addressing the subjects of international taxation, tax administration and enforcement, and accounting and cost recovery.

(b) But in December 2013 President Obama announced his intention to nominate Senator Baucus as the Ambassador to China; he was succeeded as Finance Committee Chairman (now Ranking Member) by Senator Ron Wyden of Oregon). Congressman Camp was in his third and, under House Republican rules, final term as Ways and Means Committee Chairman, and on March 31, 2014, he announced that he would retire from Congress at the end of that term. His successor as Chairman was Congressman Paul Ryan of Wisconsin, who, when he became Speaker of the House, was in turn succeeded by Congressman Kevin Brady of Texas.

(2) Meanwhile, on February 26, 2014, Chairman Camp released a 979-page "Discussion Draft" of the "Tax Reform Act of 2014" that would create just three individual income tax rates – 10, 25, and 35 percent – and would phase in a reduced top corporate income tax rate of 25 percent by 2019. The draft includes the elimination or reduction of many deductions and other tax breaks, including limitations on the charitable deduction and mortgage interest deduction and elimination of the deduction for personal state and local income, property, and sales taxes. Probably because of its treatment of many tax breaks, Camp's draft was not immediately embraced with great enthusiasm. Nevertheless, it remains a source from which reform measures may be drawn in the foreseeable future. Selected items from the draft include:

(a) Examples of changes affecting businesses:

i. Top income tax rate reduced from 35 percent to 25 percent in 2 percent annual increments from 2015 through 2019.

ii. Most special accelerated depreciation rules repealed in favor of straight-line depreciation over more realistic economic lives.

iii. Percentage depletion (which permits only extractive industries to recover more than their investments) repealed.

iv. Passive activity exception for working interests in oil and gas properties repealed.

v. Like-kind exchanges repealed.

vi. Research credit trimmed down and made permanent, and many other special credits repealed.

vii. Multiple rules for determining eligibility to use the cash method of accounting replaced (except for farming businesses and sole proprietorships) with a single test of no more than $10 million of average annual gross receipts.

viii. Last-in, first-out (LIFO) inventory method prohibited.

ix. Exceptions from the rule for transfers for value of life insurance policies repealed if the transferee has no "substantial family, business, or financial relationship" with the insured.

(b) Examples of changes affecting individuals:

i. Mortgage interest limit reduced from $1,000,000 to $500,000 in four annual increments.

ii. Charitable contributions made deductible if made by April 15 of the following year (the due date of the income tax return).

iii. Adjusted gross income (AGI) limitations "harmonized" at 40 percent for public charities (rather than 50 percent for cash and 30 percent for capital gain property) and 25 percent for most non-operating private foundations (rather than 30 percent for cash and 20 percent for capital gain property).

iv. Contributions deductible only to the extent they exceed a floor of 2 percent of AGI.

v. "Pease" overall limitation on itemized deductions (actually a rate increase on high incomes) repealed.

vi. Alternative minimum tax repealed.

vii. Special temporary rules for contributions of conservation easements, including special rules for farmers, made permanent.

viii. But no charitable deduction for land reasonably expected to be used as a golf course.

ix. 2 percent floor on "miscellaneous itemized deductions" repealed.

(c) Examples of changes affecting charitable organizations:

i. Unrelated Business Taxable Income computed separately for each unrelated business.

ii. Single 1 percent tax on investment income of private foundations (rather than 2 percent in general and 1 percent only when certain distribution standards are met). [This was also in H.R. 644, the "America Gives More Act of 2015," which the House of Representatives passed on February 12, 2015.]

iii. 2.5 percent self-dealing excise tax (10 percent in cases involving the payment of compensation) on private foundations themselves.

iv. Donor advised funds required to distribute contributions within five years of receipt.

v. Private operating foundations made subject to distribution requirements.

vi. Type II and Type III supporting organizations eliminated.

vii. Qualification simplified for social welfare (501(c)(4)) organizations – notice to IRS required, no Form 1024 needed, and information typically included on Form 1024 included on first Form 990 instead.

viii. Disclosure of donors of $5,000 or more limited to officers, directors, and highest compensated employees.

ix. One-year moratorium on changing 501(c)(4) standards.

(d) The estate, gift, and GST taxes were not addressed at all.

16. The 114th Congress (2015-2016)

a. **Another Death Tax Repeal Act**

(1) On April 16, 2015, by a largely party-line vote of 240-179 (with seven Democrats voting yes and three Republicans voting no), the House of Representatives passed the "Death Tax Repeal Act of 2015" (H.R. 1105), which had been introduced by Congressman Kevin Brady (-R-Texas).

(a) Like previous bills Congressman Brady had introduced (*e.g.*, H.R. 1259 in 2011, see Part 8.b above), H.R. 1105 would completely and permanently repeal the estate and GST taxes, would retain the gift tax at its 2011-2012 level, with a 35 percent rate (for cumulative gifts over $500,000) and an exemption of $5 million, and would retain a carryover basis for gifts and a date-of-death-value basis for transfers at death (despite the absence of an estate tax). Unlike the 2011 bill, however, H.R. 1105 would index the gift tax exemption for inflation, so that the 2015 exemption would have remained $5.43 million.

(b) H.R. 1105 would retain the estate tax under section 2056A(b)(1)(A) on distributions from qualified domestic trusts for spouses of decedents who died before the date of enactment, but only for 10 years after the date of enactment. It would immediately eliminate the estate tax under section 2056A(b)(1)(B) on the value of property remaining in QDOTs at the deaths of surviving spouses after the date of enactment.

(c) H.R. 1105 would also restore the 2001 Tax Act's enigmatic section 2511(c), providing that "[n]otwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1." (It ignores the 2002 amendment, which changed "taxable gift" to "transfer of property by gift.")

i. This provision appears to perpetuate the 2001 lore that the retention of the gift tax is needed to back-stop the income tax by subjecting to gift tax any transfer that would be "income-shifting," but, as in 2001, it is hard to be sure or to fully understand such a policy.

ii. In any event, such a provision would presumably shut down the advantages of so-called incomplete-gift non-grantor trusts (or "ING trusts").

iii. More perplexing, as in 2001, the use of the word "unless" in this provision could create the impression that a taxable gift is *avoided* by simply making the transfer to a trust that is a wholly-owned grantor trust as to the grantor or the grantor's spouse. That would certainly be different from the treatment of "intentionally defective" grantor trusts for which current funding is a completed gift but which normally include no features that would subject the trust to estate tax upon the grantor's death.

(2) The Ways and Means Committee Report (H.R. Rep. No. 114-52 of April 6, 2015) stated:

> While the Committee continues actively to pursue comprehensive tax reform as a critical means of promoting economic growth and job creation, the Committee also believes it is important to provide family businesses and farms with immediate tax relief to help encourage economic growth and job creation. By repealing the estate tax and the generation skipping transfer tax, families no longer will be threatened with the loss of a business due to the untimely death of a family member. Families also will be free to focus their attention on expanding their businesses and creating jobs rather than wasting critical resources on estate planning. A family business or farm facing an estate tax bill could be forced to sell critical assets such as land and inventory, and the business also could face years of lower capital investment, limiting growth opportunities. In addition, the Committee believes that the estate tax imposes a double or, in some cases, triple tax on assets. Repeal of the estate tax eliminates this unfair tax burden.
>
> …
>
> The Committee believes the Federal estate and generation-skipping transfer taxes harm taxpayers and the economy and therefore should be repealed. A tax on capital, such as the estate tax, motivates wealth holders to reduce savings and increase spending during life, rather than passing it to the next generation,

ultimately increasing the consumption gap between the wealthy and poor. A tax on capital also causes investors to provide less capital to workers, thereby reducing wages in the long run.

(3) The Committee Democrats replied:

> Committee Democrats oppose H.R. 1105. The estate tax has been an important component of our tax code that promotes fairness and reduces economic inequality. Repeal of the estate tax would increase the deficit by more than a quarter of a trillion dollars to provide tax cuts to the wealthiest estates in our country.
>
> Estate taxes promote fairness by providing an essential counterweight to the extraordinary benefits conferred on inherited wealth under our income tax system, and work to mitigate the impacts of wealth inequality. This legislation would further exacerbate the growing wealth and income inequality in the United States. The wealth gap is a problem for the economic health of the country as studies have consistently found that significant disparities in wealth correlate with poor economic performance. The share of total wealth owned by the top 0.1% in the U.S. grew from 7% in 1978 to 22% in 2012, according to the National Bureau of Economic Research. In 2013, the median wealth of upper income families ($639,400) was nearly seven times the median wealth of middle income families ($96,500), the widest wealth gap since the Federal Reserve began collecting data 30 years ago. The Congress must not accelerate our country's growing wealth inequality by conferring extraordinary tax benefits on the small number of ultra-wealthy taxpayers.
>
> Under present law, estates valued at less than $5.43 million ($10.86 million jointly) are exempt from the estate tax, with this exemption increasing annually for inflation. The reach of the estate tax has been significantly reduced over the past decade as the exemption amounts have increased so significantly over time such that 99.85 percent of estates are not subject to any estate tax. While the majority argues that the estate tax burdens all Americans, the fact is that only the estates of the wealthiest 0.15 percent pay any estate tax at all. Analysis from the Joint Committee on Taxation shows that H.R. 1105 would provide an average tax cut of over $22 million to each estate valued at over $50 million.
>
> These tax cuts for the wealthiest of estates would come at a cost of nearly $270 billion over the 10-year window. This is more than the budgets for the Centers for Disease Control and Prevention, the Food and Drug Administration, and the Environmental Protection Agency combined. In past years, the Republican Congress has battled over spending the dollars required to provide adequate funding for National Institutes for Health, which has an annual budget of $30.9 billion. Misguided Republican priorities have led to consistent underfunding of important research and public health institutions, while draining the fisc to deliver hundreds of billions of tax cuts for the nation's wealthiest. Furthermore, the Republican budget does not include repeal of the estate tax, which, if passed, would put their own budget out of balance. Indeed, the Republican Tax Reform plan that was released last year recognized the significant cost of repeal, both in terms of the revenue raised by the tax and by distribution, and retained the estate tax.
>
> The issue of the estate tax affecting small businesses and family farms has been used as a justification for outright repeal of the estate tax. In general, a small percentage of taxable estates contain farm or business assets. According to recent Internal Revenue Service and U.S. Department of Agriculture data, roughly 0.6 percent of all farm operator estates owed any estate tax, with 97.3 percent of all farm operator estates falling below the current exemption. Committee Democrats do not disagree with the importance of maintaining protections for small businesses and family farms. Congress has recognized their importance and has included exemptions and special provisions to address perceived burdens in existing law. If those protections are inadequate, the Congress can act to ensure that working family farms and active small businesses are not harmed without eviscerating the wealth transfer tax regime.

(4) The arguments in the committee report reflect inputs received from four witnesses (see **http://waysandmeans.house.gov/calendar/eventsingle.aspx?EventID=398177**) in a hearing of the Subcommittee on Select Revenue Measures on March 18, 2015. The following are excerpts:

> When my wife's grandmother passed in 1988, my father-in-law, who had farmed the land his entire life, was faced with a huge estate tax. The farm at the time was a little over 600 acres. Land values were booming and the value of the farm had doubled over the previous 10 years. John ended up having to sell 120 acres of land to pay estate taxes. This may not sound like much of a sacrifice since it left him with 483 acres to farm, but it completely changed the farm business. The land was lost to development and having houses so close to our fields made it impossible for us to continue raising cattle.

Brandon Whitt, a seventh-generation farmer from Murfreesboro, Tennessee

> Some in Washington may see the death tax as a minor inconvenience for the wealthy, something that does not deserve attention. The truth is, when the death tax lands on your doorstep, it is a very big deal. The death tax affects more than just the family, it affects the employees of the business and the other local businesses who are losing customers. The death tax has a ripple effect that impacts local economies for many years and

many times the damage cannot be undone. This is not a tax on the wealthy elite in America. It's a death warrant for far too many family businesses.

Bobby McKnight, a seventh-generation cattleman from Fort Davis, Texas

Over the last few years, my dad has spent countless hours and entirely too much money trying to figure out how his company can outlive him. Instead of focusing on growing his business so he can open more branches and employ more people, he has had to strategize about how to pass his company on to his kids without having to dismantle it. Most of our strategic management decisions, whether they are about day-to-day operations or opportunities to expand, involve consideration of the estate tax in one way or another. We have opted to maintain a large cash reserve as a precaution. Other companies choose to protect themselves by purchasing insurance. Either way, money that could be used to grow and create jobs is sitting on the sidelines.

Karen Madonia, next-generation CFO of a Chicago-area HVAC distributor

The estate tax promotes fairness by providing an essential counterweight to the extraordinary benefits conferred on inherited wealth under our income tax system. [Yes, the Minority report borrowed that sentence.] Our current income tax system favors inherited wealth in two significant ways:

First, inherited wealth is entirely excluded from income taxes. No matter how much wealth an individual inherits, whether it is $100, $100,000 or $100 million, she is treated the same for income tax purposes as a person who inherits nothing. [footnote omitted] The failure to tax inherited wealth is particularly glaring in comparison to the taxes imposed on wages of working Americans, who are subject to income taxes of up to 39.6% and payroll taxes of up to 15.3%.

…

Second, those with inherited wealth enjoy special benefits with respect to taxation from sales of property. Normally, when an individual sells property, she is subject to tax on the difference between the amount she receives from the sale and the purchase price (called "basis"). If the property is passed on by gift, the recipient has the same basis in the property that the donor had (thus passing on any built-in gains to the recipient.) However, there is a special basis rule that applies to property passed on at death: in that case, the heir receives the property with a basis equal to the fair market value of the property at the time of the decedent's death (called "stepped---up basis.") The effect of stepped-up basis is that an heir can sell inherited property and pay no capital gains taxes, even if the decedent had significant untaxed built-in gains at the time of death.

…

The strongest rhetorical argument in favor of repealing the estate tax is its potential impact on family farms and businesses. As a society, we value the idea of businesses staying within families. If the estate tax were to significantly limit that ability, then that could be a strong argument in favor of a legislative fix.

However, despite the rhetorical appeal of the family farm and business argument, it ultimately does not support estate tax repeal because (1) given the large exemption amount currently in effect (combined with the ability of spouses to combine their unified credit exemptions), the vast majority of family farms and businesses will fall within the exemption amount and therefore not be subject to the estate tax at all; (2) to the extent that a family farm or business is not covered by the $5/$10 million exemption there are statutory provisions designed to mitigate the impact of the estate tax; and (3) if Congress is still concerned about the potential impact of the estate tax on a family's ability to pass a family business on to the next generation, it need not repeal the estate tax, but rather could easily carve out a targeted exception that would exempt family farms and businesses from the estate tax.

…

Repealing the estate tax would impose considerable burdens on society that go well beyond the loss of revenue that the estate tax raises. In particular: (1) repeal of the estate tax would cause even greater concentration of wealth among the wealthiest Americans, resulting in an aristocracy of wealth that threatens our most cherished democratic ideals and harms our economy; and (2) repeal of the estate tax could result in a significant reduction in charitable giving which would in turn have a devastating effect on the charitable sector and the people it serves.

Prof. Ray Madoff, Boston College Law School (invited by the Minority)

(5) Along the lines of the suggestion that Congress could "carve out a targeted exception that would exempt family farms and businesses from the estate tax," on January 20, 2011, Rep. Mike Thompson (D-California), a Democrat on the Select Revenue Measures Subcommittee, had introduced the "Family Farm Preservation and Conservation Estate Tax Act" (H.R. 390, 112th

Congress), which would exclude from the gross estate the value of property used by a decedent and the decedent's family as a farm and impose a recapture tax if such farmland is sold outside the decedent's family or is no longer used for farming purposes. It attracted three Democratic cosponsors and one Republican cosponsor, but the Ways and Means Committee did not take it up.

(6) In a Statement of Administration Policy issued April 14, 2015, the White House added:

> The Administration strongly opposes H.R. 1105, which would add hundreds of billions of dollars to the deficit to provide large tax cuts exclusively to the very wealthiest Americans.
>
> Repealing the estate tax exclusively benefits just the wealthiest one or two estates out of every thousand—which would receive a tax cut averaging more than $3 million each—because current law already exempts more than $5 million of wealth for individuals and more than $10 million of wealth for couples from the tax. Given these large exemptions, well over 99 percent of Americans, including virtually all small businesses and family farms, do not pay any estate tax. H.R. 1105 would also shift a greater share of the tax burden onto working Americans at a time when the top one percent already holds more than 40 percent of the Nation's wealth and wealth disparities have risen to levels not seen since the 1930s.
>
> H.R. 1105 is fiscally irresponsible and, if enacted, would add $269 billion to the deficit over ten years, according to the Joint Committee on Taxation. The bill would worsen the Nation's long-term fiscal challenges, jeopardizing programs and investments important to the middle class and national security. In addition, H.R. 1105, which was reported by the House Ways and Means Committee on March 25, is inconsistent with the budget resolution passed by the House of Representatives that same day, which depends on current law estate tax revenues to meet its purported fiscal goals.
>
> H.R. 1105 is even more extreme than the temporary estate tax repeal enacted in 2001. That legislation provided for a "carryover basis" regime to prevent large amounts of accumulated wealth from escaping both income and estate tax. H.R. 1105 contains no such provision. Instead, it leaves in place the largest capital gains loophole in the tax code by retaining "stepped-up basis" rules that exempt capital gains on assets held until death from income taxes. The wealthiest Americans can often afford to hold onto assets until death, which lets them use the stepped-up basis loophole to avoid ever having to pay income tax on capital gains. By retaining stepped-up basis even after repealing the estate tax, enactment of H.R. 1105 would not only add hundreds of billions of dollars to the deficit to provide huge tax cuts to the most fortunate, it would endorse the principle that the wealthiest Americans should not have to pay tax on certain forms of income at all. By contrast, the President's Budget would repeal the stepped-up basis loophole.
>
> The Administration has consistently supported tax relief for middle-class and working families. The President's FY 2016 Budget proposes tax credits that allow paychecks to go further in covering the cost of child care, college, and a secure retirement, and would create and expand tax credits that support and reward work. In addition, it would invest in accelerating and sharing economic growth through education, research, infrastructure, and help for working families. The President's proposals are fully paid for, primarily by closing tax loopholes for the highest-income Americans. The Administration wants to work with the Congress on fiscally responsible tax relief for middle-class and working Americans. However, H.R. 1105 represents the wrong approach to the Nation's fiscal and economic challenges. If the President were presented with H.R. 1105, his senior advisors would recommend that he veto the bill.

b. **Other House-Passed Legislation**

(1) At the same time as it passed H.R. 1105, the House passed the "State and Local Sales Tax Deduction Fairness Act of 2015" (H.R. 622) to make permanent the section 164(b)(5) election for federal income tax purposes to deduct state and local sales taxes in lieu of state and local income taxes, which had been a temporary provision since 2004 and had expired again for 2015. The vote was somewhat less partisan (272-152, with 34 Democrats voting yes and one Republican voting no), but it was accompanied by similar partisan rhetoric and a veto threat. (Eventually this provision was made permanent in the PATH Act of December 18, 2015. See Part 16.d(1)(c) below.)

(2) On April 15, 2015, the House had passed seven stand-alone bills by voice vote under suspension of the rules.

(a) The "Prevent Targeting at the IRS Act" (H.R. 709), to permit the firing of any IRS employee for performing, delaying, or failing to perform (or threatening to perform, delay, or fail to perform) any official action (including any audit) with respect to a taxpayer for purpose of extracting personal gain or benefit or for a political purpose.

(b) Authority for the IRS to disclose to taxpayers who complain of alleged illegal conduct by IRS employees, including unauthorized disclosure or inspection of tax information, the existence, outcome, and consequences of any internal investigation based on such complaints (H.R. 1026).

(c) Another "Taxpayer Bill of Rights" (H.R. 1058), to ensure that IRS employees are familiar with and act in accordance with taxpayer rights, including the rights to be informed, to be assisted, to be heard, to pay no more than the correct amount of tax, to an appeal, to certainty, to privacy, to confidentiality, to representation, and to a fair and just tax system.

(d) Deduction for gift tax purposes of gifts to organizations described in sections 501(c)(4), (5), and (6) (H.R. 1104).

(e) Prohibition of use of personal email accounts for official business by IRS employees (H.R. 1152).

(f) Changes in determining exempt status under section 501(c)(4), requiring a social welfare organization that intends to operate as a tax-exempt entity to notify the IRS of its identity and purpose within 60 days after it is established, and allowing such an organization to seek a declaratory judgment concerning its initial or continuing classification as a tax-exempt organization. (H.R. 1295).

(g) Requiring regulations allowing a tax-exempt organization to request an administrative appeal to the IRS Office of Appeals of an adverse determination, made on or after May 19, 2014, with respect to the initial or continuing qualification of such organization as tax-exempt or the initial or continuing classification of such organization as a private foundation or a private operating foundation (H.R. 1314).

c. **The "Sensible Estate Tax Act of 2015"**

(1) On March 23, 2015, Congressman Jim McDermott (D-Washington) introduced H.R. 1544, the "Sensible Estate Tax Act of 2015," similar to H.R. 3467 he had introduced in 2011 (see Part 8.a above) and H.R. 4061 he had introduced in 2014 (see Part 15.c above). Effective January 1, 2016, it would reduce the estate and gift tax exemptions to $1 million, increase the rates to 41 percent over $1 million, 43 percent over $1.25 million, 45 percent over $1.5 million, 50 percent over $5 million, and a top rate of 55 percent over $10 million. Those numbers would be indexed for inflation *after 2016* (thus avoiding the quirky 2000 inflation base in previous bills).

(2) Section 2(c) of H.R. 1544 would provide wording to prevent the "clawback" effect if lifetime gifts exceed the estate tax exemption, and section 3 would restore the credit for state death taxes.

(3) H.R. 1544 also contained statutory language to reflect, at least roughly, revenue-raising measures that the Obama Administration has proposed in its annual budget proposals (discussed in the Part 17 below), including valuation rules for nonbusiness assets (section 4), consistency of basis reporting with estate tax values (section 5), a minimum 10-year term for GRATs (section 6), and a 90-year limit on the effectiveness of the allocation of GST exemption (section 7).

d. **Protecting Americans from Tax Hikes ("PATH") Act of 2015 (Dec. 18, 2015)**

(1) The "Tax Hikes" in view were for the most part the tax hikes Congress faces at the end of nearly every year as various "extender" provisions are about to expire or, most of the time, have already expired at the beginning of the year and need to be retroactively restored. Indeed, 56 (out of 127) sections of the PATH Act deal with such "extenders," and 22 of those sections make certain "extenders" permanent, including:

(a) *Middle-class* relief like the child tax credit (Act §101 and Code §24); American Opportunity Tax Credit (Act §102 and Code §25); and earned income credit (Act §103 and Code §32).

(b) *Business provisions* like the research and development tax credit (Act §121 and Code §41) and the reduction from ten to five years of the period in which a newly converted S corporation's built-in gains are subject to a corporate-level tax (Act §127 and Code §1374).

(c) *General provisions* like the option to claim an itemized deduction for state and local sales taxes rather than income taxes (Act §106 and Code §164(b)(5)).

(d) *Charitable provisions* like allowing distributions from IRAs of individuals over 70½, up to $100,000 per year, without including those amounts in gross income (Act §112 and Code §408(d)(8)); favorable rules for contributions of real property for conservation purposes, especially for farmers and ranchers and Alaska Native Corporations (Act §111 and Code §170(b)); favorable rules for certain contributions of food inventory (Act §113 and Code §170(e)(3)(C)); and not reducing the basis in an S corporation shareholder's stock by the unrealized appreciation in property contributed to charity by the S corporation (Act §115 and Code §1367(a)(2)).

(2) A subtitle labelled "Internal Revenue Service Reforms" reflects the wary view of the IRS held by congressional leadership, including:

(a) *Provisions related to tax-exempt organizations* like a streamlined recognition process for section 501(c)(4) social welfare organizations (Act §405 and Code §506); a requirement that the IRS allow administrative appeals of adverse exemption determinations to the Office of Appeals (Act §404 and Code §7123); extension of declaratory judgment relief under section 7428 to all organizations described in section 501(c) (not just section 501(c)(3) and explicitly including section 501(c)(4)) (Act §406 and Code §7428); and exemption from gift tax of gifts to section 501(c)(4), (5), and (6) (social welfare, labor, agricultural, horticultural, business league, etc.) organizations (Act §408 and Code §2501(a)).

(b) *Provisions of more general application* like the codification of a "taxpayer bill of rights" (Act §401 and Code §7803(a)(3)); the prohibition of IRS employees from using a personal email account to conduct government business (Act §402); a provision for taxpayers who have been victimized by the IRS, such as by unauthorized disclosure of private tax information, to learn the IRS's reaction, such as whether the case is being investigated or referred to the Justice Department for prosecution (Act §403 and Code §6103(e)(11)); and a requirement that an IRS employee who performs, delays, or fails to take any official action for personal gain or political purposes be terminated (Act §407).

17. The Obama Administration's Revenue Proposals

The "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (popularly called the "Greenbook") was released on May 11, 2009. See **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2010.pdf**. An Appendix, on page 125, confirmed that "[e]state and gift taxes are assumed to be extended at parameters in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of $3.5 million)." On pages 119-23, as revenue raisers dedicated to health care reform, three revenue-raising proposals were described under the heading "Modify Estate and Gift Tax Valuation Discounts and Make Other Reforms," requiring consistency in value for transfer and income tax purposes, modifying rules on valuation discounts, and requiring a minimum term for GRATs. On page 112, under the heading "Insurance Companies and Products," the Greenbook proposed to "modify the transfer-for-value rule [applicable to life insurance policies] to ensure that exceptions to that rule would not apply to buyers of polices" in life settlement transactions.

The "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals" was released on February 1, 2010. See **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2011.pdf**. Again, an Appendix, on page 147, stated that "[e]state and gift and GST taxes are assumed to be extended at parameters in effect for calendar year 2009 (a top rate of 45 percent and an exemption amount of $3.5 million)." (The words "and GST" are added in the 2010 Greenbook.) In footnotes on pages 124 and 126, the 2010 Greenbook stated:

> The Administration's baseline assumes that the laws governing the estate, gift and generation-skipping taxes as in effect during 2009 are extended permanently. Consequently, the discussion of Current Law set forth above reflects the applicable law as in effect during 2009.

The 2010 Greenbook included the same estate and gift tax proposals (pages 122-26), except that they were under the overall heading of "Reduce the Tax Gap and Make Reforms" and not tied to health care reform. The 2010 proposals were identical to the 2009 proposals, except in one detail related to GRATs described below, and on page 69 there was the same life insurance proposal as in the 2009 Greenbook.

The "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" was released on February 14, 2011. See **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf**. In a footnote to the table of contents, the 2011 Greenbook stated, among other things, that "[t]he Administration's policy proposals reflect changes from a tax baseline that modifies the Budget Enforcement Act baseline by … freezing the estate tax at 2009 levels." The 2011 Greenbook included the life insurance proposal (page 51) and the same three estate and gift tax proposals (pages 125-28). In addition, on pages 123-24, the 2011 Greenbook included a proposal to make permanent the portability of unused exemption between spouses and, on pages 129-30, a proposal to generally terminate an allocation of GST exemption to a trust after 90 years.

The "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals" was released on February 13, 2012 (see **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf**). The 2012 Greenbook repeated the proposals of the previous Greenbooks (pages 75-82) and added two, a surprisingly broad proposal to apparently subject all grantor trusts to gift or estate tax (page 83) and a noncontroversial proposal to extend the lien on estate tax deferrals under section 6166 (page 84).

The "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" was released on April 10, 2013 (see **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf**), about two months later than usual. Seven proposals under the heading "Modify Estate and Gift Tax Provisions" (pages 138-48) changed the grantor trust proposal, omitted the valuation discount proposal, and added one new proposal dealing with the GST tax treatment of "health and education exclusion trusts."

The "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals" was released on March 4, 2014 (see **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf**). Nine proposals under the heading "Modify Estate and Gift Tax Provisions" (pages 158-72) included without significant change the seven proposals from 2013, plus two new proposals dealing with the annual gift tax exclusion and the definition of "executor."

The "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals" was released on February 2, 2015 (see **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf**). The following eight proposals under the heading "Modify Estate and Gift Tax Provisions" (pages 193-206) were the same as the nine proposals from the 2014 Greenbook, with the proposal on GRATs combined with the proposal on grantor trusts and, in the process, ***substantially expanded***.

The "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals" was released on February 9, 2016 (see **https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf**). The following eight proposals under the heading "Modify Estate and Gift Tax Provisions" (pages 179-89) were the same as the proposals in the 2015 Greenbook, except that the proposal regarding consistent basis had become a reprise of certain features and applications that Congress eliminated from the 2015 legislation.

a. **Restore the Estate, Gift, and GST Tax Parameters in Effect in 2009**

(1) In spite of the "permanent" legislation enacted in the 2012 Tax Act (ATRA) but generally consistently with the Obama Administration's previous budget proposals, the 2013 Greenbook (pages 138-39) revived the proposal to return the estate, gift, and GST taxes to their 2009 levels, including a top 45 percent rate and non-indexed exemptions of $3.5 million for the estate and GST taxes and $1 million for the gift tax, which, as in past years, the Greenbook quixotically calls "parameters."

(a) The twist in the 2013 Greenbook was that it called for this return to 2009 levels to happen in 2018. No explanation was given for the four-year delay. The 2014 Greenbook (pages 158-59) was the same.

(b) The 2015 Greenbook (pages 193-94) returns to a more traditional effective date of January 1, 2016. The first higher tax payments would be due October 3, 2016, barely four weeks before the 2016 presidential election.

(2) Like the 2013, 2014, and 2015 Greenbooks, the 2016 Greenbook (page 178) stated that "ATRA retained a substantial portion of the tax cut provided to the most affluent taxpayers under [the 2010 Tax Act] that we cannot afford to continue. The United States needs an estate tax law that is fair and raises an appropriate amount of revenue."

(a) Even so, there was little indication that Congress was eager to revisit what it had just made permanent in January 2013.

(b) If anything, the larger number of Republicans in Congress made it more likely that Congress would want to permanently *repeal* the estate tax, although there was no indication that they would be willing to trade anything significant enough to overcome President Obama's disposition to veto it.

(3) The proposal was estimated to raise revenue by $201.754 billion over fiscal years 2017 through 2026.

(4) The 2013, 2014, 2015, and 2016 Greenbooks also called for permanent retention of portability and mitigation of the potential "clawback" that could occur when the unified credit for estate tax purposes is lower than the unified credit in effect when lifetime gifts were made. See Part 7.g above.

b. **Expand Requirement of Consistency in Value for Transfer and Income Tax Purposes**

(1) A version of the proposal in previous Greenbooks was enacted in the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, signed into law on July 31, 2015. See Part 29.b below.

(2) What Congress enacted in 2015 departed from the Obama Administration's proposals in a number of respects, including its effective date provisions, but also including the limitation of the rules to transfers at death (not by gift) and only to property transferred at death "whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate."

(3) In reaction to those changes, the 2016 Greenbook (page 179) renewed the proposal to apply the consistency rules to gifts reportable on a gift tax return and to property qualifying for an estate tax marital deduction (but not the charitable deduction). The Greenbook explained:

Reasons for Change

Because the consistency requirement enacted in 2015 applies only to the particular items of property that generate a federal estate tax, the requirement does not apply to property transferred by gift, or to property that qualifies for the estate tax marital or charitable deduction, or to any property of an estate with a total value that does not exceed the applicable exclusion amount ($5,450,000 for 2016). Although the exclusion of property given on death to charities (tax-exempt organizations) has only a minimal impact for income tax purposes, there is a possible effect on the annual excise tax imposed on certain such organizations. However, the exclusion from the application of the consistency requirement of property qualifying for the estate tax marital deduction is significant because an unlimited amount of property may qualify for the estate tax marital deduction in a decedent's estate tax proceeding. Although it is true that the value of such property passing to the decedent's surviving spouse may be increased without incurring any federal estate tax, and a high estate tax value provides a high cap on the recipient's permissible basis, current law contains provisions to prevent an inaccurately high estate tax valuation. Specifically, the executor certifies to the accuracy of the information on the estate tax return under penalties of perjury, and significant underpayment penalties are imposed on the understatement of capital gains and thus income tax that would result from an overstatement of basis.

Proposal

The proposal would expand the property subject to the consistency requirement imposed under section 1014(f) to also include (1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate's federal estate tax liability, and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return.

(4) Like the most recent Greenbook proposals (in 2014 and 2015), these Treasury proposals would be effective for transfers after the year of enactment.

(5) The 2015 Greenbook estimated the 10-year revenue gain from its original proposal as $3.237 billion, while the 2016 Greenbook estimates the 10-year revenue gain of its two changes as $1.693 billion. In other words, the Treasury revenue estimators think Congress got only about half of the job done.

c. **Modify Transfer Tax Rules for Grantor Retained Annuity Trusts and Other Grantor Trusts**

(1) The GRAT Proposal, 2009-2014

(a) After reciting the history of section 2702 and the use of GRATs, the Greenbooks, prior to 2015 (page 162 in the 2014 Greenbook) noted that "[t]axpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability."

(b) While rumors had occasionally been heard of congressional plans to limit the attractiveness of GRATs by imposing a minimum gift tax value for the remainder (such as 10 percent), the Greenbooks instead proposed to increase the mortality risk of GRATs by requiring a minimum 10-year term.

i. Both the Greenbooks and the September 8, 2009, Joint Committee staff's publication focused on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.

ii. The Joint Committee on Taxation (JCT) staff publication noted that even a 10-year GRAT could be used "as a gift tax avoidance tool" and that a 10-year minimum term might encourage the use of GRATs by younger taxpayers. As an alternative way of achieving more accurate valuation, the JCT staff publication suggested valuation of the remainder interest for gift tax purposes at the end of the GRAT term when the remainder is distributed – embracing the "hard to complete" approach floated by the Reagan Administration's "Tax Reform for Fairness, Simplicity, and Economic Growth" ("Treasury I") published by Treasury on November 27, 1984 (Part 1.d(1)(b) above).

(c) Before 2015, the Greenbook discussions actually ratified the use of "zeroed-out" GRATs, within the constraint of a minimum 10-year term.

i. In the only substantive changes from the 2009 Greenbook, the 2010 and 2011 Greenbooks added requirements that the remainder interest have a value greater than zero and that any decrease in the annuity during the GRAT term would be prohibited.

ii. Nevertheless, the 2010, 2011, 2012, 2013, and 2014 Greenbooks went on to say, like the 2009 Greenbook, that "a minimum term would not prevent 'zeroing-out' the gift tax value of the remainder interest." Obviously *near*-zeroing-out is what is meant.

(d) The 2012 Greenbook added an additional requirement of a *maximum* term equal to the life expectancy of the annuitant plus 10 years. That would limit the use of very long-term "*Walton*-style" GRATs with a low annual payout that would result in a reduced inclusion in the gross estate under Reg. §20.2036-1(c)(2)(i).

(e) The 2013 and 2014 Greenbooks made no change from the 2012 Greenbook.

(f) The proposal would apply to GRATs created after the date of enactment.

(g) The proposal was estimated to raise revenue over 10 years by $3¼ billion in the 2009 Greenbook, $2.959 billion in the 2010 and 2011 Greenbooks, $3⅓ billion in the 2012 Greenbook, $3.894 in the 2013 Greenbook, and $5.711 in the 2014 Greenbook. (The June 11, 2009, Joint Committee on Taxation estimates scored the 10-year revenue gain from the Obama Administration proposal at $2.28 billion.)

(h) These limitations on GRATs were included in section 307 of the "Small Business and Infrastructure Jobs Tax Act of 2010" (H.R. 4849), which the Democratically-controlled House of Representatives passed by a vote of 246-178 on March 25, 2010. The vote was partisan; only four Republicans voted for the bill and only seven Democrats voted against it. Reminiscent both of the Greenbooks' explanations and of the 1990 legislative history of section 2702 itself, the House Ways and Means Committee offered the following "Reasons for Change":

> The valuation rates and tables prescribed by section 7520 often produce relative values of the annuity and remainder interests in a GRAT that are not consistent with actual returns on trust assets. As a result, under present law, taxpayers can use GRATs to make gifts of property with little or no transfer tax consequences, so long as the investment return on assets in the trust is greater than the rate of return assumed under section 7520 for purposes of valuing the lead and remainder interests. The Committee believes that such uses of GRATs for gift tax avoidance are inappropriate.
>
> In some cases, for example, taxpayers "zero out" a GRAT by structuring the trust so that the assumed value of the annuity interest under the actuarial tables equals (or nearly equals) the entire value of the property transferred to the trust. Under this strategy, the value of the remainder interest is deemed to be equal to or near zero, and little or no gift tax is paid. In reality, however, a remainder interest in a GRAT often has real and substantial value, because taxpayers may achieve returns on trust assets substantially in excess of the returns assumed under section 7520. Any such excess appreciation passes to the remainder beneficiaries without further transfer tax consequences.
>
> In addition, grantors often structure GRATs with relatively short terms, such as two years, to minimize the risk that the grantor will die during the trust term, causing all or part of the trust assets to be included in the grantor's estate for estate tax purposes. Because GRATs carry little down-side risk, grantors frequently maintain multiple short-term, zeroed-out GRATs funded with different asset portfolios to improve the grantor's odds that at least one trust will outperform significantly the section 7520 rate assumptions and thereby allow the grantor to achieve a transfer to the remainder beneficiaries at little or no gift tax cost.
>
> The provision is designed to introduce additional downside risk to the use of GRATs by imposing a requirement that GRATs have a minimum term of 10 years. Relative to shorter-term (e.g., two-year) GRATs, a GRAT with a 10-year term carries greater risk that the grantor will die during the trust term and that the trust assets will be included in the grantor's estate for estate tax purposes. The provision limits opportunities to inappropriately achieve gift tax-free transfers to family members in situations where gifts of remainder interests in fact have substantial value.
>
> H.R. Rep. No. 111-447, 111th Cong., 2d Sess. 55-56 (2010) (footnote omitted).

(i) The GRAT limitations contained in H.R. 4849, like the Obama Administration's recommendations, were to apply to transfers made after the date of the enactment – that is, after the date the President signs it into law.

(j) The same provisions appeared in

   i. section 531 of the "Small Business Jobs Tax Relief Act of 2010" (H.R. 5486), which the House of Representatives passed by a vote of 247-170 (with five Republicans in favor and eight Democrats against) on June 15, 2010,

   ii. the supplemental appropriations bill (H.R. 4899) that the House approved on July 1, 2010,

   iii. section 8 of the "Responsible Estate Tax Act" (S. 3533 and H.R. 5764), introduced by Senator Sanders on June 24, 2010, and Rep. Linda Sanchez on July 15, 2010 (see Part 6.i(5) above), and

   iv. section 308 of the December 2010 "Baucus Bill" (see Part 6.j(5) above).

(k) These provisions appeared again in section 301 of the "Trade Adjustment Assistance Extension Act of 2011," (S. 1286), introduced on June 28, 2011, by Senators Casey (D-Pennsylvania) and Brown (D-Ohio), neither of whom was a member of the Finance Committee. Unlike the other bills, this provision, as introduced, would have applied to GRATs funded after December 31, 2010. There seems to be little or no chance that Congress would pass such retroactive legislation.

(l) If a minimum 10-year term for GRATs is required, it will be harder to realize one of the chief benefits of a GRAT, which is capturing upside volatility in the GRAT for the benefit of the next generation. (The Greenbooks and the JCT staff publication focused on the effect of the proposal in increasing the mortality risk of a GRAT, not necessarily its effect in diminishing the upside from volatility.)

i. With values that may be depressed, difficulty in predicting the timing of recovery or of a "liquidity event," and relatively low interest rates under section 7520, many clients have recently been opting for GRATs with terms longer than the typical two years anyway.

ii. But *requiring* a minimum 10-year term ***(at least before the 2015 proposal)*** would encourage more customizing of the terms of a GRAT, including greater use of level GRATs or GRATs in which the annuity increases in some years but not others or increases at different rates in different years. The typical 20 percent increase in the annuity payment each year would produce a payment in the tenth year equal to about 5.16 times the payment in the first year.

iii. A 10-year GRAT might also demand greater monitoring and active management. For example, if the asset originally contributed to the GRAT achieves its anticipated upside early in the 10-year term (maybe in the first year or two as is hoped for with a two-year GRAT), the grantor can withdraw that asset and substitute another asset of equivalent value with upside potential. If the grantor holds that withdrawn appreciated asset until death, this will also permit the asset to receive a stepped-up basis.

iv. A longer term for the GRAT will also permit a lower payout rate, which could make it easier to fund the annuity payments with cash (as with S corporation stock where the corporation distributes cash to equip its shareholders to pay income tax) and thereby avoid an annual appraisal.

v. A lower payout rate could result in a smaller amount includible in the grantor's gross estate under section 2036 if the grantor dies during the 10-year term. Under Reg. §20.2036-1(c)(2)(i) (promulgated in April 2008) that includible amount is the amount needed to sustain the retained annuity interest without invasion of principal – that is, in perpetuity. Thus, for example, a 10-year GRAT with a level payout created when the section 7520 rate is 2.0 percent (as it was in February 2015) will require a payout equal to about 11.1 percent of the initial value. If the section 7520 rate when the grantor dies is 5.0 percent (as it was as recently as December 2007), the amount included in the grantor's gross estate will be 222 percent of the initial value. That would represent a lot of appreciation, but often that is exactly what is hoped for when a GRAT is created. In that case, any appreciation in excess of 122 percent will pass tax-free to the next generation, even if the grantor dies during the 10-year term (*unless* the GRAT instrument provides for a reversion to the grantor, a general power of appointment, or a similar feature that would result in total inclusion of the date-of-death value in the gross estate).

(m) Planners who don't mind monitoring the requirements of two sets of tax rules in the same transaction will be intrigued by the possibility of placing a preferred (frozen) interest in a partnership (or LLC) that meets the requirements of section 2701 into a GRAT that meets the requirements of section 2702.

i. This technique is described in Angkatavanich & Yates, "The Preferred Partnership GRAT—A Way Around the ETIP Issue," 35 ACTEC Journal 289 (2009). In the paradigm addressed in this thoughtful article, the partnership (or LLC) is formed by the prospective grantor's capital contribution in exchange for the preferred interest and a capital contribution by a GST-tax-exempt generation-skipping trust in exchange for the growth interest in the partnership. The payouts on the preferred interest are structured to be "qualified payments" within the meaning of section 2701(c)(3).

ii. Even if the grantor dies during the GRAT term, the underlying appreciation in the partnership growth interest will still escape estate tax.

iii. Moreover, all the appreciation in the partnership growth interest will be captured in a generation-skipping trust, unlike the typical GRAT.

(2) The Grantor Trust Proposal, 2012-2014

(a) Most of the rules treating a grantor as the "owner" of a trust were crafted in the 1930s and 1940s to curb the shifting of taxable income to taxpayers in lower income tax brackets, even to the spouses of grantors in common law states before 1948 when joint income tax returns were introduced.

(b) At least since the promulgation of Rev. Rul. 85-13, 1985-1 C.B. 184, in which the Service held that an apparent sale between a grantor trust and its grantor would not be regarded as a sale for income tax purposes, the disconnect between the grantor trust rules and the gift and estate tax rules has inspired considerable **e**ffective planning with so-called "**de**fective" grantor trusts.

(c) It is hard to argue that the grantor's payment of income tax on someone else's income is not economically equivalent to a gift, but, because the tax is the grantor's own obligation under the grantor trust rules, it escapes gift tax. And sales to grantor trusts are often viewed as economically equivalent – or superior – to GRATs, but without the policing of sections 2702 and 2036 or the "ETIP" restrictions of section 2642(f) on allocating GST exemption.

(d) More recent developments seemed to actually ratify and validate the widespread use of grantor trusts in estate planning, including

i. Rev. Rul. 2004-64, 2004-2 C.B. 7, addressing the estate tax consequences of provisions regarding the reimbursement of the grantor for income tax on the grantor trust's income,

ii. Rev. Rul. 2007-13, 2007-11 I.R.B. 684, holding that the transfer of life insurance contracts between two grantor trusts treated as owned by the same grantor is not a transfer for valuable consideration for purposes of section 101,

iii. Rev. Rul. 2008-22, 2008-16 I.R.B. 796, providing reassurance regarding the estate tax consequences under sections 2036 and 2038 of the grantor's retention of a section 675(4)(C) power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value,

iv. Rev. Rul. 2011-28, 2011-49 I.R.B. 830, extending that reassurance to section 2042 and cases where the trust property includes policies of insurance on the grantor's life, and

v. Rev. Proc. 2008-45, 2008-30 I.R.B. 224, promulgating sample inter vivos charitable lead unitrust forms, including forms for both nongrantor and grantor CLUTs, where the feature used to confer grantor trust status is such a substitution power in a person other than the grantor.

(e) Nevertheless, there has long been interest in closing the gap between the two sets of tax rules. The Greenbook proposal, new in 2012, would simply include the date-of-death value of all grantor trusts in the grantor's gross estate and subject that value to estate tax. Specifically, the 2012 Greenbook (page 83) stated:

> To the extent that the income tax rules treat a grantor of a trust as an owner of the trust, the proposal would (1) include the assets of that trust in the gross estate of that grantor for estate tax purposes, (2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life, and (3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax purposes. In addition, the proposal would

> apply to any non-grantor who is deemed to be an owner of the trust and who engages in a sale, exchange, or comparable transaction with the trust that would have been subject to capital gains tax if the person had not been a deemed owner of the trust. In such a case, the proposal would subject to transfer tax the portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction. The proposal would reduce the amount subject to transfer tax by the value of any taxable gift made to the trust by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

(f) That proposal was very broad and vague, and many observers assumed that it would be revised. Sure enough, in the 2013 Greenbook (page 145) and the 2014 Greenbook (page 166), the proposal was reworded as follows:

> If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner. The proposal would reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

(g) In comparison to the 2012 Greenbook, the 2013 and 2014 Greenbooks referred more to "a deemed owner" and less to "the grantor."

   i. The classic paradigm trust deemed owned by a beneficiary for income tax purposes under section 678(a) would likely be included in the beneficiary's gross estate anyway, because the power described in section 678(a) would essentially be a general power of appointment. Therefore, the changes in this Greenbook from references to "the grantor" to "a deemed owner" may indicate that more sophisticated beneficiary-owned trusts are in view.

   ii. It is no secret that the Service is concerned about such trusts and is watching the developments that might affect such trusts. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01(48) included "[w]hether trust assets are includible in a trust beneficiary's gross estate under §§ 2035, 2036, 2037, 2038, or 2042 if the beneficiary sells property (including insurance policies) to the trust or dies within 3 years of selling such property to the trust, and (i) the beneficiary has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, (ii) the trust purchases the property with a note, and (iii) the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased" among what Rev. Proc. 2013-3 described as "areas in which rulings or determination letters will not ordinarily be issued." That fact pattern was also included as a no-rule area for purposes of deemed owner status (§4.01(43)), completed gift treatment (§4.01(55)), and the application of section 2702 (§4.01(63)). That IRS position is maintained in Rev. Proc. 2022-3, 2022-1 I.R.B. 144, §4.01(42) (deemed owner status), (49) (estate inclusion), (52) (completed gift treatment) and (60) (application of section 2702).

(h) Like the 2012 Greenbook, the 2013 Greenbook also stated:

> The proposal would not change the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, including without limitation the following: grantor retained income trusts; grantor retained annuity trusts; personal residence trusts; and qualified personal residence trusts.

i. That is an odd concession, implying that the treatment of GRATs, for example, does not have to be changed because GRATs already are treated consistently with the Greenbook proposal. In fact, while all or most GRATs are grantor trusts (which can facilitate payment of the annuity in kind without capital gain), the value of the assets in a long-term GRAT might not be fully included in the grantor's gross estate, and the termination of a GRAT's grantor trust status, which may or may not occur at the end of the GRAT term, is not treated as a taxable gift.

ii. In any event, the trusts cited in the Greenbook – GRITs, GRATs, PRTs, and QPRTs – ordinarily do not acquire assets from the grantor by purchase, so there is no reason to think that they would be affected by this proposal anyway.

(i) The Greenbooks say nothing about adjustments to basis, under either section 1015(d)6) with respect to gift tax or section 1014(b)(9) with respect to estate tax.

(j) The reference to GRITs, GRATs, PRTs, and QPRTs was followed in the 2012 Greenbook by a description of the proposed effective date, accompanied by a reference to "[r]egulatory authority …, including the ability to create transition relief for certain types of automatic, periodic contributions to existing grantor trusts," fueling the speculation that the proposal was aimed at life insurance trusts, where the periodic payment of premiums, while not exactly "automatic," is typically done under the terms of a preexisting insurance contract.

(k) In contrast, the reference to GRITs, GRATs, PRTs, and QPRTs in the 2013 Greenbook was followed by disclaimers that the proposal "would not apply to any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor" (possibly a reference to a "rabbi trust") or "to any trust that is a grantor trust solely by reason of section 677(a)(3)" (evidently a reference to life insurance trusts).

i. The passes given to these trusts were no doubt meant to be helpful, and they were helpful, but they only highlighted the tension that remains inherent in the proposal.

ii. For example, life insurance trusts sometimes can and do acquire assets from the grantor by purchase, including life insurance policies, and those policies are certainly expected to increase in value. The fact that they nevertheless are not covered by the clarified proposal still leaves us wondering what policy lies behind the proposal or what characteristics of estate planning techniques actually offend that policy.

iii. And the implication that a life insurance trust that purchases a policy from the grantor is covered by the proposal if it has some other grantor trust feature, like a substitution power under section 675(4)(C), even though the economics might be identical, was just as baffling. Probably in response to that, the 2014 Greenbook revised this reference to state: "The proposal … would not apply to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor's spouse."

iv. The staff of the Joint Committee on Taxation has expressed some of the same concerns. *See* Staff of the Joint Comm. on Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal 104-05 (Dec. 2013).

(l) Moreover, while the last sentence of the 2013 and 2014 Greenbook descriptions, like the 2012 Greenbook, proposed regulatory authority, the stated example was "the ability to create exceptions to this provision."

i. This may be the most important feature of the proposal, because, without it, while narrower than last year's proposal, the proposal is still very broad.

ii. In particular, the proposal appears to apply to all sales, no matter how leveraged, no matter what the interest rate is on any promissory note, no matter what the other terms of the note are, and no matter whether the note is still outstanding at the seller's death. A

GRAT, for example, has clear regulatory safe harbors for all those features and "works" for estate tax purposes if it falls within those safe harbors. It would be odd if a simple installment sale to a grantor trust, which is a sale and not a gift, is subjected to harsher gift (and estate) tax treatment than the funding of a GRAT, which actually is a gift.

iii. But these are complex issues. And for that reason, it may be best, or even crucial, that they be addressed in regulations. So viewed, the changes to this proposal reflected in the 2013 Greenbook, and particularly the implicit promise of workable regulations, should be welcomed.

iv. Nevertheless, except in the extraordinary event that Treasury and the IRS release an indication of what will be in such regulations before the legislation is enacted, there might still be a gap between enactment and such a release in which a popular and effective estate planning technique will have been chilled.

(m) The proposal would apply with respect to transactions (possibly including even the substitution of assets by the grantor, whether under a section 675(4)(C) reserved power or otherwise) engaged in on or after the date of enactment.

(n) In the 2012 Greenbook, the almost unlimited proposal was estimated to raise revenues by $910 million over 10 years. In the 2013 Greenbook, the ostensibly narrower proposal was estimated by Treasury to raise revenues by $1.087 billion over 10 years. In 2014, an essentially unchanged proposal is estimated by Treasury to raise revenues by $1.644 billion over 10 years. The staff of the Joint Committee on Taxation estimated that the 2013 proposal would raise revenues by $3.227 billion over 10 years. Staff of the Joint Comm. On Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal 206 (Dec. 2013).

(3) The 2015 and 2016 Combined GRAT and Grantor Trust Proposal

(a) The 2015 Greenbook combined the GRAT and grantor trust proposals into one proposal.

(b) The GRAT proposal added "a requirement that the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed)."

i. While a minimum gift tax value as such is not a surprise, the 25 percent level is surprisingly high. For example, 10 percent is the minimum remainder value required for the IRS to consider ruling that an interest in a GRAT is a qualified annuity interest under section 2702. Rev. Proc. 2022-3, 2022-1 I.R.B. 144, §4.01(58). In the context of an installment sale to a grantor trust, it is well known that the IRS required the applicants for Letter Ruling 9535026 (May 31, 1995) to commit to "equity" of at least 10 percent of the purchase price. And 10 percent is the equity floor, the minimum value of the common stock of a corporation or "junior equity interest" in a partnership, under section 2701(a)(4), which was enacted at the same time as section 2702.

ii. The alternative minimum remainder value of $500,000 means that 25 percent is not enough for GRATs funded with less than $2 million. It is possible that one of the targets of that provision is a $100,000 GRAT that appreciates miraculously before the first annuity payment is due. In any event, this rule would require a substantial invasion of the grantor's lifetime gift tax exemption, or even the payment of gift tax, to create a qualified GRAT.

(c) The 2015 Greenbook also added that "the proposal … would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust." That would diminish the availability of some of the proactive techniques described in Part 17.c(1)(l) above.

(d) The 2015 grantor trust proposal was substantively the same as in 2013 and 2014.

(e) The combined and revised proposal in the 2015 Greenbook was estimated to raise revenue by $18.354 billion over 10 years, compared to a total of $7.355 billion for both proposals in the 2014 Greenbook.

(f) The 2016 Greenbook proposal (pages 180-82) is the same as the 2015 proposal, with a 10-year revenue estimate of $19.149 billion.

(4) Descriptions of statutory language to implement these proposals are in Part 25.b(7) and (8) below.

d. **Limit Duration of GST Exemption**

(1) This proposal, which first appeared in the 2011 Greenbook, was essentially unchanged in the 2016 Greenbook (pages 183-84). It was reminiscent of an option presented by the staff of the Joint Committee on Taxation in January 2005. See Part 4.a above.

(a) Unlike the 2005 option, which would have in effect limited an allocation of GST exemption to one generation, the Greenbook proposal would limit the duration of GST exemption to 90 years, requiring the inclusion ratio of a trust to reset to one on the ninetieth anniversary of the creation of the trust.

(b) Like the 2005 option, the Greenbooks cited the repeal or limitation of the Rule Against Perpetuities in many states as the occasion for this proposal. The 2005 option would have been harsher than present law under a classical rule against perpetuities, which easily allows transfers to great-great-grandchildren. This proposal could also be harsher than present law under a classical rule against perpetuities, which would permit some trusts to last longer than 90 years, but it would not be nearly as uneven or arbitrary in that respect.

(c) The Greenbook proposal arguably was more tailored to the structure of chapter 13.

(2) If enacted, the proposal would presumably have prompted a lot of distributions to young beneficiaries in 90 years. It is hard to know how to plan for that now (other than to provide trustees with discretion); the entire estate tax is barely 90 years old.

(3) The proposal would apply to trusts created after the date of enactment and to additions to trusts made after the date of enactment.

(4) Understandably, the proposal to subject all trusts to tax after 90 years was estimated to have only a negligible effect on revenues over the next 10 fiscal years.

e. **Extend the Lien on Estate Tax Deferrals Provided Under Section 6166**

(1) Although it would make no change to substantive tax rules, this proposal (page 185 in the 2016 Greenbook), new in 2012, to extend the 10-year estate tax lien under section 6324(a)(1) to cover the last four years and nine months of the potential deferral period under section 6166 would be very important as a practical matter to some successors to family businesses.

(2) The 2015 Greenbook made no substantive change, but it corrected the calculation of the due date of the last installment payment under section 6166 to 14 years and nine months. It had been 15 years and three months, which inappropriately took into account a possible six-month extension of time to file the estate tax return (but not to pay the tax).

(3) As proposed, this change would apply both to the estates of decedents dying on or after the date of enactment and the estates of decedents who died before the date of enactment if the 10-year lien under section 6324(a)(1) had not expired before the date of enactment. Probably for that reason, this proposal was estimated in the 2016 Greenbook to increase revenue over 10 years by $260 million (up from $213 million in 2014 and $248 million in 2015).

f. **Modify GST Tax Treatment of Health and Education Exclusion Trusts (HEETs)**

(1) A "health and education exclusion trust" ("HEET") builds on the rule of section 2611(b)(1) that distributions from a trust directly for a beneficiary's school tuition or medical care or insurance are not generation-skipping transfers, no matter what generation the beneficiary is in. Sometimes, by

including charities, *or section 501(c)(4) social welfare organizations*, as permissible beneficiaries with interests that are vague enough to avoid being treated as separate shares, the designers of such trusts hope that a non-skip person (the charity) will always have an interest in the trust within the meaning of section 2612(a)(1)(A), and thereby the trust will avoid a GST tax on the taxable termination that would otherwise occur as interests in trusts pass from one generation to another.

(2) The Greenbook proposal, new in 2013 (page 148), would limit the exemption of direct payments of tuition and medical expenses from GST tax to payments made by individuals, not distributions from trusts.

(a) The Greenbook justifies this proposal by stating that "[t]he intent of section 2611(b)(1) is to exempt from GST tax only those payments that are not subject to gift tax, that is, payments made by a living donor directly to the provider of medical care for another person or directly to a school for another person's tuition." But section 2611(b)(1) exempts from the definition of a "generation-skipping transfer" "any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(e)…." Certainly that wording was an odd way for Congress to express an intent to limit the exception only to transfers actually made by living individuals (which already are exempt under section 2642(c)(3)(B) anyway).

(b) Moreover, in contrast with other proposals, the Greenbook proposes that this change would be effective when the bill proposing it is introduced and would apply both to trusts created after that date and to transfers after that date to pre-existing trusts. Such an effective date, used more often in the past, is today rather unusual.

(c) The extraordinary interpretation of congressional intent and the urgent effective date reveal a really intense reaction to HEETs.

(d) But, curiously, the proposal would not address the use *in any trust* of charitable interests to avoid taxable terminations, which arguably could be viewed as abusive and could explain such an intense reaction. Under section 2652(c)(2), however, the IRS already has the authority to disregard any interest used primarily to postpone or avoid GST tax. Without offering any specifics, Reg. §26.2612-1(e)(2)(ii) states that "[a]n interest is considered as used primarily to postpone or avoid the GST tax if a significant purpose for the creation of the interest is to postpone or avoid the tax." *See* Staff of the Joint Comm. On Taxation, Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal 109-10 (Dec. 2013) (pointing out some of the same anomalies in this Greenbook proposal).

(e) Meanwhile, a trustee of a trust with broad discretion over distributions could get around this limitation by making a distribution to a non-skip person (and generally there will always be a beneficiary who in effect is a non-skip person under section 2653, leaving aside a charitable or other interest that prevent taxable terminations), who could in turn make the educational or medical payment free of gift tax under section 2503(e) itself. Ironically, the trustee of a more old-fashioned trust with distributions limited, for example, to support, maintenance, and health, might have a harder time doing that.

(f) Surprisingly, the 2014 Greenbook (page 169) made no change, except to change "clarify" to "provide" in describing the proposal and to change "CLARIFY" to "MODIFY" in the heading. The 2015 Greenbook (page 203) made no substantive change, and neither does the 2016 Greenbook (page 186).

(g) The Greenbooks appeared to estimate that this proposal would *lose* revenue ($247 million over 10 years in the 2016 Greenbook), but there was no explanation of that.

g. **Simplify Gift Tax Exclusion for Annual Gifts**

(1) This proposal appeared for the first time, at least since similar Clinton Administration proposals in 1998 and 2000, in the 2014 Greenbook (pages 170-71). The Greenbook cited *Crummey v.*

Commissioner, 397 F.2d 82 (9th Cir. 1968), and pointed out that the use of "*Crummey* powers" has resulted in significant compliance costs, including the costs of giving notices, keeping records, and making retroactive changes to the donor's gift tax profile if an annual exclusion is disallowed. The Greenbook added that the cost to the IRS of enforcing the rules is significant too.

(2) The 2014 Greenbook also acknowledged an IRS concern with the proliferation of *Crummey* powers, especially in the hands of persons not likely to ever receive a distribution from the trust, and lamented the IRS's lack of success in combating such proliferation (citing *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991); *Kohlsaat v. Commissioner*, T.C. Memo. 1997-212).

(3) The 2015 Greenbook (pages 204-05) dropped the citation of *Crummey*, but continued to refer to "*Crummey* powers" and the challenges they create.

(4) The 2014 Greenbook offered the following explanation of the proposal:

> The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

(5) As to interests in passthrough entities, see the IRS successes in *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003) (interests in an LLC engaged in tree farming); *Price v. Commissioner*, T.C. Memo. 2010-2 (interests in a limited partnership holding marketable stock and commercial real estate); *Fisher v. United States*, 105 AFTR 2d 2010-1347 (D. Ind. 2010) (interests in an LLC owning undeveloped land on Lake Michigan).

(6) So this is what apparently would be left as excludable gifts:

(a) Unlimited gifts directly for tuition or medical expenses under section 2503(e).

(b) Up to $50,000 of annual exclusion for transfers that otherwise might be impermissible, suspect, or at least controversial. There apparently wouldn't even have to be an arguable basis for the annual exclusion under the law prior to such an amendment. (The Greenbook provides the simple example of "transfers in trust.")

i. Some were inclined to interpret the 2014 proposal as proposing that the "new category of transfers" would be allowed, up to $50,000 per donor per year, without tapping into the donor's $14,000-per-donee annual exclusions. Others were inclined to view the proposal only as allowing up to $50,000 of annual exclusion gifts (also subject to the $14,000-per-donee limit) to avoid the tightened outright-or-tax-vested requirement. In fact, that interpretation was quickly confirmed informally to have been the intention of the drafters. The 2015 Greenbook removed all doubt by adding a new sentence: "This new $50,000 per-donor limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion."

ii. So limited, the proposal is less of a simplification. For example, for the "new category of transfers" up the $50,000 per year, it apparently would then still be necessary to identify the donees, the very function of *Crummey* powers that the IRS has viewed as complicating and sometimes aggressive

iii. The 2015 Greenbook also added that the proposed limit of $50,000 would be indexed for inflation.

(c) Gifts up to $14,000 (at that time) per donee per year, or $28,000 if split, consisting of

i. simple outright gifts (other than gifts of interests in passthrough entities, property subject to a prohibition on sale, assets that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated, etc.) and

ii. gifts to trusts described in section 2642(c)(2) – that is, "tax-vested" trusts exempt from GST tax. This latter provision would effectively permit "2503(c) trusts" to any age (not just 21).

(7) The 2016 Greenbook (pages 187-88) makes no change.

(8) The proposal would be effective for gifts made after the year of enactment. It is estimated to raise revenues by $3.68 billion over 10 years.

h. **Expand Applicability of Definition of Executor**

(1) The 2014 Greenbook (page 172) noted that "[b]ecause the tax code's definition of executor currently applies only for purposes of the estate tax, no one (including the decedent's surviving spouse who filed a joint income tax return) has the authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent's death. Thus, there is no one with authority to extend the statute of limitations, claim a refund, agree to a compromise or assessment, or pursue judicial relief in connection with the decedent's share of a tax liability." [Section 2203 provides a meaning of "the term 'executor' wherever it is used in this title in connection with the estate tax imposed by this chapter."]

(2) Interestingly, the Greenbook added that "[t]his problem has started to arise with more frequency, as reporting obligations, particularly with regard to an interest in a foreign asset or account, have increased, and survivors have attempted to resolve a decedent's failure to comply."

(3) The proposal in the 2014 Greenbook would "expressly make the tax code's definition of executor applicable for all tax purposes, and authorize such executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or obligations that the decedent could have done if still living. In addition, the proposal would grant regulatory authority to adopt rules to resolve conflicts among multiple executors authorized by this provision."

(4) The 2015 Greenbook was identical, except that it added a clarification that the executor, as defined, would be empowered to deal with all tax liabilities "whether arising before, upon, or after death." The 2016 Greenbook (page 189) makes no change.

(5) The proposal would apply upon enactment, regardless of a decedent's date of death, and would have a negligible revenue effect.

i. **Another Topic: Taxation of Appreciation at Death**

(1) Elsewhere in the 2015 Greenbook (pages 156-57) and the 2016 Greenbook (pages 155-56), under the general heading of "Reforms to Capital Gains Taxation, Upper-Income Tax Benefits, and the Taxation of Financial Institutions," there is a proposal labeled simply "Reform the Taxation of Capital Income."

(2) In describing current law, the proposal points out that capital gains are subject to a top income tax rate of 20 percent, plus the 3.8 percent tax on net investment income, while appreciation during the life of someone who dies holding the asset escapes income tax because the decedent's heir receives a new basis equal to the fair market value of the asset at the decedent's death.

(3) Believing that "[p]referential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers," the Greenbook explains:

> Because the person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value on the decedent's death, the appreciation that accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement must pay income tax on their realized capital gains. This increases the inequity in the tax treatment of capital gains [the "equity" argument]. In addition, the preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily

for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments [the "lock-in" argument].

(4) The proposal would increase the top rate on capital gains and qualified dividends to 24.2 percent, which, with the 3.8 percent tax on net investment income, would produce a rate of 28 percent. It would also treat a gift or bequest of appreciated property as a realization event, subjecting the appreciation to capital gains tax.

(a) Gifts or bequests to a spouse or charity would not be taxed, but the spouse or charity would take a carryover basis in the asset.

(b) Tangible personal property such as household furnishings and personal effects, but not "collectibles," would be exempt.

(c) The gain would be taxable to a donor in the year a gift is made, and to a decedent either on the final individual return or on a separate capital gains return.

(d) Each taxpayer would be allowed an additional exclusion of capital gains at death of up to $100,000 (indexed for inflation after 2016), and each person's $250,000 exclusion of capital gain on a principal residence would be extended to all residences. Both of these exclusions would be portable to the decedent's surviving spouse "under the same rules that apply to portability for estate and gift tax purposes." The exclusion under section 1202 for capital gain on certain small business stock would also apply.

(e) Taxation of the appreciation in the value of certain small family-owned and operated businesses (no further details given) would be deferred until the business is sold or ceases to be family-owned and operated.

(f) A "15-year fixed-rate payment plan" would be allowed for the tax on appreciated illiquid assets transferred at death.

(g) The Greenbooks clarify that the income tax on capital gains deemed realized at death would be deductible for estate tax purposes.

(5) The proposal is estimated to raise revenues by $235.208 billion over 10 years.

(6) This proposal was featured in President Obama's State of the Union Address on January 20, 2015, and previewed in a White House "Fact Sheet" (see **http://content.govdelivery.com/attachments/USEOPWHPO/2015/01/17/file_attachments/356770/FactSheet.pdf**) released on Saturday, January 17, 2015.

(a) The first page of the Fact Sheet highlighted three bullet points:

- **"Close the trust fund loophole – the single largest capital gains tax loophole – to ensure the wealthiest Americans pay their fair share on inherited assets.** Hundreds of billions of dollars escape capital gains taxation each year because of the 'stepped-up' basis loophole that lets the wealthy pass appreciated assets onto their heirs tax-free.
- **"Raise the top capital gains and dividend rate back to the rate under President Reagan.** The President's plan would increase the total capital gains and dividends rates for high-income households to 28 percent.
- **"Reform financial sector taxation to make it more costly for the biggest financial firms to finance their activities with excessive borrowing.** The President will propose a fee on large, highly-leveraged financial institutions to discourage excessive borrowing.

(b) The label of "trust fund loophole" is an odd way to describe the stepped-up basis for appreciated assets at death, when assets in typical ancestral trusts are not subject to estate tax and do not get a stepped-up basis. And the idea that ***"[h]undreds of billions*** of dollars escape capital gains taxation each year" is hard to reconcile with the overall *10-year* revenue estimate of $208 billion, especially as the Fact Sheet noted that "99 percent of the impact of the President's capital gains reform proposal (including eliminating stepped-up basis and raising the capital gains rate) would be on the top 1 percent, and more than 80 percent on the top 0.1 percent (those with incomes over $2 million)," who would likely be paying the top 28 percent rate.

(c) The Fact Sheet also mentions the equity argument and lock-in argument that are recapitulated in the Greenbook.

(d) The "financial sector" proposal (Greenbook page 160), by the way, would impose on any financial firm with assets over $50 billion a fee equal to 7 basis points applied to the firm's liabilities. It would become effective January 1, 2016, and is estimated to raise revenue by an astonishing $111.814 billion over 10 years.

(7) Generally, the Greenbook articulation of the proposal avoids the anomalies of the White House Fact Sheet and presents a clearer picture. Showing appreciation for the complexities involved, the Greenbook adds the following:

> The proposal also would include other legislative changes designed to facilitate and implement this proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; and a broad grant of regulatory authority to provide implementing rules.
>
> To facilitate the transition to taxing gains at death and gift, the Secretary would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable.

18. The Section 2704 Proposed Regulations of 2016

a. Background

(1) The section 2704 regulation project was opened in 2002 and first appeared in the 2003-04 Treasury-IRS Priority Guidance Plan.

(2) From May 2009 until April 2013, the status of this regulation project had to be evaluated in light of the related revenue proposal in the Treasury Department's annual "General Explanations of the Administration's Revenue Proposals" (popularly called the "Greenbook"). The 2013, 2014, 2015, and 2016 Greenbooks omitted that proposal.

(3) Proposed regulations were released August 2, 2016, and published in the Federal Register August 4, 2016. 81 Fed. Reg. 51413-51425 (Aug. 4, 2016). They were proposed under the statutory authority of section 2704(b)(4), which states, in the context of corporate or partnership restrictions that are disregarded:

> The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.

(4) Comments on the proposed regulations were due by November 2, 2016, and a public hearing was held on December 1, 2016.

b. The Proposed Regulations

(1) Disregarding Certain Restrictions on Redemption or Liquidation

(a) The heart of the proposed regulations would change the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to restrictions on redemption or liquidation – that is, subject to limitations on the ability of the owner of the interest to require the entity or other owners to redeem or buy out that owner. The overall effect of section 2704(b) is that specified restrictions are disregarded in valuing such an interest for estate, gift, or GST tax purposes when that interest is transferred to a family member. Under the proposed regulations, the threshold element of the new type of disregarded restriction (like the "applicable restrictions" of the statute and the current regulations) was still the fact that after the transfer the restriction will lapse or can be removed by the transferor or any member or members of the transferor's family. Proposed Reg. §25.2704-3(b)(1).

i. But for this purpose, interests held by nonfamily members, which otherwise might give those nonfamily members the power to prevent the removal of a restriction, would be disregarded unless those interests have been held for at least three years, those interests represent at least 10 percent of the ownership of the entity (and 20 percent in the aggregate with other nonfamily members), and each interest held by a nonfamily member can be redeemed by the nonfamily holder on no more than six months' notice. Proposed Reg. §25.2704-3(b)(4)(i) & -3(b)(6). In other words, the nonfamily member's interest must be substantial (reflected in the 10-percent and 20-percent requirements) and must be a willing and active investment (reflected in the decision of all nonfamily investors to have stayed in for at least three years despite the ability to get out). Even so, it would be rarely if at all that such attributes would all be found in nonfamily holders.

ii. A typical target is evidently a nominal interest held by a "captive" charity, which has neither the ability to bail out nor, because it is merely the beneficiary of a gratuitous gift, any incentive to rock the boat. An example would be the interests given to the University of Texas in *Kerr v. Commissioner*, 113 T.C. 449, 473 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002), about which the preamble to the proposed regulations explicitly stated that "taxpayers have avoided the application of section 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction. Kerr, 292 F.3rd at 494."

(b) Rather than describing the *kinds* of such lapsing or removable restrictions that will be disregarded in making such valuations, the proposed regulations defined those restrictions with reference to the *effect* they could have on the ability of the holder of an interest to be redeemed or bought out. If the effect of a restriction on an interest in an entity is to limit the ability of the holder of that interest to compel liquidation or redemption of that interest on no more than six months' notice for cash or property equal at least to what the proposed regulations call "minimum value," then that restriction would be disregarded. "Minimum value" was defined as the pro rata share of the net fair market value of the assets of the entity – that is, the fair market value of those assets reduced by the debts of the entity (but only to the extent those debts would be deductible under section 2053 if they were claims against a decedent's estate), multiplied by the share of the entity represented by that interest.

(c) The property for which the interest may be redeemed at the holder's election could not include a promissory note or other obligation of the entity, its owners, or persons related to the entity or its owners. But there was an exception for a note issued by an entity engaged in an active trade or business (at least 60 percent of the value of which consists of the non-passive assets of that trade or business) to the extent the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B) that, as the proposed regulations stated, "is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." Proposed Reg. §25.2704-3(b)(1)(iv).

(d) It was significant that the proposed regulations specified "market interest rates" and "fair market value," rather than an "applicable federal rate" or other objective rate determined from published sources and a value inferred from the use of such a rate. This small difference in wording would have converted the standard, where it applied, from a relatively objective standard to a much more subjective standard.

(2) Effect of Disregarding a Restriction

(a) Awkwardly, "minimum value" in the proposed regulations did not purport to be "minimum value" for transfer tax purposes. In fact, "minimum value" played no direct role at all in determining transfer tax value. Therefore, there was no basis for appraising the interest as if it carried a "deemed put right" or any other rights at all other than rights that are affirmatively granted by the applicable law or the governing documents.

(b) Significantly, the Greenbook legislative proposals had contemplated that "an additional category of restrictions ('disregarded restrictions') … would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family … [and] the transferred interest would be valued ***by substituting for the disregarded restrictions certain assumptions to be specified in regulations***" (emphasis added). But legislative authority was never granted under those Greenbook proposals, and substituted valuation assumptions that might have "deemed" the holder of an interest to have a put right or any other rights were omitted from the proposed regulations.

(c) Proposed Reg. §25.2704-3(f) confirmed that "[i]f a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise." It did not provide for a "deemed put right."

(d) The preamble added that "the fair market value of the interest in the entity is determined assuming that the disregarded restriction did not exist, either in the governing documents or applicable law. Fair market value is determined under generally accepted valuation principles, ***including any appropriate discounts or premiums***, subject to the assumptions described in this paragraph" (emphasis added). 81 Fed. Reg. 51413, 51418 (Aug. 4, 2016). Again, there was no suggestion of a "deemed put right."

(e) If the proposed regulations had become final, then, in appraising such an interest in an entity for transfer tax purposes, an appraiser would have been expected, as always, to take into account all relevant factors, including (1) the risk that the holder of the interest may be unable to negotiate a favorable buyout, (2) the risk a hypothetical willing buyer would incur in dealing with an unrelated family, and (3) the lack of ability to control or influence the entity as a going concern. And in the case of a family-owned operating business, the appraiser should have been expected to take into account any relevant additional factors, including (4) illiquidity or other obstacles to the business's redemption of the interest, (5) the possible lesser relevance of a redemption or asset-based approach to valuation of an operating business, and (6) the simple fact of life that the managers or majority owners of the business may not consider a partial liquidation to be in the best interests of the business or the other owners. **We could therefore have expected discounts of the kind we are used to observing to continue to be applied by appraisers to reflect those and other relevant factors.**

(f) If, however, the creators or owners of the entity try to "put a thumb on the scale" to artificially enhance those discounts by provisions in the governing documents explicitly prohibiting a favorable buy-out even if those systemic barriers can be overcome by negotiation, the appraiser would have been obliged to ignore those provisions. **That will have reduced discounts at the margin in many cases, especially in the more aggressive cases of the most artificial and ephemeral restrictions.**

(3) Restrictions Imposed or Required by Law

(a) Section 2704(b)(3)(B) exempts restrictions on the ability to liquidate the entity "imposed or required to be imposed, by any Federal or State law."

(b) The original regulations, finalized in 1992, state that "[a]n applicable restriction is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction" (often referred to as the "default" state law). Reg. §25.2704-2(b). **This invocation of *default* state law is a lenient adaptation of the statute.**

(c) When section 2704 was enacted and the current regulations were issued, the state law applicable to partnerships granted owners certain rights to liquidate the entity. Since then, state legislatures have tightened their default laws to more significantly restrict the liquidation rights of the owners. Those restrictions, provided by default state law or by provisions in governing documents consistent with the default state law, are believed not to be applicable restrictions and therefore are respected for transfer tax purposes.

(d) The 2016 proposed regulations would have provided that a default state law restriction that may be superseded by the governing documents or by the selection of another statute is not a restriction imposed or required to be imposed by federal or state law. Thus, a restriction would be disregarded unless it is **absolutely mandatory and unavoidable** under federal or state law. Proposed Reg. §25.2704-2(b)(4)(ii) & -3(b)(5)(iii). Moreover, the proposed regulations stated that "[f]or this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction." *Id.* In other words, shopping for a foreign jurisdiction (or a particular local jurisdiction) with very harsh mandatory restrictions would not work.

(4) Other Exceptions

(a) A commercially reasonable restriction imposed by an unrelated investor, as under the current regulations. Proposed Regs. §§25.2704-2(b)(4)(i) & -3(b)(5)(ii).

(b) "An option, right to use property, or agreement that is subject to section 2703," as under the current regulations. Proposed Regs. §§25.2704-2(b)(4)(iii) & -3(b)(5)(iv). It was not clear whether the term "subject to" was intended to mean "compliant with," "overridden by," or both.

(c) Additional exceptions in the case of the new "disregarded restrictions":

i. An "applicable restriction" under Proposed Reg. §25.2704-2. Proposed Reg. §25.2704-3(b)(5)(i).

ii. Any restriction if every holder of an interest in the entity may redeem their interest on no more than six months' notice for cash or other property. Proposed Reg. §25.2704-3(b)(5)(v). (This must be an *actual* put right, not a "deemed put right." It would be a very unusual feature of most entities, especially operating businesses.)

(5) "Nontax Reasons"

(a) The application of a "legitimate and significant nontax reason" test to family entities in *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005) (reviewed by the Court), was welcomed by some as a relaxation or at least a clarification of a narrower "business purpose" test. Indeed, Judge Laro, joined by Judge Marvel, wrote a concurring opinion in *Bongard* stating: "I disagree with the use of the majority's 'legitimate and significant nontax reason' test. … I would apply the longstanding and well-known business purpose test of *Gregory v. Helvering*, 293 U.S. 465 (1935)." Ironically, the underlying assets in *Bongard* were an operating business, and even Judges Laro and Marvel concurred in the result. Judge Halpern found "a legitimate and significant nontax reason" to be "an inappropriate motive test" and dissented in part, while Judges Chiechi, Wells, and Foley, citing *United States v. Byrum*, 408 U.S. 125 (1972), questioned the need for "any significant nontax reason" and would have gone even farther in the taxpayer's favor than the majority.

(b) The *Bongard* "legitimate and significant nontax reason" test is used in applying the "bona fide sale for an adequate and full consideration in money or money's worth" exception of sections 2036(a) and 2038(a)(1), not for determining the effect on value of an entity-level restriction as such, but it has been applied in many cases and has become a staple of the family entity planning vocabulary.

(c) The proposed section 2704 regulations had no nontax reason exception. Even so, applying "generally applicable valuation principles as if the disregarded restriction does not exist" could have resulted in transfer tax values for interests in operating businesses that are the same or nearly the same as the values that would have been accepted without regard to the proposed regulations.

(6) A Holistic Approach to Marital and Charitable Deductions

(a) The proposed regulations included provisions that apparently were an attempt to clarify that the valuation rules for determining a marital deduction would be the same as the rules for determining the value included in taxable gifts or in the gross estate. Proposed Reg. §25.2704-3(g), *Examples 3 & 4*. In addition, section 2704 would not have applied to transfers to nonfamily members like charities. Where those rules would apply, they could override or mitigate the harsh "reverse-*Chenoweth*" result seen in Technical Advice Memoranda 9050004 (Aug. 31, 1990) and 9403005 (Oct. 14, 1993) (all stock owned by the decedent valued as a control block in the gross estate, but the marital bequest valued separately for purposes of the marital deduction), relying on *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987) (estate of a decedent who owned all the stock of a corporation entitled to a control premium for a 51-percent block bequeathed to the surviving spouse for purposes of the marital deduction), and *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

(b) Proposed Reg. §25.2704-3(e) stated:

> *Certain transfers at death to multiple persons*. Solely for purposes of section 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are nonfamily members of the decedent [*e.g.*, charity], and if the part passing to the members of the decedent's family is to be valued pursuant to paragraph (f) of this section, then that part is treated as a single, separate property interest. In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest. See paragraph (g) *Example 4* of this section.

(c) Proposed Reg. §25.2704-2(f) was similar.

(d) And Proposed Reg. §25.2704-3(g), *Example 4*, provided:

> *Example 4*. (i) The facts are the same as in *Example 1*, except that D made no gifts and, on D's subsequent death pursuant to D's will, a 53 percent limited partner interest passes to D's surviving spouse who is a U.S. citizen, a 25 percent limited partner interest passes to C, an unrelated individual, and a 20 percent limited partner interest passes to E, a charity. The restriction on a limited partner's ability to liquidate that partner's interest is a disregarded restriction. In determining whether D's estate and/or D's family may remove the disregarded restriction after the transfer occurring on D's death, the interests of C and E are disregarded because these interests were not held by C and E for at least three years prior to D's death, nor do C and E have the right to withdraw on six months' notice and receive their respective interest's share of the minimum value of X. Thus, the 53 percent interest passing to D's surviving spouse is subject to section 2704(b). D's gross estate will be deemed to include two separate assets: a 53 percent limited partner interest subject to section 2704(b), and a 45 percent limited partner interest not subject to section 2704.
>
> (ii) The fair market value of the 53 percent interest is determined for both inclusion and deduction purposes under generally applicable valuation principles taking into account all relevant factors affecting value, including the rights determined under the governing documents and local law, and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise. The 45 percent interest passing to nonfamily members is not subject to section 2704(b), and will be valued as a single interest for inclusion purposes under generally applicable valuation principles, taking into account all relevant factors affecting value including the rights determined under the governing documents and local law as well as the restriction on a limited partner's ability to liquidate that partner's interest. The 20 percent passing to charity will be valued in a similar manner for purposes of determining the allowable charitable deduction. Assuming that, under the facts and circumstances, the 45 percent interest and the 20 percent interest are subject to the same discount factor, the charitable deduction will equal four-ninths of the value of the 45 percent interest.

(7) Lapse of Voting or Liquidation Rights

(a) Section 2704(a) treats the lapse of a voting or liquidation right in a family-owned entity as a transfer (or additional transfer) by the individual holding the right immediately before its lapse.

(b) The original 1992 regulations exempt such a transfer if the rights with respect to the transferred interest are not restricted or eliminated. Reg. §25.2704-1(c)(1). Again, this is a lenient adaptation of the statute, and it permits, for example, a gift of a minority interest by someone who holds a controlling interest (at least before the gift) to escape treatment as a lapse.

(c) The proposed regulations would have amended Reg. §25.2704-1(c)(1) to deny that exemption for transfers occurring within three years before the transferor's death if the entity is controlled by the transferor and members of the transferor's family immediately before and after the lapse.

(d) The proposed regulations would have modified Reg. §25.2704-1(f), Example (4) to illustrate the impact of this provision. In the example, an individual owning 84 percent of the stock in a corporation whose bylaws require at least 70 percent of the vote to liquidate gives one-half of the individual's stock in equal shares to the individual's three children. The individual in this example gave up the individual's right to liquidate or control the corporation by making the gift. The example provided that if those transfers had occurred within three years of the individual's death, the transfers would have been treated as if the lapse of the liquidation right occurred at the individual's death.

(e) Details were not given, and it was not clear exactly how this new three-year rule would work, including (1) whether the lapse would be valued at the time of the *inter vivos* transfer or at death, (2) how double taxation would be prevented if the new valuation rules also applied at the time of the *inter vivos* transfer (which there is no reason to assume is intended), (3) whether the transfer treated as occurring at death would qualify for a marital deduction or support a stepped-up basis, and (4) how in any event the tax on what amounts to a "phantom asset" in the estate would be appropriately apportioned.

(f) Proposed Reg. §25.2704-1(c)(1) stated that "[t]he lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death is treated as a lapse *occurring* on the transferor's date of death, includible in the gross estate pursuant to section 2704(a)" (emphasis added). Proposed Reg. §25.2704-4(b)(1) stated that the new three-year rule would "apply to lapses of rights … *occurring* on or after the date these regulations are published as final regulations in the Federal Register" (emphasis added). The repetition of the word "occurring" suggested that the three-year rule would apply even if the relevant lifetime transfer had been made before the regulations had been finalized, although it is doubtful that such a harsh result was intended, and, indeed, the government representatives denied at the December 1, 2016, public hearing that that result had been intended.

(g) In addition, Proposed Reg. §25.2704-1(a)(5) provided that if an owner of an interest in an entity transferred that interest, and the transferee became a mere assignee, not a full owner of the entity, there would be a lapse of the voting and liquidation rights associated with the transferred interest.

(8) Covered Entities

(a) Although section 2704, when it was enacted, referred only to corporations and partnerships, the proposed regulations would have clarified that it applies to "any other entity or arrangement that is a business entity within the meaning of §301.7701-2(a)." Proposed Reg. §25.2701-2(b)(5)(i) & (iv).

(b) Reg. §301.7701-2(a) provides, rather circularly, that "a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code."

(9) Effective Dates

(a) The provisions of the proposed regulations applicable to voting and liquidation rights, as proposed, would have applied to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations were published as final regulations.

(b) The new rules for "Disregarding Certain Restrictions on Redemption or Liquidation" would not have taken effect until 30 days after the date the regulations were published as final regulations. That is the general rule of the Administrative Procedure Act applicable to "substantive" regulations. 5 U.S.C. §553(d).

(10) Revenue Estimates

(a) Proposed regulations are not generally accompanied by revenue estimates. But these proposed regulations resembled legislative proposals that were included in the first four General Explanations of the Administration's Revenue Proposals ("Greenbooks") of the Obama Administration. The 10-year revenue estimates in those Greenbooks – $19.038 billion in 2009, $18.667 billion in 2010, $18.166 billion in 2011, and $18.079 billion in 2012 – trending downward to, say, $18 billion, represent a revenue gain of about $1.8 billion per year.

(b) At a 40 percent estate and gift tax rate, an annual recovery of $4.5 billion of value otherwise lost to discounts would raise $1.8 billion per year. This is a grossly simplified model that ignores income tax effects, opportunity costs, and doubtless a host of other factors that Treasury's revenue estimators use. But it is all we had. Moreover, it is reasonable to assume that the omission of presumably tougher rules for which the Greenbooks had sought legislative cover made those estimates out-of-date on the high side.

c. **Reactions**

(1) Contemporaneous Comments from the Obama Administration

(a) Shortly after the proposed regulations were released on August 2, 2016, Assistant Secretary of the Treasury for Tax Policy Mark Mazur released the following "Note" (**https://www.treasury.gov/connect/blog/Pages/Treasury-Issues-Proposed-Regulations-to-Close-Estate-and-Gift-Tax-Loophole.aspx**):

> Today, the U.S. Department of the Treasury announced a new regulatory proposal to close a tax loophole that certain taxpayers have long used to understate the fair market value of their assets for estate and gift tax purposes.
>
> Estate and gift taxes, or transfer taxes, are taxes on the transfer of assets from one person to another either by gift during his or her lifetime or by inheritance at death. Only transfers by an individual or their estate in excess of $5.45 million are subject to tax. For married couples, no tax is collected on the first $10.9 million transferred. These generous exemption amounts mean that fewer than 10,000 of the largest estates are subject to any transfer tax at all in a year.
>
> It is common for wealthy taxpayers and their advisors to use certain aggressive tax planning tactics to artificially lower the taxable value of their transferred assets. By taking advantage of these tactics, certain taxpayers or their estates owning closely held businesses or other entities can end up paying less than they should in estate or gift taxes. Treasury's action will significantly reduce the ability of these taxpayers and their estates to use such techniques solely for the purpose of lowering their estate and gift taxes. These proposed regulations are subject to a 90-day public comment period. The regulations themselves will not go into effect until the comments are carefully considered and then 30 days after the regulations are finalized.

(b) Also on August 2, 2016, the White House chimed in with a statement that began as follows (**https://www.whitehouse.gov/blog/2016/08/03/closing-estate-tax-loophole-wealthiest-few-what-you-need-know**):

> The Obama administration has made considerable progress over the past eight years to make our tax code fairer. This week, the Treasury Department is building on that progress through proposed new rules closing a loophole that allows some wealthy families to avoid paying their fair share in estate taxes.

> Treasury's action will help working families around the country because, when the wealthiest households are able to use sophisticated techniques to exploit loopholes and reduce the taxes that they owe, more of the tax burden ultimately falls on middle-class taxpayers.

(2) Reactions in Congress

(a) Bills were introduced to block the regulations:

i. H.R. 6042 (Rep. F. James Sensenbrenner, Jr. (R-Wisconsin), Sept. 15, 2016):

> Regulations proposed for purposes of section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016 (81 Fed. Reg. 51413), and any substantially similar regulations hereafter promulgated, shall have no force or effect.

ii. "Protect Family Farms and Businesses Act," H.R. 6100 (Rep. Warren Davidson (R-Ohio), Sept. 21, 2016) and S. 3436 (Sen. Marco Rubio (R-Florida) Sept. 28, 2016):

> The proposed regulations under section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016, in the Federal Register (81 Fed. Reg. 51413) shall have no force or effect. No Federal funds may be used to finalize, implement, administer, or enforce such proposed regulations or any substantially similar regulations.

iii. The "Protect Family Farms and Businesses Act" was reintroduced in the new Congress on January 2, 2017, as H.R. 308 and S. 47.

(b) In this vein, section 115 of the Fiscal Year 2018 appropriations bill reported out of the House Appropriations Committee on June 29, 2017, provided:

> None of the funds made available by this Act may be used to finalize, implement, or enforce amendments to Treasury Regulations proposed in the Notice of Proposed Rulemaking in the Federal Register on August 4, 2016 (81 Fed. Reg. 51413) (relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes under section 2704 of the Internal Revenue Code of 1986), or any substantially similar amendments to such regulations.

(c) On the other hand, when Secretary of the Treasury Steven Mnuchin was asked in his confirmation hearing on January 19, 2017, if he would consider withdrawing the proposed regulations, his reply suggested that he had received a balanced briefing on the proposed regulations and that he understood the special distinctions of family-owned operating businesses:

> Absolutely. I will tell you that both I and the President-elect believe in appropriate regulation. … And specifically on what you've mentioned, on the IRS regs on family businesses, I am committed to working with you and your office—we want to make sure that we cover the appropriate loopholes, so that if people have businesses set up to avoid taxes it's one thing—and they're not real operating business. But any operating business we need to make sure that people who own minority interests in operating businesses that the valuation for tax purposes are reflected appropriately.

(3) Initiatives of the Trump Administration

(a) Executive Order 13789 of April 21, 2017, directed the identification of tax regulations issued on or after January 1, 2016, that

i. impose an undue financial burden on United States taxpayers;

ii. add undue complexity to the Federal tax laws; or

iii. exceed the statutory authority of the Internal Revenue Service

and the recommendation of specific actions to mitigate the burdens identified.

(b) Treasury's first response to the Executive Order, Notice 2017-38 (dated June 22 and released July 7, 2017), 2017-30 I.R.B. 147 (July 24, 2017), identified eight regulations that met at least one of the first two criteria specified by the Executive Order. One of these was the proposed section 2704 regulations, about which the Notice said:

> Section 2704(b) of the Internal Revenue Code provides that certain non-commercial restrictions on the ability to dispose of or liquidate family-controlled entities should be disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. These proposed regulations would create an additional category of restrictions that also would be disregarded in assessing the fair market value of an interest. Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

(c) Treasury's second response to the Executive Order was a report dated October 2 and released October 4, 2017 (**https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf**), declaring that the proposed section 2704 regulations would be withdrawn. Here is the report's full discussion of that decision:

> Section 2704 addresses the valuation, for wealth transfer tax purposes, of interests in family-controlled entities. In limited cases, Section 2704 disregards restrictions on the ability to liquidate family-controlled entities when determining the fair market value of an interest for estate, gift, and generation-skipping transfer tax purposes. Also in limited cases, Section 2704 treats lapses of voting or liquidation rights as if they were transfers for gift and estate tax purposes. The proposed regulations, through a web of dense rules and definitions, would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded under Section 2704. In addition, the proposed regulations would have required an entity interest to be valued as if disregarded restrictions did not exist, either in the entity's governing documents or under state law. No exceptions would have been allowed for interests in active or operating businesses.
>
> The goal of the proposed regulations was to counteract changes in state statutes and developments in case law that have eroded Section 2704's applicability and facilitated the use of family-controlled entities to generate artificial valuation discounts, such as for lack of control and marketability, and thereby depress the value of property for gift and estate tax purposes. Commenters warned, however, that the valuation requirements of the proposed regulations were unclear and that their effect on traditional valuation discounts was uncertain. In particular, commenters argued that it was not feasible to value an entity interest as if no restrictions on withdrawal or liquidation existed in either the entity's governing documents or state law. A legal vacuum in which there is no law relevant to an interest holder's right to withdraw or liquidate is impossible, commenters asserted, and, therefore, cannot meaningfully be applied as a valuation assumption. Commenters also argued that the proposed regulations could have produced unrealistic valuations. For example, the lack of a market for interests in family-owned operating businesses is a reality that, commenters argued, should continue to be taken into account when determining fair market value.
>
> After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it is unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts. Moreover, merely to reach the conclusion that an entity interest should be valued as if restrictions did not exist, the proposed regulations would have compelled taxpayers to master lengthy and difficult rules on family control and the rights of interest holders. The burden of compliance with the proposed regulations would have been excessive, given the uncertainty of any policy gains. Finally, the proposed regulations could have affected valuation discounts even where discount factors, such as lack of control or lack of a market, were not created artificially as a value-depressing device.
>
> In light of these concerns, Treasury and the IRS currently believe that these proposed regulations should be withdrawn in their entirety. Treasury and the IRS plan to publish a withdrawal of the proposed regulations shortly in the Federal Register.

The report said nothing about re-proposing the regulations in the future or about any modifications it was considering. This was a contrast with its discussion of the seven other regulations it addressed, although six of those other regulations were already in effect as final or temporary regulations, and thus presumably Treasury and the IRS had had greater opportunity to study them. And unlike those six, the report's treatment of the only other *proposed* regulation on the list (relating to the definition of a political subdivision for purposes of section 103) was very general, saying only that "Treasury and the IRS may propose more targeted guidance in the future after further study of the relevant legal issues." Thus, the report arguably left the door open for the section 2704 regulations to be modified and re-proposed in the future. Significantly, though, the report concluded not only that details of the proposed regulations needed clarification, but that "the proposed regulations' *approach* to the problem of artificial valuation discounts is unworkable," and that "these proposed regulations should be withdrawn in their entirety." While Treasury and the IRS might still have had the same concerns about "artificial valuation discounts" that prompted the drafting of the proposed regulations in the first place, they obviously found the subject very difficult to address.

d. **Withdrawal**

The proposed section 2704 regulations were withdrawn on October 20, 2017, after a life of 14½ months. 82 Fed. Reg. 48779-80 (Oct. 20, 2017).

19. The House Republican Leadership's 2016 "Blueprint"

a. **Significance**

(1) The House of Representatives Republican leadership released a "Blueprint" for "A Better Way: Our Vision for a Confident America" dated June 24, 2016.

(2) The Republicans' retained control of the Senate and of course the election of President Trump gave the Blueprint new life.

(3) It appeared, at least originally, that the Trump Administration would by and large defer to the Blueprint as the primary vehicle for tax reform in the 115th Congress (1917-1918).

b. **Goals**

"This Blueprint will achieve three important goals:

- It will fuel job creation and deliver opportunity for all Americans.
- It will simplify the broken tax code and make it fairer and less burdensome.
- It will transform the broken IRS into an agency focused on customer service."

c. **The Stated Problems with "Our Broken Tax Code"**

(1) It imposes burdensome paperwork and compliance costs.

(2) It delivers special interest subsidies and crony capitalism.

(3) It penalizes savings and investments.

(4) It encourages businesses to move overseas.

(5) It enables a broken tax collector.

(a) Described in the Blueprint as "a broken tax collection agency that continues to fail the American people."

i. This represents a residue of fallout from allegations of politically-motivated IRS discriminatory treatment of citizens, destruction of emails, and similar misconduct.

ii. It has been aggravated by the partisanship in Congress and, during the Obama Administration, was arguably fueled both by extravagant accusations by Republicans and by extravagant defenses by Democrats.

iii. It resulted in several serious reductions in the IRS budget over the years. The Trump Administration's fiscal 2019 budget proposal (released March 16, 2017) would have cut another $239 million from the IRS budget. The fiscal year 2019 budget proposal (released February 12, 2018) asked for a total of about $11.1 billion for the IRS. That is down only about $24 million, but still down, from the annualized level of the fiscal year 2018 "continuing resolutions" and down about $1 billion from fiscal year 2010. On May 24, 2018, the House Appropriations Financial Services and General Government Subcommittee approved fiscal year 2019 funding for the IRS in the amount of $11.6 billion, including $77 million for implementing the 2017 Tax Act, subject to conditions and limitations that largely reflect recent congressional concerns with the IRS.

iv. It is illustrated in the Blueprint by references to "abysmal" customer service, including telephone service; abuse of law-abiding citizens through civil asset forfeitures; billions of dollars in improper payments (such as payments of fraudulently claimed earned income tax credits); and outdated IT systems that foster theft-related tax fraud.

(b) To be replaced by a proposed "New IRS for the 21st Century":

i. Streamlined into three units: (1) a families and individuals unit focused on customer service; (2) a business unit focused on administering the new tax code for businesses of all sizes and types, including specialists for start-up and small businesses, large domestic companies, and American-based global corporations; and (3) an independent "small claims court" to quickly resolve routine disputes.

ii. Headed by an Administrator appointed by the President with the advice and consent of the Senate for a three-year term and a limit of two terms.

d. **Provisions for Businesses ("Job Creators")**

(1) A top corporate rate of 20 percent.

(2) A top rate of 25 percent on small businesses and passthrough income.

(3) Greater use of expensing the cost of capital investments.

(4) Disallowance of deductions for net interest expense.

(a) Interest expense may be deducted against interest income.

(b) Disallowed net interest may be carried forward indefinitely.

(5) Limitation of net operating losses to 90 percent of net taxable income determined without regard to the carryforward.

(6) Replacement of the "outdated worldwide tax system" with a territorial tax system.

(7) Border adjustments to equalize the tax treatment of imports and exports – basically taxing imports to compensate for the taxes the creation of the import has avoided because it is outside the United States. [By the end of July 2017, it appeared that this unpopular feature would not be pursued.]

(8) Retention of the credit for research and development.

(9) Repeal of the corporate alternative minimum tax.

e. **Provisions for Individuals**

(1) Compression of income tax rate brackets into three brackets – 12 percent, 25 percent, and 33 percent.

(2) "Postcard" filing simplicity.

(3) Retention of itemized deductions only for mortgage interest and charitable contributions.

(4) Continuation of the current tax incentives for retirement savings.

(5) Repeal of the estate and generation-skipping taxes (conspicuously omitting any reference to repeal of the gift tax).

20. President Trump's Tax Reform Outline

a. Outline (Released by the White House April 26, 2017)

2017 Tax Reform for Economic Growth and American Jobs

The Biggest Individual And Business Tax Cut In American History Goals For Tax Reform

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families-especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

Individual Reform

- Tax relief for American families, especially middle-income families:
  - Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%
  - Doubling the standard deduction
  - Providing tax relief for families with child and dependent care expenses
- Simplification:
  - Eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers
  - Protect the home ownership and charitable gift tax deductions
  - Repeal the Alternative Minimum Tax
  - Repeal the death tax
- Repeal the 3.8% Obamacare tax that hits small businesses and investment income

Business Reform

- 15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

Process

- Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides massive tax relief, creates jobs, and makes America more competitive – and can pass both chambers.

b. Analysis and Comment

(1) Although touted as a "plan" – even a "phenomenal" plan – this one-pager was only an outline.

(2) The "business tax rate" of 15 percent was apparently intended to apply to corporations and passthroughs alike.

(3) The outline was silent on expensing of capital expenditures and non-deductibility of net business interest deductions (Part 19.d(3) and (4) in the discussion of the "Blueprint" above).

(4) The outline omitted any reference to border adjustments (Part 19.d(7) above), but does advocate a territorial tax system (as in Part 19.d(6)), apparently with a one-time deemed repatriation tax of an unspecified rate (possibly about 3 or 5 percent but probably no higher than about 10 percent). [By the end of July 2017, it appeared that the unpopular border adjustment proposal would not be pursued.]

(5) President Trump had campaigned for a 33 percent top individual rate. His top rate of 35 percent was 2 percent higher than the Blueprint (Part 19.e(1)), while his lowest rate of 10 percent was 2 percent lower.

(6) The outline was silent on changing the tax treatment of retirement savings (Part 19.e(4)).

(7) The outline retained (from the presidential campaign) the vague proposal to "[r]epeal the death tax."

(8) In contrast, the Trump campaign website had stated that "[t]he Trump Plan will repeal the death tax, but capital gains held [*sic*] until death and valued [*sic*] over $10 million will be subject to tax."

(9) The outline omitted any reference to reforming the IRS (Part 19.c(5)) as part of tax reform.

21. Unified Framework for Fixing our Broken Tax Code

a. Framework (September 27, 2017)

(1) A nine-page summary compiled and released September 27, 2017, by the "Big Six," who had been working together for some time:

(a) House Speaker Paul Ryan and Ways and Means Committee Chairman Kevin Brady,

(b) Senate Majority Leader Mitch McConnell and Finance Committee Chairman Orrin Hatch, and

(c) Secretary of the Treasury Steven Mnuchin and National Economic Council Director Gary Cohn from the Administration.

(2) It began by stating:

> President Trump has laid out four principles for tax reform. First, make the tax code simple, fair and easy to understand. Second, give American workers a pay raise by allowing them to keep more of their hard-earned paychecks. Third, make America the jobs magnet of the world by leveling the playing field for American businesses and workers. Finally, bring back trillions of dollars that are currently kept offshore to reinvest in the American economy.
>
> …
>
> This unified framework serves as a template for the tax-writing committees that will develop legislation through a transparent and inclusive committee process. The committees will also develop additional reforms to improve the efficiency and effectiveness of tax laws and to effectuate the goals of the framework. The [House Ways and Means Committee and Senate Finance Committee] Chairmen welcome and encourage bipartisan support and participation in the process.

b. "Competitiveness and Growth for All Job Creators" (Businesses)

(1) Introduction:

> Small businesses drive our economy and our communities, and they deserve a significant tax cut. This framework creates a new tax structure for small businesses so they can better compete. Furthermore, America's outdated tax code has fallen behind the rest of the world – costing U.S. workers both jobs and higher wages. In response, the framework puts America's corporate tax rate below the average of other industrialized countries and promotes greater investment in American manufacturing.

(2) Tax rates matching the June 2016 House Republican leadership's "Blueprint."

(a) A top rate of 25 percent on "the business income of small and family-owned businesses conducted as sole proprietorships, partnerships and S corporations."

i. The Blueprint had described this income at one point as "small business and pass-through income."

ii. No doubt reacting to speculation that individuals in professions such as law or medicine could qualify for the reduced rate, the Framework added:

> The framework contemplates that the [Ways and Means and Finance] committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate.

(b) A top corporate rate reduced from 35 percent to 20 percent, which the Framework described as "below the 22.5% average of the industrialized world."

(c) Elimination of the corporate alternative minimum tax (AMT).

(3) "Expensing," or immediate write-off of capital investments "for at least five years," with an effective date of September 28, 2017. The Framework added: "The committees may continue to work to enhance unprecedented expensing for business investments, especially to provide relief for small businesses."

(4) The deduction for net interest expense incurred by C corporations "partially limited." The Framework added: "The committees will consider the appropriate treatment of interest paid by non-corporate taxpayers."

(5) With regard to other business deductions and credits, the Framework stated.

> Because of the framework's substantial rate reduction for all businesses, the current-law domestic production ("section 199") deduction will no longer be necessary. Domestic manufacturers will see the lowest marginal rates in almost 80 years. In addition, numerous other special exclusions and deductions will be repealed or restricted.
>
> The framework explicitly preserves business credits in two areas where tax incentives have proven to be effective in promoting policy goals important in the American economy: research and development (R&D) and low-income housing. While the framework envisions repeal of other business credits, the committees may decide to retain some other business credits to the extent budgetary limitations allow.
>
> ….
>
> Special tax regimes exist to govern the tax treatment of certain industries and sectors. The framework will modernize these rules to ensure that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance.

c. **"Tax Relief and Simplification for American Families" (Individuals)**

(1) Roughly doubling the standard deduction, or the "zero tax bracket."

(2) Collapsing the then current seven brackets into three brackets of 12, 25, and 35 percent.

(3) The Framework added:

(a) "An additional top rate may apply to the highest-income taxpayers to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers."

(b) "The framework also envisions the use of a more accurate measure of inflation for purposes of indexing the tax brackets and other tax parameters."

(4) Enhancing the child tax credit and middle class tax relief:

> To further simplify tax filing and provide tax relief for middle-income families, the framework repeals the personal exemptions for dependents and significantly increases the Child Tax Credit. The first $1,000 of the credit will be refundable as under current law.
>
> In addition, the framework will increase the income levels at which the Child Tax Credit begins to phase out. The modified income limits will make the credit available to more middle-income families and eliminate the marriage penalty in the existing credit.
>
> The framework also provides a non-refundable credit of $500 for non-child dependents to help defray the cost of caring for other dependents.
>
> Finally, the committees will work on additional measures to meaningfully reduce the tax burden on the middle-class.

(5) Repeal of the individual alternative minimum tax (AMT).

(6) Elimination of most itemized deductions, other than deductions for home mortgage interest and charitable contributions.

(7) Under the heading of "Work, Education and Retirement":

> The framework retains tax benefits that encourage work, higher education and retirement security. The committees are encouraged to simplify these benefits to improve their efficiency and effectiveness. Tax reform will aim to maintain or raise retirement plan participation of workers and the resources available for retirement.

(8) Under the heading of "Other Provisions Affecting Individuals":

> Numerous other exemptions, deductions and credits for individuals riddle the tax code. The framework envisions the repeal of many of these provisions to make the system simpler and fairer for all families and individuals, and allow for lower tax rates.

d. **Transfer Taxes**

(1) "The framework repeals the death tax and the generation-skipping transfer tax."

(2) The "Death Tax Repeal Act of 2015" (H.R. 1105), discussed in Part 16.a above, was expected to be the initial model for repeal of the estate and GST taxes.

(a) Sure enough, the designated vehicle for estate tax repeal, the "Death Tax Repeal Act of 2017," H.R. 631, introduced by Rep. Kristi Noem (R-South Dakota) and Rep. Sanford Bishop (D-Georgia) on January 24, 2017, was substantially similar to H.R. 1105 (including the continued taxation for 10 years of distributions from QDOTs), except that the clerical and conforming amendments were organized more consistently with federal tax legislation standards and the enigmatic section 2511(c), discussed in Part 16.a(1)(c) above, was omitted. The bill would be effective on the date of enactment.

(b) A "companion bill," S. 205, introduced the same day by Senator John Thune (R-South Dakota), included section 2511(c), but did not reflect the format clean-ups.

(c) Meanwhile, on January 3, 2017, Rep. Mac Thornberry (R-Texas) introduced H.R. 198, also called the "Death Tax Repeal Act of 2017," which would totally repeal the estate, GST, and gift taxes, with no other changes to the law. When it was introduced it had 39 cosponsors, and by April 3, 2017, it had 61 cosponsors, all Republicans.

(d) In any event, the statements of majority and minority views and the testimony of witnesses summarized in Part 16.a can provide relevant perspective and background for future debates.

e. **Rollout (September 27, 2017)**

(1) Republican congressional leaders announced it together.

(2) President Trump spoke in Indiana, Vice President Pence's state.

(3) Secretary Mnuchin issued a statement:

> Today President Donald J. Trump shared how middle-income families will win when we cut their taxes, and make American businesses competitive again. The President outlined a framework with Congress that will create a simpler and fairer tax code that fuels job creation, higher wages, and economic growth, and will lead to the lowest marginal income tax rate for small and mid-size businesses in more than 80 years. Indiana is a great example of how tax relief and reforms like these can lead to record-high employment, more investment in education and innovation, and more manufacturing right here in America. Democrats and Republicans have a historic opportunity to work together to pass meaningful legislation that, as the President stated, will begin the "Middle Class Miracle." With the President's leadership, we will create a level playing field so that American businesses and workers will be in a position to succeed in our global economy.

22. Consideration of the "Tax Cuts And Jobs Act"

a. **Introduction and Initial Consideration**

(1) The "Tax Cuts and Jobs Act" was introduced as H.R. 1 by Ways and Means Committee Chairman Kevin Brady on November 2, 2017. Chairman Brady followed with a "chairman's mark, or "amendment in the nature of a substitute," on November 3 and a shorter targeted amendment on November 6, both making a few technical corrections. The Ways and Means Committee finished reviewing and amending H.R. 1 on November 9. The House approved it on November 16 by a vote of 227-205. The vote was very partisan: 13 Republicans voted against it, but no Democrat voted for it.

(2) On November 9, Senate Finance Committee Chairman Orrin Hatch revealed a different version of H.R. 1, reflected in a publication of the staff of the Joint Committee on Taxation titled "Description of the Chairman's Mark of the 'Tax Cuts and Jobs Act.'" Statutory language,

reflecting the Finance Committee's approval, was released on November 21. On November 29, 2017, the Senate agreed, by a strictly partisan vote of 52-48, to consider the substitution of the Finance Committee version for the House-passed H.R. 1. After several amendments, the Senate approved a substitute by a vote of 51-49. Again the vote was very partisan: Senator Corker of Tennessee was the only Republican to vote against it, and no Democrat voted for it. In general, the provisions of the Senate version sunsetted in 2026.

b. **Income Tax Provisions**

(1) The House version of H.R. 1 followed the Blueprint of June 23, 2016 (Part 19 above) and the Unified Framework of September 27, 2017 (Part 21 above) by proposing (i) a corporate income tax rate of 20 percent, (ii) a 25 percent net rate on the business income of individuals (either in a sole proprietorship or in a passthrough entity), and (iii) repeal of the corporate alternative minimum tax, all effective January 1, 2018.

(2) The Senate version (i) embraced the 20 percent corporate rate, but deferred it until 2019, (ii) recast the individual business income provision in a more mathematically subtle manner as a deduction generally of "the lesser of (A) 23 percent of the taxpayer's qualified business income with respect to the trade or business, or (B) 50 percent of the W-2 wages with respect to the qualified trade or business," and (iii) retained the corporate AMT but with an exemption for that "qualified business income."

(3) The House version generally followed the Blueprint and Framework regarding individual income tax rates and supplied four brackets for those rates. The Senate version would retain seven brackets, but would recast them, again in a more mathematically subtle manner. Here, for example, is a comparison of the House and Senate versions with former law for married individuals filing joint returns and surviving spouses:

Married Couples Filing Jointly and Surviving Spouse					
Former Law (for 2018)		House Version (2018)		Senate Version (2018)	
Rate	Starting at (taxable income)	Rate	Starting at (taxable income)	Rate	Starting at (taxable income)
10%	$0	12%	$0	10%	$0
15%	$19,050			12%	$19,050
25%	$77,400	25%	$90,000	22%	$77,400
28%	$156,150			24%	$140,000
33%	$237,950	35%	$260,000	32%	$320,000
35%	$424,950			35%	$400,000
39.6%	$480,050	39.6%	$1,000,000	38.5%	$1,000,000

(4) And for estates and trusts:

Estates and Trusts					
Former Law (for 2018)		House Version (2018)		Senate Version (2018)	
Rate	Starting at (taxable income)	Rate	Starting at (taxable income)	Rate	Starting at (taxable income)
15%	$0	12%	$0	10%	$0
25%	$2,600	25%	$2,550	24%	$2,550
28%	$6,100	35%	$9,150	35%	$9,150
33%	$9,300				
39.6%	$12,700	39.6%	$12,500	38.5%	$12,500

The House and Senate's proposed 2018 brackets were the current 2017 brackets.

(5) In both versions, bracket amounts would be indexed after 2018, but by reference not to the customary Consumer Price Index (CPI), but to a "Chained CPI." A Chained CPI would take into account anticipated consumer shifts from products whose prices increase to products whose prices do not increase or increase at a lower rate. The result would generally be slower inflation adjustments and higher tax levels over the long term.

(6) The House version would have repealed the individual alternative minimum tax. The Senate version retained the individual AMT, with a significantly increased exemption.

c. **Transfer Tax Provisions**

(1) Effective January 1, 2018, both the House and Senate versions of H.R. 1 doubled the exemptions – technically the basic exclusion amount for estate and gift tax purposes and the GST exemption for GST tax purposes. Thus, those amounts for 2018 would be approximately $11,200,000 (2 times $5,600,000). The exemptions would continue to be indexed for inflation going forward, also by using a "Chained CPI" approach. The tax rate would remain 40 percent.

(2) Effective January 1, 2025, the House version of H.R. 1, but not the Senate version, would repeal the estate and GST taxes – technically, would provide that those taxes "shall not apply."

(a) The gift tax would be retained, at a rate of 35 percent (its lowest point in recent history, in 2010). The doubled exclusion amount, indexed, would continue.

(b) Basis rules would not change. Indeed, amendments to section 1014 would explicitly preserve the stepped-up basis for appreciated assets at death.

(c) Distributions from (but not terminations of) qualified domestic trusts (QDOTs) for surviving spouses of decedents dying before January 1, 2025, would continue to be taxed as under the then current law through 2034.

(d) Except for the deferred effective date, these provisions would resemble the "Death Tax Repeal Act of 2015" passed by the House of Representatives on April 16, 2015 (see Part 16.a above) and the "Death Tax Repeal Act of 2017" introduced on January 24, 2017 (see Part 21.d(2)(a) above).

23. The 2017 Tax Act

a. **Enactment**

(1) The conference agreement to resolve the differences between the House and Senate versions of H.R. 1 was approved by the House 227-203 on December 19, by the Senate 51-48 early on December 20, and by the House again 224-201 later on December 20 to approve changes made by the Senate. Again the votes were very partisan. In the House 12 Republicans voted against it and no Democrat voted for it. In the Senate all the Democrats voted against it and all the Republicans voted for it except Senator McCain, who was not in Washington.

(2) One of the changes made by the Senate was to drop the short title "Tax Cuts and Jobs Act" when the Senate parliamentarian ruled that the reference to "Jobs" was not strictly fiscal enough to comply with the "Byrd Rule" for budget reconciliation in the Senate. The description in the Act – "An Act To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" – will probably not be commonly used.

(3) President Trump signed the Act (Public Law 115-97) on December 22, 2017.

b. **Income Tax Provisions**

(1) The compromise top corporate income tax rate, apparently selected mainly to make the revenue estimates acceptable, was 21 percent.

(2) The Qualified Business Income Deduction in section 199A largely followed the Senate model, again to help the Senate comply with its reconciliation rules, but at a 20 percent level, and included adjustments designed to achieve certain fiscal goals or meet the specific concerns of

some lawmakers. After some suspense, trusts were included among the passthrough entities receiving the preferential treatment.

(3) The basic income tax rates and brackets with respect to ordinary income resembled the Senate version.

(a) The Senate's proposed top rate of 38.5 percent was reduced to 37 percent. The top four individual brackets were flattened somewhat, with the starting point for the top bracket reduced from $1,000,000 to $600,000 (although the top *rate* was also reduced). The result was that the 2018 tax on a married couple's taxable income of $1,000,000 would have been $301,479 under the Senate version, but was $309,379 under the 2017 Tax Act.

(b) With the lower top rate of 37 percent in the final Act, the crossover point was $1,526,667. At a taxable income of $1,526,667, a married couple's tax would be the same under both the Senate substitute and the Act – $504,246. At a taxable income above $1,526,667, the tax was lower under the Act.

(4) Here is a comparison of the 2017 Tax Act with former law for married individuals filing joint returns and surviving spouses:

Married Couples Filing Jointly and Surviving Spouses			
Former Law (for 2018)		**New Law (2018)**	
Rate	**Starting at (taxable income)**	**Rate**	**Starting at (taxable income)**
10%	$0	10%	$0
15%	$19,050	12%	$19,050
25%	$77,400	22%	$77,400
28%	$156,150	24%	$165,000
33%	$237,950	32%	$315,000
35%	$424,950	35%	$400,000
39.6%	$480,050	37%	$600,000

(5) And for estates and trusts:

Estates and Trusts			
Former Law (for 2018)		**New Law (2018)**	
Rate	**Starting at (taxable income)**	**Rate**	**Starting at (taxable income)**
15%	$0	10%	$0
25%	$2,600	24%	$2,550
28%	$6,100	35%	$9,150
33%	$9,300		
39.6%	$12,700	37%	$12,500

As in the House and Senate versions, the 2018 brackets were the same as the 2017 brackets.

(6) As in both the House and Senate versions, bracket amounts were indexed after 2018 by reference to a "Chained CPI."

(7) As in the Senate version, the Act retained the individual alternative minimum tax, with a significantly larger exemption and much higher phase-out threshold.

c. Estate and Trust Administration Expenses

(1) The Act added new Section 67(g) as follows:

> **(g) Suspension for taxable years 2018 through 2025**.—Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026

(2) Section 67, and specifically subsection (a), was added to the Code by the Tax Reform Act of 1986 to subject most itemized deductions to a floor equal to 2 percent of adjusted gross income. Subsection (b) defines "miscellaneous itemized deductions" as all itemized deductions except 12 specified deductions that are excluded from the definition. Thus, simply put, what Congress did in the 2017 Tax Act was to completely disallow the deductions it had merely limited in the 2-percent floor in 1986.

(3) The Tax Reform Act of 1986 also added subsection (e), which, since its amendment in 1988, provides:

> **(e) Determination of adjusted gross income in case of estates and trusts.**
>
> For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—
>
> (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and
>
> (2) the deductions allowable under sections 642(b), 651, and 661,
>
> shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

d. **Transfer Tax Provisions**

(1) The 2017 Tax Act did not repeal the estate and GST taxes, not even in the future or temporarily (as in 2001).

(2) There were no structural or technical changes to the estate, gift, and GST taxes, and no changes to the determination of the basis of property received by gift or upon death.

(3) The only change was to double the basic exclusion amount for estate and gift tax purposes and the GST exemption for GST tax purposes – as both the House version (through 2024) and Senate version (through 2025) would have done. In the final Act, the doubling of the exemptions was made to sunset January 1, 2026, as in the Senate version, to help the Senate comply with its reconciliation rules.

(4) Annual increases in the exemptions, **including the initial increase from 2017 to 2018 itself**, are measured, like income tax brackets and other significant numbers under the Act, by a "Chained" Consumer Price Index, resulting in slower inflation adjustments over the long term. This has made the basic exclusion amount $11.18 million for 2018 (Rev. Proc. 2018-18, 2018-10 I.R.B. 392, sec. 3.35), $11.4 million for 2019 (Rev. Proc. 2018-57, 2018-49 I.R.B. 827, sec. 3.41), $11.58 million for 2020 (Rev. Proc. 2019-44, 2019-47 I.R.B. 1093, sec. 3.41), $11.7 million for 2021 (Rev. Proc. 2020-45, 2020-46 I.R.B. 1016, sec. 3.41), and $12.06 million for 2022 (Rev. Proc. 2021-45, 2021-48 I.R.B. 764, sec. 3.41).

(5) The Act retained section 2001(g), redesignated section 2001(g)(1), the "anti-clawback" language added by the 2010 Tax Act to prevent, in effect, gifts exempt from gift tax under the higher exemption from being nevertheless subject to estate tax if the increased exemption were to actually "sunset" – then in 2013 and now in 2026. This is a lesson the drafters learned after the awkward failure to address such a scenario in the 2001 Tax Act, although section 2001(g)(1) standing alone arguably is insufficient. See Part 7.g(6) above.

(a) The potential for clawback results from the decision made when the gift and estate tax rates were "unified" by the Tax Reform Act of 1976 to replace the historic exemptions ($30,000 for the gift tax and $60,000 for the estate tax) with a credit, because "a tax credit tends to confer more tax savings on small- and medium-sized estates" and therefore "would be more equitable" (H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 15 (1976)). With estate and gift taxes now viewed as being imposed in effect at a flat rate, and "small- and medium-sized estates" now exempt, that decision now produces little equity but considerable complexity in tax return preparation and, as seen here, in statutory drafting.

(b) In fact, the statutory drafting was apparently so daunting that Congress simply gave up and left completion of the task to Treasury in a new section 2001(g)(2):

> (2) Modifications to estate tax payable to reflect different basic exclusion amounts.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—
>
> (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
>
> (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

(c) This looks simply like authority to do the math needed to carry out the mandate of the 2010 Tax Act in section 2001(g)(1), although some expressed concern that it could be used to cut back the benefits to decedents' estates that the 2017 Tax Act was intended to confer, either by Treasury and IRS drafters not necessarily as committed to the agenda of the congressional leadership or by a new Administration.

(d) Here is a simplified illustration of how clawback might work. (For a more detailed analysis, in the context of the 2010 Tax Act, see Part 7.g(5) above.)

i. For the sake of simplicity, assume an unindexed exclusion amount of $10 million in 2018 under the 2017 Tax Act, reverting to $5 million after sunset in 2026, and no portability.

ii. Assume that the donor's only lifetime taxable gift is a gift of $10 million in 2018, the donor dies in 2026 with a taxable estate (line 3 of Form 706) of $20 million, and there has been no change in the law.

iii. There is no gift tax on the 2018 gift because of the exclusion amount.

iv. Intuitively, the estate tax in 2026 should be $8 million – 40 percent of $20 million.

v. Adjusted taxable gifts under section 2001(b)(1)(B) (line 4) are $10 million, and the total base for the tentative tax under section 2001(b)(1) (line 5) is $30 million ($20 million + $10 million). The tentative tax on $30 million under section 2001(c) (line 6) is $11,945,800.

vi. Using "the rates of tax … in effect at the decedent's death" under section 2001(g)(1) – but not the exclusion amount in effect at the decedent's death (because section 2001(g)(1) addresses only "rates") – the subtraction under section 2001(b)(2) (line 7) is zero (which is what the gift tax on the 2018 gift was).

vii. Thus, the gross estate tax computed under section 2001(b) (line 8) is $11,945,800. Subtracting the applicable credit amount (line 11) of $1,945,800 (calculated on a $5 million exclusion amount) leaves a net estate tax (lines 12 and 16) of $10 million.

viii. This result of $10 million exceeds the intuitively correct result of $8 million by exactly **$2 million** (40 percent of the additional $5 million exclusion in 2018). That is the clawback penalty.

(e) The regulatory response of Treasury and the IRS to the clawback potential is discussed in Part 29.c below.

24. Administrative Guidance in the Trump Administration

a. Design Changes in the 2017-2018 Priority Guidance Plan

The 2017-2018 Treasury-IRS Priority Guidance Plan (for the 12 months beginning July 1, 2017) was released on October 20, 2017 (**https://www.irs.gov/pub/irs-utl/2017-2018_pgp_initial.pdf**). Reflecting additional review mandated by President Trump, the organization and tone of the 2017-2018 Priority Guidance Plan differed from previous Plans, including its division into several parts. The introduction to the original October 2017 Plan provided the following explanation:

> Part 1 [ultimately Part 2] of the plan focuses on the eight regulations from 2016 that were identified pursuant to Executive Order 13789 and our intended actions with respect to those regulations. Part 2 [ultimately Part 3] of the plan describes certain projects that we have identified as burden reducing and that we believe can be completed in the 8½ months remaining in the plan year. As in the past, we intend to update the plan on a quarterly basis, and additional burden reduction projects may be added. Part 3 [later Part 4 and then Part 5] of the plan describes the various projects that comprise our implementation of the new statutory partnership audit regime, which has been a topic of significant concern and focus as the statutory rules go into effect on January 1, 2018. Part 4 [later Part 5 and then Part 6] of the plan, in line with past years' plans and our long-standing commitment to transparency in the process, describes specific projects by subject area that will be the focus of the balance of our efforts this plan year.

b. 2018-2019, 2019-2020, and 2020-2021 Priority Guidance Plans

Treasury and the IRS released their 2018-2019 Priority Guidance Plan (for the 12 months from July 2018 through June 2019) on November 8, 2018, and the Fourth Quarter Update to the Plan (**https://www.irs.gov/pub/irs-utl/2018-2019_pgp_4th_quarter_update.pdf**) on August 28, 2019. They released their 2019-2020 Priority Guidance Plan (for the 12 months from July 2019 through June 2020) on October 8, 2019, and the Fourth Quarter Update on September 2, 2020 (**https://www.irs.gov/pub/irs-utl/2019-2020_pgp_4th_quarter_update.pdf**). They released their 2020-2021 Priority Guidance Plan (for the 12 months from July 2020 through June 2021) (**https://www.irs.gov/pub/irs-utl/2020-2021_pgp_initial.pdf**) on November 17, 2020.

(1) Regulations Under Sections 199A and 643(f)

(a) In the 2019-2020 Priority Guidance Plan, Part 1 was titled "Implementation of Tax Cuts and Jobs Act (TCJA)," and Item 16 of Part 1 was described as "Guidance on computational, definitional, and anti-avoidance rules under §199A and §643(f). Final and proposed regulations were published on February 8, 2019. Notice 2019-07 was published on February 25, 2019."

(b) A 184-page Notice of Proposed Rulemaking (including a 104-page preamble) was released on August 8, 2018 (REG-107892-18) and published at 83 Fed. Reg. 40884 (Aug. 16, 2018). The IRS received over 300 comments and heard from 28 witnesses at a public hearing on October 16, 2018. Final regulations were released on January 18, 2019, corrected on February 1, 2019, and published as **Regs. §§1.199A-0, 1.199A-1, 1.199A-2, 1.199A-3, 1.199A-4, 1.199A-5, 1.199A-6, and 1.643(f)-1, T.D. 9847, 84 Fed. Reg. 2952 (Feb. 8, 2019), 2019-9 I.R.B. 670 (Feb. 25, 2019), corrected, 84 Fed. Reg. 15954 (April 17, 2019)**.

(c) Reg. §1.199A-1 provides that the term "trade or business" will be applied consistently with the guidance under section 162, which allows a deduction for ordinary and necessary business expenses. The regulations, however, expand the traditional definition under section 162 to include certain rental or licensing of property to related parties under common control. Notice 2019-7, issued contemporaneously with the final regulations, contains a draft revenue procedure prescribing safe harbor parameters for a real estate rental business. The regulations provide that the section 199A deduction is applied at the partner or shareholder level. The final regulations clarify that the rules of subchapters K and S apply in determining each partner's or shareholder's share of applicable items and that an entity with a single owner that is disregarded as an entity separate from its owner under Reg. §301.7701-3 is disregarded under section 199A also. The section 199A deduction does not affect the adjusted basis of a partner’s interest in a partnership, the adjusted basis of a shareholder’s stock in an S corporation, or an S corporation’s accumulated adjustments account.

(d) Reg. §1.199A-2 prescribes rules for determining W-2 wages of a qualified trade or business for purposes of section 199A, generally using the rules that applied under former section 199 with respect to the domestic production activities deduction. Rev. Proc. 2019-11, issued contemporaneously with the final regulations, further explains methods that may be used to calculate W-2 wages for this purpose. Reg. §1.199A-2 also addresses many issues concerning the related factor used in computing the deduction – the unadjusted basis immediately after the acquisition (UBIA) of qualified property – including its allocation among relevant passthrough entities, the effect of subsequent improvements to the qualified property, and the effect of nonrecognition transactions such as like-kind exchanges.

(e) Reg. §1.199A-3 restates the definition of qualified business income (QBI) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified publicly traded partnership income. The regulations describe in further detail the exclusions from QBI, including capital gains, interest income, reasonable compensation, and guaranteed payments.

(f) Reg. §1.199A-4 addresses rules for aggregating multiple trades or businesses for purposes of applying section 199A. Comments from the public had urged the IRS to apply the grouping rules for determining passive activity loss and credit limitation rules under section 469. The IRS concluded that the rules under section 469 were inappropriate for purposes of section 199A, but did agree that some aggregation should be permitted.

(g) Reg. §1.199A-5 contains guidance related to a specified service trade or business (SSTB).

i. In general, under section 199A, if a trade or business is an SSTB, none of its items are taken into account for determining a taxpayer’s QBI. A taxpayer who owns an SSTB conducted through an entity, such as an S corporation or partnership, is treated as engaged in an SSTB for purposes of section 199A, regardless of the taxpayer’s actual level of participation in the trade or business.

ii. Notwithstanding that general rule, taxpayers with taxable income of less than $157,500 ($315,000 for married couples filing jointly) may claim a deduction under section 199A for QBI received from an SSTB. The section 199A deduction phases out for taxpayers with taxable incomes over this threshold amount. If a trade or business is conducted by a passthrough entity, the phase-out threshold is determined at the individual, trust, or estate level, not at the level of the passthrough entity.

iii. The regulations contain a lengthy and detailed definition of an SSTB. Pursuant to section 199A(d)(2)(A), which incorporates the rules of section 1202(e)(3)(A), an SSTB is any trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, or trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. The regulations limit “reputation or skill” to trades or businesses involving the receipt of income for endorsing products or services, licensing or receiving income for the use of an individual’s publicity rights, or receiving appearance fees.

iv. The common law and statutory rules used to determine whether an individual is an employee for federal employment tax purposes apply to determining whether an individual is engaged in the trade or business of performing services as an employee for purposes of section 199A. In an effort to prevent taxpayers from reclassifying employees as independent contractors in order to claim a section 199A deduction, the regulations also create a rebuttable presumption that an individual who was treated as an employee for federal income tax purposes but is subsequently treated as other than an employee with respect to the same services is for three years still engaged in the trade or business of performing services as an employee for purposes of section 199A. The limitation to three years was added in the final regulations.

(h) Reg. §1.199A-6 contains special rules for passthrough entities, publicly traded partnerships, nongrantor trusts, and estates.

   i. Passthrough entities, including S corporations and entities taxable as partnerships for federal income tax purposes, cannot claim a deduction under section 199A. Any passthrough entity conducting a trade or business, along with any publicly traded partnership conducting a trade or business, must report all relevant information – including QBI, W-2 wages, basis of qualified property, qualified REIT dividends, and qualified publicly traded partnership income – to its owners so they may determine the amount of their respective section 199A deductions.

   ii. The regulations require that a nongrantor trust or estate conducting a trade or business allocate QBI, expenses properly allocable to the trade or business, W-2 wages, and basis of qualified property among the trust or estate and its beneficiaries. The allocation is based on the ratio that the distributable net income (DNI) distributed or deemed distributed to each beneficiary bears to the trust's or estate's total DNI for the taxable year. Any DNI not distributed is allocated to the nongrantor trust or estate itself. The unadjusted basis immediately after acquisition of qualified property is allocated without taking into account how depreciation deductions are allocated among the beneficiaries under section 643(c). On June 24, 2020, **T.D. 9899** added Reg. §1.199A-6(d)(3)(iii), effective August 24, 2020, clarifying that in the case of a trust or estate subject to the separate share rules of section 663(c), the allocation of these items to the separate shares will be governed by the regulations under section 663(c).

   iii. T.D. 9899 also added Reg. §1.199A-6(d)(3)(v), confirming that a charitable remainder trust described in section 664 is not entitled to a section 199A deduction because it is not subject to income tax. It also provides, however, that a taxable recipient of a unitrust or annuity amount from the trust applies the recipient's own threshold amount for purposes of section 199A, taking into account the annuity or unitrust amount received, and may take relevant section 199A items into account for purposes of determining the section 199A deduction to the extent that the unitrust or annuity amount distributed to that recipient consists of such items under Reg. §1.664-1(d).

   iv. For purposes of the section 199A regulations, a qualified subchapter S trust (QSST) is treated as a grantor trust, and the individual treated as the owner of the QSST is treated as having received QBI directly from the trade or business and not through the QSST. The IRS and Treasury requested comments on whether a taxable recipient of an annuity or unitrust interest in a charitable remainder trust should be eligible for a section 199A deduction to the extent the taxpayer receives QBI from the trust.

(i) The regulations under section 199A are generally effective as of February 8, 2019, the date they were published in the Federal Register. But the preamble to the final regulations provides that for taxable years ending in 2018 taxpayers may rely either on the final regulations under section 199A in their entirety or on the proposed regulations in their entirety.

(j) Rev. Proc. 2019-38, 2019-42 I.R.B. 942, providing a safe harbor for certain rental real estate enterprises, was released September 24, 2019.

(k) In addition to regulations under section 199A, the IRS and Treasury issued regulations under **section 643(f)** to prevent taxpayers from manipulating the section 199A deduction by the use of **multiple trusts**.

i. Section 643(f), enacted by the Deficit Reduction Act of 1984, states:

> For purposes of this subchapter [subchapter J], under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter. For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

ii. Proposed Reg. §1.643(f)-1(a), mirroring the statute, stated that

> two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

iii. Proposed Reg. §1.643(f)-1(b) added, however, that:

> A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts.

iv. The effective downgrading of the "principal purpose" standard to a "significant income tax benefit" standard in the proposed regulations was quite controversial and was likely to be challenged if it had been finalized without change. But the final regulations dropped that proposal and are limited to mirroring the statute in Reg. §1.643(f)-1(a), with only the clarification that "a principal purpose for establishing such trusts" means "a principal purpose for establishing *one or more of* such trusts." The preamble to the final regulations reported that "the Treasury Department and the IRS … are taking under advisement whether and how these questions should be addressed in future guidance."

v. Unlike the regulations under section 199A, which are generally effective on February 8, 2019, the date they were published in the Federal Register, this multiple trust rule mirroring the 1984 statute applies to taxable years ending after August 16, 2018, the date the proposed regulations were published. Moreover, the preamble to the final regulations added:

> Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

(2) **Regulations Relating to Estate and Trust Administration Expenses**

(a) Item 4 of Part 1 in the 2020-2021 Priority Guidance Plan was described as "Regulations clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts. Notice 2018-61 was published on July 30, 2018 and proposed regulations were published on May 11, 2020." This item first appeared in the 2018-2019 Priority Guidance Plan.

(b) Notice 2018-61, 2018-31 I.R.B. 278, released on July 13, 2018, stated that "[t]he Treasury Department and the IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses described in section 67(e)(1)" despite the eight-year "suspension" of section 67(a) in the 2017 Tax Act by new section 67(g). The IRS received comments from the public agreeing with that statement and confirmed it in an amendment to Reg. §1.67-4(a)(1) proposed in REG-113295-18, 85 Fed. Reg. 27693 (May 11, 2020), and finalized by **T.D. 9918, 85 Fed. Reg. 66219 (Oct. 19, 2020)**.

(c) Deductibility, however, continues to be limited by the harsh treatment in Reg. §1.67-4(b)(4) and (c)(2) of fees for investment advice, including the portion of a "bundled" fiduciary fee attributable to investment advice (which now will mean total disallowance, not just the application of a 2-percent floor). Reg. §1.67-4(a)(1)(i)(A) & 4(a)(2). Notice 2018-61 had stated flatly that "nothing in section 67(g) impacts the determination of what expenses are described in section 67(e)(1)." In addition, the new regulations do not address the treatment of deductions for purposes of the alternative minimum tax, and the preambles to both the proposed and final regulations state that such treatment "is outside the scope of these [proposed] regulations."

(d) Notice 2018-61 also indicated that regulations would address the availability of "excess deductions" to individual beneficiaries under section 642(h)(2) on termination of a trust or estate, including the treatment of those deductions as miscellaneous itemized deductions (and therefore entirely nondeductible through 2025) as current Reg. §1.642(h)-2 implies, and the Notice asked for comments on those issues.

i. Public comments urged relief on those points, noting, as the preamble to the proposed regulations put it, "that the regulations under §1.642(h)-2 were written before the concept of miscellaneous itemized deductions was added to the Code and need to be updated."

ii. The regulations affirm the availability to beneficiaries of such excess deductions and affirm, as comments recommended, that "[e]ach deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust." Reg. §1.642(h)-2(b)(1).

iii. The final regulations include helpful clarifications of the allocation of expenses among items of income, including the fiduciary's discretion to make those allocations, that had been recommended by public comments on the proposed regulations.

iv. Accordingly, the 2020 "Instructions for Schedule K-1 (Form 1041) for a Beneficiary Filing Form 1040 or 1040-SR" (released Oct. 21, 2020), citing the final regulations, clarify and elaborate previous versions in explanations titled "Box 11, Code A—Excess Deductions on Termination - Section 67(e) Expenses" and "Box 11, Code B—Excess Deductions on Termination - Non-Miscellaneous Itemized Deductions."

(e) The ability of fiduciaries to pass through those final-year excess deductions provides very important relief from what would otherwise be pressure to artificially time the payment of expenses, the sale or distribution of assets, and the termination of the trust or estate in ways that could be unfair and frustrating to both fiduciaries and beneficiaries.

(3) **Opportunity Zone Regulations and Implications for Estate Planning in General**

Item 33 of Part 1 in the 2020-2021 Priority Guidance Plan was described as "Guidance under §§1400Z–1 and 1400Z–2 concerning Opportunity Zones, including census tract changes. Proposed regulations were published on October 29, 2018 and May 1, 2019. Final regulations were issued on January 13, 2020. Notice 2020-39 was published on June 22, 2020." Those regulations may shed some light on how the IRS might view common estate planning structures.

(a) **2017 Statutory Background.** One of the provisions of the 2017 Tax Act that had bipartisan support added a new Subchapter Z to the income tax chapter of the Internal Revenue Code, containing two new sections 1400Z-1 and 1400Z-2. These sections provide income tax incentives to invest in distressed low-income communities called "opportunity zones." A qualified opportunity fund (QOF) is a corporation or partnership that has at least 90 percent of its assets invested in qualified opportunity zone property.

i. An investor who has sold appreciated property may defer recognition of the resulting capital gain, at least until December 31, 2026, by investing the amount of the gain in a qualified opportunity fund within 180 days. The investor's basis in the QOF is initially zero and increases by 10 percent of the original deferred gain after five years (in effect the forgiveness of 10 percent of the original gain) and by another 5 percent after seven years (in effect the forgiveness of another 5 percent of the original gain). On December 31, 2026, the gain is recognized and the investor's basis in the fund is stepped up to the amount of the original gain that was invested in the fund.

ii. Of course, Congress might extend the December 31, 2026, recognition date, as it might extend some or all of the other provisions of the 2017 Tax Act that sunset at the beginning of 2026. It is already impossible to make an investment and hold it for seven years before December 31, 2026. In addition, section 1400Z-2(c) provides an opportunity to avoid recognition of all gain and obtain a fair market value basis by holding the investment for 10 years (necessarily beyond December 31, 2026).

(b) **2019 Regulations.** Regulations implementing these provisions were published as proposed regulations in May 2019 and finalized in December 2019. **T.D. 9889, 85 Fed. Reg. 1866 (Jan. 13, 2020).** As released by the Treasury Department and the IRS (not as published in the Federal Register), the final regulations are 190 pages, and the Preamble is 354 pages. The regulations discussed here generally took effect for taxable years beginning after March 13, 2020 (that is, for calendar year taxpayers, January 1, 2021), with taxpayers permitted to elect to apply them earlier.

(c) **"Inclusion Event."** Reg. §1.1400Z2(b)-1 provides rules for determining when deferred gain is accelerated by an "inclusion event" regarding an investor's interest in a QOF, which the regulations call a "qualifying investment" (defined in Reg. §1.1400Z2(a)-1(b)(34)).

(d) **Gifts.** Of most interest from an estate planning perspective, Reg. §1.1400Z2(b)-1(c)(1)(i) provides that an event is an inclusion event if it "reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment." As suggested by that broad definition, Reg. §1.1400Z2(b)-1(c)(3)(i) provides in general that a transfer of a qualifying investment by **gift** is an inclusion event.

(e) **Transfers at Death.** Reg. §1.1400Z2(b)-1(c)(4)(i) provides that a transfer of a qualifying investment by reason of the investor's **death** is not an inclusion event. It further provides:

> Transfers by reason of death include, for example:
>
> (A) A transfer by reason of death to the deceased owner's estate;
>
> (B) A distribution of a qualifying investment by the deceased owner's estate;
>
> (C) A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death;
>
> (D) The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law; and
>
> (E) Any other transfer of a qualifying investment at death by operation of law.

In contrast, Reg. §1.1400Z2(b)-1(c)(4)(ii) specifies that "a transfer by reason of the taxpayer's death" does not include any other sale, exchange, or disposition by the deceased investor's estate or trust, any disposition by the legatee, heir, beneficiary surviving joint owner, or other recipient who received the qualifying investment by reason of the taxpayer's death.

(f) **Grantor Trusts.** An exception from the treatment of gifts of qualifying investments as inclusion events is Reg. §1.1400Z2(b)-1(c)(5)(i), which exempts a contribution to a trust if "under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust)."

i. The reference to subpart E generally and the use of the term "deemed owner" rather than "grantor" suggest that the regulation applies to trusts deemed owned by a third party under section 678, not just trusts owned by the "grantor" under sections 673 through 677. And, in an addition not included in the May 2019 proposed regulations, Reg. §1.1400Z2(b)-1(c)(5)(i) goes on to provide:

> Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event. For all purposes of the section 1400Z-2 regulations, references to the term grantor trust mean the portion of the trust that holds the qualifying investment in the QOF, and such a grantor trust, or portion of the trust, is a wholly grantor trust as to the deemed owner. Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules.

ii. This addition helpfully clarifies that transfers from the trust to the deemed owner, not just transfers from the deemed owner to the trust, are exempt from treatment as inclusion events. It also clarifies that the term "contribution" includes not just gifts (as in funding the trust) but "any other type of transfer … that is a nonrecognition event as a result of the application of the grantor trust rules." As an example, a sale to a deemed owned trust comes to mind. The Preamble, somewhat timidly, seems to affirm application to a sale in the following explanation:

> A commenter also requested clarification that non-gift transactions between a grantor trust and its deemed owner that are not recognition events for Federal income tax purposes are not inclusion events, and that such transactions do not start a new holding period for purposes of section 1400Z. In such transactions, the deemed owner of the trust continues, for Federal income tax purposes, to be the taxpayer liable for the Federal income tax on the qualifying investment. Thus, the Treasury Department and the IRS have determined that, like transfers by the deemed owner to the grantor trust, these transactions (including transfers from the grantor trust to its deemed owner) are not inclusion events.

iii. Finally, Reg. §1.1400Z2(b)-1(c)(5)(ii) adds that "the termination of grantor trust status or the creation of grantor trust status … is an inclusion event," except that "termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event."

(g) **Tacking Holding Periods.** Consistently with the exception of transfers by reason of death and transfers to a deemed owned trust from treatment as an inclusion event, Reg. §1.1400Z2(b)-1(d)(1)(iii) provides that the recipient in either of those scenarios does not begin a new holding period for the qualifying investment, but succeeds to or "tacks" the decedent's or other transferor's holding period. This is a clarifying rewording of the proposed regulation (Proposed Reg. §1.1400Z2(b)-1(d)(1)(iv)), which bore the possibly misleading heading "Tacking with donor or deceased owner" and identified one of its subjects as "a gift that was not an inclusion event." The final regulation drops the use of the word "gift" and elaborates as follows:

> This same rule [applicable to transfers by reason of death] also applies to allow a grantor trust to tack the holding period of the deemed owner if the grantor trust acquires the qualifying investment from the deemed owner in a transaction that is not an inclusion event.

This does not explicitly pick up the expansion of Reg. §1.1400Z2(b)-1(c)(5)(i) to include "a transfer of the investment **by** the grantor trust **to** the trust's deemed owner" (emphasis added) described above, but it is reasonable to hope that in context the tacking rule of Reg. §1.1400Z2(b)-1(d)(1)(iii) will be given the same scope as Reg. §1.1400Z2(b)-1(c)(5)(i).

(h) **Comment.** Treatment of a gift as a recognition event is not the normal result estate planners are accustomed to, and it is especially surprising in light of section 1400Z-2(b)(1), which states that the otherwise deferred gain "shall be included in income in the taxable year which includes the earlier of (A) the date on which such investment is sold or exchanged, or (B) December 31, 2026."

i. A gift obviously is not a sale or exchange. But the Preamble explains why that obvious interpretation wouldn't work (emphasis added):

> As indicated … in the Explanation of Provisions in the May 2019 proposed regulations, the termination of a direct interest in a qualifying investment that resulted in an inclusion event terminated the status of an investment in a QOF as a qualifying investment "[f]or purposes of

sections 1400Z-2(b) and (c)." This is because the statutory text of each of section 1400Z-2(a), (b), (c), and (e)(1) focuses on one holding period of "the taxpayer" tested at various points during a period of at least 10 years. [The inclusion of subsection (e)(1) looks like a typo, possibly meant to be subsection (d)(3).]

…

This degree of identity of taxpayer [between the transferor and transferee] is fundamentally different (and more demanding) than a mere "step in the shoes" concept based on whether the transferee of the interest can tack the holding period and basis of the transferor. Accordingly, the May 2019 proposed regulations treated, among other transactions, gifts and section 351 exchanges as inclusion events because, in each instance, (i) the initial eligible taxpayer had severed the direct investment interest in the QOF and (ii) the transferee taxpayer was not treated for Federal income tax purposes either as the same taxpayer as the initial eligible taxpayer or as a successor taxpayer.

…

As noted in the preamble to the May 2019 proposed regulations, section 1400Z-2(b)(1) does not directly address non-sale or exchange dispositions, such as gifts and bequests. However, the Conference Report provides that, under section 1400Z-2(b)(1), the "deferred gain is recognized on the earlier of the date on which the [qualifying] investment *is disposed of* or December 31, 2026." See Conference Report at 539 (indicating that continued gain recognition deferral requires the taxpayer to maintain directly the taxpayer's qualifying investment).

… The Treasury Department and the IRS have concluded that (i) no authority exists to impose the donor's deferred capital gains tax liability on the donee of the qualifying investment, and therefore (ii) the Federal income tax on the deferred gain must be collected from the donor at the time of the gift of the qualifying investment. Accordingly, the final regulations continue to provide that a gift of the qualifying investment in a QOF is an inclusion event.

ii. In other words, a qualifying investment in a qualified opportunity fund is simply not like other assets, because section 1400Z-2 requires the tax law, in effect, to follow the investment, but the general rules in the rest of the Code do not provide a way to do that. So the tax is collected from the investor-transferor when the transfer is made.

iii. Applying that principle, the exception for transfers (in either direction) between a grantor trust and the deemed owner of the trust makes sense, because "the taxpayer" – that is, the deemed owner who bears the tax liability under the grantor trust rules – does not change. Indeed, although the regulations and Preamble do not cite Rev. Rul. 85-13, 1985-1 C.B. 184 (the acknowledged foundation of much grantor trust planning), they do mirror its analysis.

iv. Similarly, the creation or termination of grantor trust status does not qualify for the exception and must be treated as an inclusion event, because "the taxpayer" does change. Finally, a transfer at death can be exempted, because the rest of the Code does provide an enforcement tool in the rules of section 691 governing income in respect of a decedent, which are explicitly incorporated into section 1400Z-2(e)(3).

v. The Preamble provides confirmation of this analysis:

The Treasury Department and the IRS have determined that [rules similar to those for certain other passthrough entities] for a grantor trust are not necessary because the grantor is treated as the owner of the grantor trust's property for Federal income tax purposes. Therefore, the final regulations set forth different rules applicable to the grantor.

…

The Treasury Department and the IRS have received several comments requesting clarification that qualifying investments include interests received in a transfer by reason of death that is not an inclusion event. In the case of a decedent, section 1400Z-2(e)(3) provides a special rule requiring amounts recognized under section 1400Z-2, if not properly includible in the gross income of the decedent, to be includible in gross income as provided by section 691. In that specific case, the beneficiary that receives the qualifying investment has the obligation to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient. … In other words, unlike an inclusion event contemplated by the general rules of section 1400Z-2(b), the obligation to include the original taxpayer investor's deferred gain in income travels with that taxpayer's qualifying investment to the beneficiary. Accordingly, the May 2019 proposed regulations excepted transfers of a qualifying investment to the deceased owner's estate, as well as distributions by the estate, from the definition of "inclusion event."

(i) **Implications for Estate Planning in General.** Because of the unique origin and nature of QOFs, care is required in generalizing the rules of these regulations beyond the QOF context. But a few observations regarding the implications for estate planning in general include:

i. As noted above, the notion that a gift is a recognition event while death is not a recognition event is inconsistent with general rules, but is explained by the unique requirements of the QOF rules to follow the investment. Thus, the distinction between gifts and transfers by reason of death in the QOF regulations should have no general implications outside of that context.

ii. Similarly, when contrasted with general rules, it is ironic that a qualifying investment in effect gets a stepped-up basis upon a gift (because of the donor-investor's recognition) but a carryover basis at death (subject to the holding period that the recipient succeeds to or "tacks"). But that also is just the result of the unique requirements of the QOF rules, as well as the income in respect of a decedent rules that always, in effect, produce a carryover basis at death.

iii. The most interesting implications arise from the treatment of grantor trusts. Recognition of gain upon the loss of grantor trust status during life has generally come to be expected, under authorities such as Reg. §1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); and Rev. Rul. 77-402, 1977-2 C.B. 222. On the other hand, avoiding recognition of gain when grantor trust status is unavoidably lost at the death of the grantor is not always as clear and has sometimes been debated. Chief Counsel Advice 200923024 (issued Dec. 31, 2008; released June 5, 2009) has often been cited as an indication that the IRS acknowledges that there is no recognition at death. After discussing Reg. §1.1001-2(c), Example 5, *Madorin*, and Rev. Rul. 77-402, the CCA stated (emphasis added):

> We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by *the death of the owner which is generally not treated as an income tax event.*

iv. Now a regulation has added significantly more weight to that proposition.

25. The 117th Congress and Potential Legislative Agenda in the Biden Administration

a. Insights from President Biden's Campaign

(1) In General

President Biden desires to reverse or roll back many of the 2017 changes. Beginning in his campaign, he has spoken of his desire to "Build Back Better" by increasing the corporate income tax rate from 21 percent to 28 percent and increasing individual income taxes for annual incomes over $400,000, including an increase in the top rate from 36 percent to 39.6 percent and taxation of capital gains at the same rates as ordinary income for individuals with taxable incomes over $1 million.

(2) Estate, Gift, and GST Taxes

His campaign website (**https://joebiden.com/plans-to-support-women-duringcovid19/**), under the topic of "Highlights of Joe Biden's Plans to Support Women During the COVID-19 Crisis," stated:

> **Permanently provide family, medical, and safe leave as well as sick and safe days.** As President, Biden will work to provide the type of comprehensive 12 weeks of paid family and medical leave envisioned in the FAMILY Act sponsored by Senator Kristen Gillibrand and Representative Rosa DeLauro. Biden will pay for this proposal by returning the estate tax to 2009 levels.

Similarly, the "Greenbook" revenue proposals of the Obama Administration, beginning in 2013, had proposed to return the estate, gift, and GST taxes to their 2009 levels, which included a top

45 percent rate and non-indexed but portable exemptions of $3.5 million for the estate and GST taxes and $1 million for the gift tax.

(3) **Treatment of Appreciation at Death**

In connection with the taxation of capital gains as ordinary income, President Biden has also referred to the step-up in basis, likely meaning the step-up for appreciated assets that pass from a decedent. Although, again, he has offered few details, insight may be gained from the final two Greenbooks of the Obama Administration, in 2015 (pages 156-57) and 2016 (pages 155-56), which, under the general heading of "Reforms to Capital Gains Taxation, Upper-Income Tax Benefits, and the Taxation of Financial Institutions," include a proposal labeled simply "Reform the Taxation of Capital Income." See Part 17.i above. In addition to increasing the rate of tax on capital gains in general (although not as high as the rate on ordinary income), that proposal would treat the transfer of appreciated property at death (as well as by lifetime gift) as a realization event, subjecting the appreciation to income tax. That proposal was even featured in President Obama's State of the Union Address on January 20, 2015.

Additional details of the Obama Administration's 2015 and 2016 proposals included:

(a) Gifts or bequests to a spouse or charity would not be taxed, but the spouse or charity would take a carryover basis in the asset.

(b) Tangible personal property such as household furnishings and personal effects, but not collectibles, would be exempt.

(c) The gain would be taxable to a donor in the year a gift is made, and to a decedent either on the final individual return or on a separate capital gains return.

(d) Each taxpayer would be allowed an additional exclusion of capital gains at death of up to $100,000 (indexed for inflation), and each person's $250,000 exclusion of capital gain on a principal residence would be extended to all residences. Both of these exclusions would be portable to the decedent's surviving spouse "under the same rules that apply to portability for estate and gift tax purposes."

(e) Taxation of the appreciation in the value of certain small family-owned and operated businesses (no further details given) would be deferred until the business is sold or ceases to be family-owned and operated.

(f) A "15-year fixed-rate payment plan" would be allowed for the tax on appreciated illiquid assets transferred at death.

(g) The Greenbooks clarified that the income tax on capital gains deemed realized at death would be deductible for estate tax purposes.

(h) Showing acknowledgment of the complexities involved, the Greenbooks added the following:

> The proposal also would include other legislative changes designed to facilitate and implement this proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; and a broad grant of regulatory authority to provide implementing rules.
>
> To facilitate the transition to taxing gains at death and gift, the Secretary would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable.

b. **"For the 99.5 Percent Act" Introduced by Senator Sanders**

(1) **The "For the 99.5 Percent Act."** On March 25, 2021, Senator Bernie Sanders (I-Vermont) introduced S. 994, titled "For the 99.5 Percent Act," an updated compilation of legislative proposals he and Democrats have been offering for many years regarding the estate, gift, and GST taxes and related grantor trust income tax issues. Senator Sanders has introduced a bill like

this in every Congress since 2010, when he named it the "Responsible Estate Tax Act" (S. 3533, 111th Cong., June 24, 2010). In this Congress he has changed the name from the "For the 99.8 Percent Act" he introduced on January 31, 2019. The bill includes, but is not limited to, adaptations of proposals in the Treasury Department's "General Explanations" (popularly called "Greenbooks") of revenue provisions in the budget proposals of the Obama Administration and even the Clinton Administration. A companion bill (H.R. 2576) was introduced in the House of Representatives on April 15, 2021, by Congressman Jimmy Gomez (D-California).

(a) Senator Sanders' proposals will be important to his Democratic colleagues as a source for ideas if comprehensive estate tax reform becomes a priority and political possibility. One reason for that is simply that his proposals have been written – that is, reduced to statutory wording – and they are "out there" or "on the shelf" for lawmakers to incorporate into whatever other legislation happens to be popular at the time. These proposals are distinguished in that respect from some other more fundamental ideas that are offered from time to time, such as a "wealth tax" that would have to be analyzed, modeled, written, and refined and might still face years of uncertainty about its scope, operation, and constitutionality.

(b) Senator Sanders' bill is important for another reason. Drafted legislation like this can be the source for fillers in the legislation of the day, for Republicans as well as Democrats, particularly a revenue-raiser that has just the right revenue estimate to "pay for" other legislation. That is exactly what happened when "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent" was added to the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) by a Republican-controlled Congress in July 2015. It raised just the right amount of money to fund a desired extension of the Highway Trust Fund that was scheduled to expire on the day President Obama signed the Act into law. Significantly, the first introduced statutory wording for the consistent basis provision had been section 6 of Senator Sanders' "Responsible Estate Tax Act" of 2010. See Part 29.b(5)(b)i below.

(2) **Modifications to Rates and Exemptions.** Section 2 of the "For the 99.5 Percent Act" would raise rates and lower exemptions.

(a) The marginal estate and gift tax rate would be increased to

i. 45 percent (the top rate in 2007 through 2009 under the 2001 Tax Act signed by President George W. Bush), from $3.5 million to $10 million,

ii. 50 percent (the top rate in 2002 under the 2001 Tax Act), from $10 million to $50 million,

iii. 55 percent (the top rate achieved in 1984 through 2001 under the 1981 Act signed by President Reagan), from $50 million to $1 billion, and

iv. 65 percent (the top estate tax rate in effect in 1982; this is down from 77 percent in Senator Sanders' 2019 bill) over $1 billion.

(b) The basic exclusion amount would be reduced to

i. $3.5 million, not indexed, for estate tax purposes and

ii. $1 million, not indexed, for gift tax purposes.

(c) Portability would be retained for both estate and gift tax purposes.

(d) A detailed set of "anti-clawback" rules that had been included in Senator Sanders' 2019 bill is omitted, perhaps simply in recognition of the fact that the anti-clawback regulations have now been finalized, with a proposed "anti-abuse" refinement that Senator Sanders would presumably favor. See Part 29.c(8) below.

(e) The bill says nothing about the GST tax, which apparently would make the GST tax rate 65 percent and the GST exemption $3.5 million.

(f) These proposals would "apply to estates of decedents dying, and generation-skipping transfers and gifts made, after December 31, 2021." This is consistent with the effective dates in Senator Sanders' previous bills and reflects a long-observed drafting principle (or at least drafting preference) for estate and gift tax changes. Presumably, pursuant to that preference, if this legislation were enacted, for example, in 2022, the reference to 2021 would be changed to 2022, making the effective date January 1, 2023.

(3) **Value of Farm, etc. Real Property.** Section 3, like section 4 of the 2010 "Responsible Estate Tax Act," would, effective January 1, 2022, increase the cap on the reduction in value under the special use valuation rules of section 2032A from $750,000 ($1.19 million in 2021 and $1.23 million in 2022, after indexing since 1998) to $3 million, indexed for inflation going forward from 2022.

(4) **Land Subject to Conservation Easements.** Section 4, like section 5 of the 2010 "Responsible Estate Tax Act," would, effective January 1, 2022, increase the maximum exclusion from the gross estate under section 2031(c) by reason of a conservation easement from the lesser of $500,000 or 40 percent of the net value of the land to the lesser of $2 million or 60 percent of the net value of the land.

(5) **No Step-up in Basis for Assets in Grantor Trusts.** Section 5 would add a new section 1014(f) (redesignating the current section 1014(f) as 1014(g)), providing that property "held in a trust of which the transferor is considered the owner under subpart E of part I of subchapter J" would not receive a new basis at the deemed owner's death if "such property is not includible in the gross estate of the transferor for purposes of chapter 11." Although subpart E includes section 678, which treats "[a] person other than the grantor" as the owner of part or all of a trust, it seems that the reference in this bill to "the transferor" is intended to exclude section 678 deemed owners.

(a) This amendment would "apply to transfers after the date of the enactment of this Act." That would evidently apply to grantor trusts created and funded after enactment. It is less clear how it would apply to transfers to a trust after its initial funding, including perhaps transfers involving sales or exchanges with an existing trust.

(b) Section 5 of Senator Sanders' 2019 bill would have extended the "consistent basis" rules of section 1014(f) and the accompanying reporting rules of section 6035(a) (discussed in Part 29.b below) to property received by gift. That provision is omitted from this Congress's bill, although it presumably would be moot to the extent other legislation taxes unrealized appreciation upon gift or death.)

(6) **Valuation of Nonbusiness Assets; Limitation on Minority Discounts.** Section 6 is titled "Valuation Rules for Certain Transfers of Nonbusiness Assets; Limitation on Minority Discounts." It is almost identical to section 7 of Senator Sanders' 2010 "Responsible Estate Tax Act."

(a) Section 6 is also similar to section 276 of H.R. 3874, introduced in March 2000 by Rep. Charles Rangel of New York, the Ranking Democrat on the House Ways and Means Committee, to implement a legislative proposal in the 1998 Clinton Administration's "Greenbook." And it is almost identical to section 303 of H.R. 1264, introduced by Rep. Rangel in March 2001 as an alternative to the Republican proposals that became the 2001 Tax Act, and to three bills subsequently introduced by Rep. Earl Pomeroy (D-North Dakota): H.R. 5008 in June 2002, H.R. 1577 in April 2005, and H.R. 4242 in November 2007. See Part 1.e(1)(b) and (c) above.

(b) The bill would add a new section 2031(d) to the Code, applicable to transfers after the date of enactment. Section 2031(d)(1) would read as follows:

> (d) Valuation Rules for Certain Transfers of Nonbusiness Assets—For purposes of this chapter and chapter 12—
>
> (1) In General—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092) [*see* Reg. §1.1092(d)-1(a) & (b)]—

> (A) the value of any nonbusiness assets held by the entity with respect to such interest shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
>
> (B) such nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

The bill includes detailed rules about "passive assets" that might be used in a business and "look-thru rules" for entities that are at least 10 percent owned by another entity.

(c) The bill would also add a new section 2031(e), to read as follows:

> (e) Limitation on Minority Discounts—For purposes of this chapter and chapter 12, in the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092), no discount shall be allowed by reason of the fact that the transferee does not have control of such entity, or by reason of the lack of marketability of the interest, if the transferor, the transferee, and members of the family (as defined in section 2032A(e)(2)) of the transferor and transferee—
>
> (1) have control of such entity, or
>
> (2) own the majority of the ownership interests (by value) in such entity.

The words "or by reason of the lack of marketability of the interest" are new in this version. Simply stated, the objectives of the proposed new section 2031(e) are to attribute control among family members and to presume control from majority ownership, without exception, apparently not even an exception for an active trade or business. Both objectives will undoubtedly be viewed as unrealistic in many contexts, especially in the context of an active trade or business.

(7) **Grantor Retained Annuity Trusts.** Section 7 mirrors the proposals of the Obama Administration's Greenbooks regarding GRATs, generally in the form in which those proposals solidified in the 2015 and 2016 Greenbooks.

(a) Like the 2015 and 2016 Greenbooks, the bill, applicable to transfers after the date of enactment, would require any GRAT to

i. have a term no shorter than 10 years (the proposal in the original 2009 Obama Administration Greenbook),

ii. prohibit any decrease in the annuity during the GRAT term (a proposal added in the 2010 Greenbook),

iii. have a term no longer than the life expectancy of the grantor plus 10 years (a proposal added in the 2012 Greenbook), and

iv. have a remainder interest with a value for gift tax purposes when the GRAT is created equal to at least 25 percent of the value of the assets contributed to the GRAT or $500,000, whichever is greater (but not greater than the total value of the assets contributed) (a proposal added in the 2015 Greenbook).

(b) Section 8 of Senator Sanders' 2010 "Responsible Estate Tax Act" had included only the minimum 10-year term and the prohibition on decreases in the annuity, reflecting only the 2009 and 2010 Greenbooks that had been published before then.

(c) The 2015 Greenbook had also added that "the proposal … would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust." That would diminish the availability of some techniques for managing long-term GRATs. The "For the 99.5 Percent Act" omits that proposal.

(8) **Grantor Trusts in General.** Similarly, section 8 mirrors the proposals of the Obama Administration's Greenbooks regarding grantor trusts and provides proposed statutory language for those proposals, also generally following the 2015 and 2016 Greenbooks.

(a) The bill would add to the Code a new chapter 16 (titled "Special Rules for Grantor Trusts"), containing a single section 2901 (titled "Application of Transfer Taxes").

(b) Section 2901 would apply to any portion of a trust if

i. the grantor is the deemed owner of that portion under subchapter J, or

ii. a person other than the grantor is the deemed owner of that portion under subchapter J, if that person "engages in a sale, exchange, or comparable transaction with the trust that is disregarded for purposes of subtitle A [the federal income tax subtitle]," to the extent of "the portion of the trust attributable to the property received by the trust in such transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of consideration received by the deemed owner in such transaction." (This second category appears to target the techniques known as "BDITs" and perhaps some "BDOTs," whether as a matter of tax policy or simply to crack down on techniques known to be in use.)

(c) Tracking the Obama Administration Greenbooks, section 2901 would

i. include the value of the assets of such portion in the gross estate of the deemed owner for estate tax purposes,

ii. subject to gift tax any distribution from such portion to one or more beneficiaries [presumably beneficiaries other than the grantor] during the deemed owner's life, and

iii. treat as a gift by the deemed owner, subject to gift tax, all assets of such portion at any time during the deemed owner's life if the deemed owner ceases to be treated as the owner of such portion for income tax purposes.

(d) Section 2901 would reduce the amount thereby subject to estate or gift tax by "the value of any transfer by gift by the deemed owner to the trust previously taken into account by the deemed owner under chapter 12." This is not an exception for the **portion** of the trust attributable to such a taxable gift; it is a "reduction" by the amount reported as a gift. In other words, section 2901 would "freeze" the amount excluded from its reach at its initial gift tax value (thus targeting "leveraged" transfers).

(e) Section 2901 provides that it "shall not apply to any trust that is includible in the gross estate of the deemed owner (without regard to [section 2901])." (An additional exception in Senator Sanders' 2019 bill for "any other type of trust that the Secretary determines by regulations or other guidance does not have as a significant purpose the avoidance of transfer taxes" is omitted from his 2021 bill.)

(f) Section 2901 would provide that "[a]ny tax imposed by [section 2901] shall be a liability of the trust." It does not specify whether any such tax, especially estate tax, would be calculated at the average or marginal tax rate, or in some other way.

(g) Section 2901 would apply to

i. trusts created on or after the date of enactment,

ii. any portion of a trust attributable to a contribution on or after the date of enactment to a trust created before the date of enactment, and

iii. any portion of a trust created before the date of enactment if a sale, exchange, or comparable transaction referred to in paragraph (b)ii above occurs on or after the date of enactment.

(h) There is considerable overlap in the effects of sections 5 and 8 of this bill. In general, section 5 appears to provide that there is no stepped-up basis at death for assets in a grantor trust if the value of those assets is not included in the decedent's gross estate, while section 8 appears to ensure that there are no such trusts by including the value of the assets of all grantor trusts in the gross estate. There are some differences, such as the application to section 678 deemed owners, the exception for "any trust that is includible in the gross estate of the deemed owner (without regard to [section 2901])," the possible application to foreign trusts, the effect of transactions between the trust and the deemed owner after the effective date, and even a one-day difference in the effective date itself (section 5 would apply "after" the date of enactment while section 8 would apply "**on or** after" the date of enactment). But, in the main, it appears that there is a lot of redundancy between these two sections, which tends to reinforce the narrative that this bill has been put together with a view toward making it easy for one or more, but not all, of the individual provisions of this bill to be "pulled off the shelf" to serve a targeted policy or revenue purpose in the consideration of legislation on almost any subject.

(9) **Elimination of GST Exemption for Certain Long-Term Trusts.** Section 9 would mandate an inclusion ratio of one for any trust that is not a "qualifying trust." A "qualifying trust" is "a trust for which the date of termination of such trust is not greater than 50 years after the date on which such trust is created."

(a) This recalls a similar proposal in the Obama Administration's Greenbooks, but would be significantly more aggressive. It would use a period of 50 years (rather than 90 years as in the Greenbooks) and would mandate an inclusion ratio of one from the beginning of a trust (rather than resetting the inclusion ratio to one on the 90th anniversary), thus apparently without any "wait and see" relief.

(b) A trust created before the date of enactment with an inclusion ratio less than one would be allowed to keep that inclusion ratio for 50 years after enactment, and then the inclusion ratio would be reset to one.

(c) Special rules would be provided for portions of trusts treated as separate trusts (see section 2654(b)(1) and Reg. §26.2654-1) and for transfers between trusts.

(10) **"Simplifying" Gift Tax Exclusion for Annual Gifts.** Section 10 would significantly limit the availability of the gift tax annual exclusion, effective January 1, 2022. It would implement a similar proposal in the Obama Administration Greenbooks, from which it borrows the characterization of "simplifying."

(a) Like the Greenbooks, the bill would introduce a **per-donor** limit on the annual exclusion, as a further limitation on the $10,000 (indexed for inflation since 1998) **per-donee** exclusion of current law.

(b) While the per-donor limit in the Greenbooks would have been $50,000 (indexed for inflation), the "For the 99.5 Percent Act" would set the annual per-donor limit at twice the per-donee limit, $30,000 in 2021 and $32,000 in 2022 (also indexed for inflation).

(c) Like the Greenbooks, the bill would impose this new limitation on transfers in trust (without an exception for trusts described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

(d) Like the Greenbooks, the bill would leave in place the per-donee annual exclusion ($15,000 in 2021 and $16,000 in 2022), for example for outright gifts of cash or marketable securities.

(e) The bill would repeal section 2503(c), which now provides a special way that a trust for a minor can qualify as a present interest.

(f) As in the Greenbook proposals, the new $32,000 per-donor limit would apply to all transfers in trust, but apparently would not include a present-interest requirement at all, although it apparently would still require identification of donees to apply the $16,000 per-donee limit.

(g) The bill would not change the unlimited exclusion in section 2503(e) for tuition and medical expenses paid directly to the provider.

(h) The bill would not change the gift-splitting rules in section 2513.

c. **Deemed Realization Proposals in Congress**

(1) **Legislation Introduced and Under Discussion.** On March 29, 2021, Ways and Means Committee Member Bill Pascrell, Jr. (D-New Jersey) introduced H.R. 2286, described as a bill "to amend the Internal Revenue Code of 1986 to treat property transferred by gift or at death as sold for fair market value, and for other purposes." On the same day, Senator Chris Van Hollen (D-Maryland), joined by Senators Cory Booker (D-New Jersey), Bernie Sanders (I-Vermont), Sheldon Whitehouse (D-Rhode Island), and Elizabeth Warren (D-Massachusetts), issued a statement calling "the Stepped-Up Basis Loophole" "one of the biggest loopholes in the U.S. tax code, which subsidizes America's wealthiest heirs," citing a Joint Committee on Taxation estimate that it would cause a loss of $41.9 billion of tax revenue in 2021 alone. The statement was accompanied by a 32-page "discussion draft" of statutory language titled the "Sensible Taxation and Equity Promotion ("STEP") Act of 2021," with the acronym of "STEP" evidently designed to recall the "step-up" in basis that it attacks.

(2) **Effective Dates.** A conspicuous and significant difference between Congressman Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the "STEP Act" is their effective dates.

H.R. 2286 would apply to gifts and transfers made, including transfers from decedents dying, after December 31, 2021. As discussed in the context of section 2 of Senator Sanders' "For the 99.5 Percent Act" in Part 25.b(2)(f) above, that is the typical effective date for broad changes in the taxation of transfers by gift and at death, although other provisions of the Sanders bill itself show how the date of enactment can be a typical effective date for changes to the tax treatment of particular transactions or structures.

For the Senate discussion draft, the corresponding date would be December 31, 2020. In other words, it would be uncharacteristically retroactive to the beginning of 2021. This could be a portent of less deference to conventional effective-date norms in the political climate of the current Congress. Or it could mean only that Congressman Pascrell, as a member of the Ways and Means Committee, has received more technical assistance from staff members who understand the historical and practical preferences for avoiding retroactivity. Or it could mean that a "discussion draft" is only that.

Both proposals would tax past appreciation, not just appreciation following enactment. This contrasts with the 1969 proposed "Taxation of Appreciation of Assets Transferred at Death or by Gift," which stated that "[o]nly appreciation occurring after the date of enactment would be subject to tax." "Tax Reform Studies and Proposals, U.S. Treasury Department," Joint Publication of the House Committee on Ways and Means and Senate Committee on Finance, at 335 (91st Cong., 1st Sess., Feb. 5, 1969). It also contrasts with the 1976 enactment (which proved to be temporary) of carryover basis, which provided a "fresh start" valuation on December 31, 1976, and a proration of appreciation over the entire holding period of nonmarketable assets acquired before that date. Section 1023(h), added by section 2005(a)(2) of the Tax Reform Act of 1976, Public Law 94-455 (94th Cong., 2d Sess., Oct. 4, 1976). Interestingly, it does not contrast as sharply with the "aggregate basis increase" and "spousal property basis increase" provided by the second (also temporary) enactment of carryover basis in 2001, taking effect in 2010, which was not as clearly tailored to sheltering pre-enactment appreciation. Section 1022(b) and (c), added by section 542(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (107th Cong., 1st Sess., June 7, 2001).

(3) **Deemed Sale Rule of New Section 1261.** The proposals would add a new section 1261 to the Code, generally treating any property transferred by gift or at death as sold for its fair market value on the date of the gift or death. Both proposals appear to contemplate that the gain on deemed sales at death would be reported on the decedent's final income tax return (Form 1040), or a supplement to it, but they do not say that.

(4) **Exception for Tangible Personal Property.** The deemed sale rules would not apply to transfers of tangible personal property other than collectibles (including coins and bullion) and property held

in connection with a trade or business. H.R. 2286 adds property held for investment, and the STEP Act adds property related to the production of income under section 212, to the coverage of the deemed sale rules.

(5) **Exception for Transfers to Spouses.** A transfer to the spouse of a transferor or surviving spouse of a decedent would be exempt from this deemed sale treatment if the spouse is a U.S. citizen (or long-term resident under the STEP Act), essentially deferring sale treatment until the spouse disposes of the asset.

Under H.R. 2286, this exemption is extended to a "qualifying spousal trust," which is defined as a qualified domestic trust ("QDOT") of which the transferor's spouse or surviving spouse is the sole current income beneficiary and has the power to appoint the entire trust. Under the STEP Act, this exemption is extended to a QTIP trust. Awkwardly, the STEP Act describes a QTIP trust as "qualified terminal [*sic*, not "terminable"] interest property." Also awkwardly, H.R. 2286 incorporates the QDOT definition of section 2056A, even though the spouse must be a U.S. citizen to qualify for the deemed sale exception in H.R. 2286 in the first place. That could conceivably even require any ordinary QTIP trust for a U.S. citizen spouse to mandate the withholding under section 2056A(a)(1)(B) of estate tax payable with respect to distributions, for example (or, channeling it into the deemed sale context, withholding the income tax on unrealized appreciation avoided by the transfer to the trust), although there is no indication that such an odd result is intended or would serve any purpose of this proposed legislation. And a strict application of the "qualifying spousal trust" rules in H.R. 2286 would also require the spouse to have the power to appoint the entire trust, which is not normal in an ordinary QTIP trust.

Property transferred in such an exempt transfer to an eligible trust for the benefit of the transferor's spouse or surviving spouse would be subject to the deemed sale rules (1) upon a distribution from the trust to someone other than the spouse, (2) upon the cessation of the trust's status as an eligible trust, or (3) upon the spouse's death.

(6) **Exception for Transfers to Charity.** A transfer to a charity or another organization described in section 170(c) would not be a deemed sale. The STEP Act adds explicit exemptions for (1) a trust in which property is set aside for such an organization (subject to annuity, unitrust, and other valuation rules of section 2702), (2) a qualified disability trust defined in section 642(b)(2)(C)(ii), and (3) a cemetery perpetual care fund described in section 642(i).

(7) **Other Estate-Includible Grantor Trusts.** In the case of a transfer to a trust is that is **both** deemed owned by the transferor under subpart E of part 1 of subchapter J (commonly called generically the "grantor trust rules") **and** includible in the transferor's gross estate, **the deemed sale would occur**, not when the property is transferred to the trust, but when:

(a) a distribution is made to a person other than the deemed owner,

(b) the transferor ceases to be the deemed owner of the trust (including, apparently, upon the transferor's death), or

(c) the trust ceases to be includible in the gross estate of the transferor (oddly, in H.R. 2286, explicitly including upon the transferor's death).

(8) **Other, Non-Includible, Grantor Trusts.** Under the STEP Act, in the case of other deemed-owned trusts (except the spousal, charitable, disability, and cemetery care trusts discussed above) – that is, a deemed-owned trust that is not includible in the transferor's gross estate – the deemed sale would apparently occur:

(a) when a transfer is made to the trust,

(b) when a distribution is made to a person other than the deemed owner,

(c) when the transferor ceases to be the deemed owner of the trust, or

(d) upon the death of the transferor.

This type of trust is commonly called a "defective grantor trust." The treatment of a transfer to the trust, a distribution from the trust, the termination of grantor trust status, and the death of the transferor as deemed realization events, in effect overturning Rev. Rul. 85-13, 1985-1 C.B. 184, would likely be viewed as quite harsh.

(9) **Non-Grantor Trusts.** In the case of other trusts – that is, a trust that is not deemed owned by the transferor for income tax purposes – the transfer to the trust would be treated as a sale, and property held in a long-term trust would be deemed sold at specified intervals. In H.R. 2286, property that has been held in trust for **30 years** without being subject to section 1261 would be deemed sold, or, if it has been continuously held in trust for more than 30 years on the effective date (January 1, 2022), it is treated as sold on that date. In the STEP Act, **all** property held by such a trust would be treated as sold every **21 years**, with property in a trust created before January 1, 2006, first treated as sold on December 31, 2026. Thus, H.R. 2286 would apparently require tracking the holding period of each individual asset, while the STEP Act would apparently subject all trust assets to tax every 21 years regardless of the asset's holding period.

In addition, H.R. 2286 would treat a modification of the direct or indirect beneficiaries of a trust (or the beneficiaries' rights to trust assets) or the transfer or distribution of trust assets (including to another trust) as a deemed sale, unless Treasury and the IRS determine "that any such transfer or modification is of a type which does not have the potential for tax avoidance." This apparently is intended to include some decantings.

(10) **Other Exclusions.** H.R. 2286 would exclude annual exclusion gifts and up to $1 million of net capital gain at death. The $1 million amount would be indexed for inflation after 2022. Thus, lifetime exclusions would be measured by the total value transferred (and the number of donees), while the exclusion at death would be measured by the net gain. Among other complications, the exclusion of gifts to the extent of the dollar amount of the annual exclusion would present the challenge of allocating that exclusion when gifts to any individual of assets with different bases exceed the annual exclusion amount in any year, as well as the challenge of applying that allocation in the case of gift-splitting by spouses.

The STEP Act would provide what amounts to a "lifetime exclusion" of $100,000 of gain, expressed as "the excess of … $100,000, over … the aggregate amount excluded under this subsection for all preceding taxable years." For transfers at death, the exclusion would be $1 million, less the amount of the $100,000 exclusion applied to lifetime gifts. Both the $100,000 and $1 million amounts would be indexed for inflation.

The proposals would not change the exclusion for sales of a principal residence.

(11) **Netting of Gains and Losses.** In the case of deemed sales occurring upon death, the proposals would exempt the sales from the disallowance of related-party losses under section 267, which would allow losses on deemed sales to offset gains.

(12) **Coordination with Basis Rules.** The basis rules for property acquired from a decedent (section 1014) or upon gift or transfer to a trust (section 1015) would be amended to more or less coordinate with the new deemed sale rules, generally providing a stepped-up (or stepped-down) basis if there is a deemed sale. Apparently, under H.R. 2286, that would mean that even annual exclusion gifts excluded from deemed sale treatment would receive a new basis equal to the fair market value at the time of the gift. Spouses and surviving spouses would receive a carryover basis in all cases.

(13) **Extension of Time for Payment of Tax.** The proposals would add a new section 6168, providing an election to pay the income tax on deemed sales in installments, similar to the rules in section 6166 for estate taxes. Like section 6166, section 6168 would apply only with respect to transfers at death, not during life. In contrast to section 6166, however, section 6168 would apply not only to closely held business interests that exceed 35 percent of the gross estate, but to all assets other than "actively traded" personal property (such as securities traded on an exchange).

The STEP Act would mirror section 6166 by allowing payment of the additional income tax in up to 10 equal annual installments beginning no later than five years after the prescribed due date. H.R. 2286 would allow up to seven equal annual installments, with no deferral of the first installment.

Both proposals would provide for payment of interest (at 45 percent of the normal rate as in section 6601(j)(1)(B) for estate tax extended under section 6166, but with no "2-percent portion" as in section 6601(j)(1)(A)), and the STEP Act would make that interest nondeductible for estate tax purposes. Both proposals, like section 6166, would also include provisions for a special lien (which the STEP Act would allow to be partially replaced by a bond), extensions of the period of limitations on assessment, and proration of deficiencies to installments.

The STEP Act, but apparently not H.R. 2286, would provide for acceleration of the payment of deferred tax if the subject property is disposed of or is used in whole or in part to secure nonrecourse indebtedness.

(14) **Information Reporting.** H.R. 2286 would add a new section 6050Z requiring that, except in the case of securities transactions reported by brokers under section 6045(g), the donor or executor must report to the IRS the name and taxpayer identification number of the recipient of each transfer and information describing the property and stating its fair market value and basis. The donor or executor must also report that fair market value and basis to the recipient of the property. These requirements are similar to the rules currently in section 6035 regarding the consistent basis of property transferred at death, except that section 6050Z would require this information reported to the IRS to be shared only with "the person to whom such transfer was made" (not, for example, to all beneficiaries who might receive an asset, as with Schedule A of Form 8971) and only "at such time and in such form and manner as the Secretary shall by regulations prescribe."

The STEP Act omits such a reporting requirement, but, seeming to step off-topic somewhat, it would add a new section 6048A requiring any trust (not already reporting under section 6034(b) or 6048(b)) with assets of more than $1 million or gross income for the year of more than $20,000 to report annually to the IRS "(1) a full and complete accounting of all trust activities and operations for the year, (2) the name, address, and TIN of the trustee, (3) the name, address, and TIN of the grantor, (4) the name, address, and TIN of each beneficiary of the trust, and (5) such other information as the Secretary may prescribe."

(15) **Miscellaneous Matters.** In addition, the STEP Act would provide that the costs of appraising property deemed sold under new section 1261 would be deductible for income tax purposes and would not be a "miscellaneous itemized deduction" subject to section 67.

The STEP Act also would waive penalties for underpayment of estimated tax related to income tax on deemed realized gains at death (which, of course, would not have been foreseeable).

d. **Estate Tax Repeal Bills**

(1) On March 9, 2021, joined by several of his Republican colleagues, Senator John Thune (R-South Dakota) introduced the "Death Tax Repeal Act of 2021" (S. 617). The bill resembles repeal bills that have been introduced over the last two or three decades.

(a) S. 617 would permanently repeal the estate and GST taxes, effective for estates of decedents dying, and generation-skipping transfers, after the date of enactment. As in past bills, it would retain the estate tax under section 2056A(b)(1)(A) on distributions from qualified domestic trusts for spouses of decedents who died before the date of enactment, but only for 10 years after the date of enactment. It would immediately eliminate the estate tax under section 2056A(b)(1)(B) on the value of property remaining in QDOTs at the deaths of surviving spouses after the date of enactment.

(b) S. 617 would retain the gift tax with a 35 percent rate for cumulative gifts over $500,000 and would make permanent the current gift tax exclusion amount of $10 million indexed for inflation since 2011 (that is, $11.7 million for 2021 and $12.06 million for 2022), effective for gifts made on or after the date of enactment.

i. S. 617 would deal with the issue currently posed by the phrase "as of the end of the calendar year" in section 2505(a)(1) by treating the year in which the bill is enacted as two separate calendar years, one ending on the day before the date of enactment and the other beginning on the date of enactment.

ii. It would also restore the 2001 Tax Act's enigmatic section 2511(c) (see Part 16.a(1)(c) above), providing that "[n]otwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1." (It ignores the 2002 amendment, which changed "taxable gift under section 2503" to "transfer of property by gift.")

a. This provision appears to perpetuate the 2001 lore that the retention of the gift tax is needed to back-stop the income tax by subjecting to gift tax any transfer that would be "income-shifting," but, as in 2001, it is hard to be sure or to fully understand such a policy.

b. In any event, such a provision would presumably shut down the advantages of so-called incomplete-gift non-grantor trusts (or "ING trusts").

c. More perplexing, as in 2001, the use of the word "unless" in this provision could create the impression that a taxable gift is **avoided** by simply making the transfer to a trust that **is** a wholly-owned grantor trust as to the grantor or the grantor's spouse. That would certainly be different from the treatment of "intentionally defective" grantor trusts for which current funding is a completed gift, but which normally include no features that would subject the trust to estate tax upon the grantor's death.

(2) A companion bill, H.R. 1712, was introduced in the House of Representatives on the same day by Congressman Jason Smith (R-Missouri).

e. **Treasury's Explanation of Fiscal Year 2022 Budget Proposals ("Greenbook")**

The Treasury Department released its "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (popularly called the "Greenbook") on May 28, 2021. See **https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf**. It proposes no changes to the estate and gift taxes.

Following up proposals announced in the Administration's "American Families Plan" on April 28, 2021, and citing the need to "reduce economic disparities among Americans," the Greenbook (at pages 60-62) includes proposals to increase the top marginal individual income tax rate to 39.6 percent (as it was before the 2017 Tax Act), effective January 1, 2022, and to tax capital gains at the same rate as ordinary income for taxpayers with adjusted gross income greater than $1 million, effective "for gains required to be recognized after the date of announcement" (presumably April 28, 2021).

The Greenbook (at pages 62-64) also provides details focusing and clarifying the proposal for the "deemed realization" of capital gains foreshadowed by the Obama Administration's Greenbooks for Fiscal Years 2016 (Feb. 2, 2015, pages 156-57) and 2017 (Feb. 9, 2016, pages 155-56) discussed in Part 17.i above, by President Biden's campaign, and by Representative Bill Pascrell's H.R. 2286 and Senator Van Hollen's "discussion draft" of the Sensible Taxation and Equity Promotion ("STEP") Act of 2021 discussed in Part 25.c above. That Greenbook proposal is summarized as follows:

(1) **Effective Date.** The proposal would take effect on January 1, 2022, like H.R. 2286. But it would apply to pre-2022 appreciation; there would be no "fresh start" as, for example, in the 1976 carryover basis legislation.

(2) **Realization Events.** Gain would be explicitly recognized on transfers by gift or at death, equal to the excess of an asset's fair market value on the date of the gift or death over the donor's or decedent's basis in that asset. Losses obviously would also be recognized if basis exceeds fair market value because the Greenbook refers to "the use of capital losses … from transfers at death" as an offset. The Greenbook does not mention holding periods or distinguish short-term and long-term gain. The Greenbook also does not specifically incorporate the alternate valuation date for transfers at death, although it does state generally that a transfer "would be valued using the methodologies used for gift or estate tax purposes."

(3) **Taxpayer, Return, and Deductibility.** The Greenbook states that the gain would be reported "on the Federal gift or estate tax return or on a separate capital gains return." Reassuringly, however, the Greenbook confirms that the gain "would be taxable income to the decedent" and, consistently with that characterization, explicitly adds that "the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any)." That means that the 39.6 percent capital gains rate and 40 percent estate tax rate would produce a combined rate of 63.76 percent ($0.396 + 0.4 \times (1 - 0.396)$) on appreciation.

(4) **Exclusion for Tangible Personal Property.** "[T]angible personal property such as household furnishings and personal effects (excluding collectibles)" would be exempt. There is no mention of explicit application to property held for investment as in H.R. 2286 or property related to the production of income as in the STEP Act.

(5) **Exclusion for Transfers to Spouses.** The Greenbook would exempt "[t]ransfers by a decedent to a U.S. spouse," without explicitly exempting lifetime gifts to a spouse as both H.R. 2286 and the STEP Act do. There is no elaboration of the term "U.S. spouse" (for example, citizen or resident), and there are no special provisions targeted to spousal trusts. Typically the effect of exempting transfers to spouses will be simply to defer the application of the deemed realization rules until the spouse's disposition of the asset or the spouse's death.

(6) **Exclusion for Transfers to Charity.** The Greenbook would exempt transfers to charity. But it adds that "[t]he transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes." This will require further elaboration.

(7) **Other Exclusions.** The Greenbook proposes a single unified exclusion of capital gains for transfers both by gift and at death of $1 million per person, indexed for inflation after 2022 and "portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes." The Greenbook adds that this would "mak[e] the exclusion effectively $2 million per married couple," without explaining exactly how that would be accomplished for lifetime gifts when there has been no "decedent" or "surviving spouse." The Greenbook does not address whether the use of the exclusion for lifetime gifts is mandatory or elective.

To the extent that exclusion applies, the Greenbook proposes to retain the current basis rules under sections 1014 and 1015. Thus, to that extent, "[t]he recipient's basis in property received by reason of the decedent's death would be the property's fair market value at the decedent's death" (presumably subject to the consistent basis rules of section 1014(f) added in 2015), and the basis of property received by gift would be the donor's basis in that property at the time of the gift. To the extent the exclusion does not apply, the recipient, whether of a gift or at death, will receive a basis equal to the fair market value used to determine the gain. The Greenbook leaves for further elaboration the manner in which those adjustments to basis would be allocated among multiple assets in a case of a lifetime gift or gifts where some but not all of the gain realized under this proposal is sheltered by the exclusion.

In addition, the Greenbook confirms that the exclusion of $250,000 per person of gain from the sale or exchange of a taxpayer's principal residence under section 121 would apply to the gain realized under this proposal with respect to all residences, and it adds that that exclusion would be made "portable to the decedent's surviving spouse." In this case the application to lifetime gifts may be less of an issue because section 121(b)(2) itself doubles the exclusion to $500,000 for joint returns involving jointly used property. The Greenbook also confirms that the exclusion under current law for capital gain on certain small business stock under section 1202 would apply.

(8) **Netting of Gains and Losses.** For transfers at death, capital losses and carry-forwards would be allowed as offsets against capital gains and up to $3,000 of ordinary income, mirroring the current income tax rules in sections 1211 and 1212. There is no mention of relaxing the related-party loss rules of section 267 as there is in both H.R. 2286 and the STEP Act, but it seems very unlikely that it would be omitted from any provision for taking losses into account at death, where transfers to related parties are the norm.

(9) **Valuation.** As noted above, the Greenbook contemplates that a transfer generally "would be valued using the methodologies used for gift or estate tax purposes." But the Greenbook adds that "a transferred partial interest would be its proportional share of the fair market value of the entire property." In other words, no discounts. The Greenbook does not indicate whether "partial interest" is meant to be limited to undivided interests such as in tenancies-in-common, or whether it might include nonmarketable interests in entities like partnerships, limited liability companies, and corporations. Surely it would not include, for example, publicly traded stock, but attention in drafting might be required to confirm that.

(10) **Special Rules for Trusts and Entities.** Generally mirroring H.R. 2286 and the STEP Act, the Greenbook provides that transfers into, and distributions in kind from, a trust would be recognition events, unless the trust is a grantor trust deemed wholly owned and revocable by what the Greenbook calls "the donor." There is no mention of exempting irrevocable trusts in existence on the date of enactment, and therefore this Greenbook feature would apparently apply to distributions of appreciated assets to both current and successive or remainder beneficiaries of preexisting trusts, including, for example, both the grantor and the remainder beneficiaries of a pre-2022 GRAT. With regard to revocable trusts, the deemed owner would recognize gain on the unrealized appreciation in any asset distributed (unless in discharge of the deemed owner's obligation) to anyone other than the deemed owner or the deemed owner's "U.S. spouse" (again undefined), and on the unrealized appreciation in all the assets in the trust when the deemed owner dies or the trust otherwise becomes irrevocable.

But the Greenbook goes a lot farther. The rules about transfers into and distributions in kind from a trust also apply to a "partnership" or "other non-corporate entity." This seems like a far reach, but the Greenbook does not explain further.

The Greenbook also states:

> Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.

Ninety years for periodic "mark-to-market" treatment of trust assets is a surprising departure from the somewhat similar rules in H.R. 2286 (30 years) and the STEP Act (21 years), but it again would apply to assets of partnerships and other entities. And again the Greenbook does not explain further. Because 90 years from January 1, 1940, is January 1 (not December 31), 2030, it appears that the Greenbook contemplates recognition only at the end of the year, but the Greenbook does not clarify that.

(11) **Deferral of Tax.** The Greenbook reprises the Obama Administration's Fiscal Year 2016 and 2017 proposals that "[p]ayment of tax on the appreciation of certain family-owned and -operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated." Providing that the payment of tax is not "due" (rather than merely providing for a section 6166-like "extension of time for payment") implies at a minimum that there would be no interest charged (which can otherwise be a big problem, even for the no-

more-than-14-year deferral of section 6166). The implementing statutory language might also provide that the realization event itself is deferred until ownership or operation of the business passes outside the family. That could increase the amount of tax if there is more appreciation, but it could also prevent the payment of tax to the extent the value of the business declines (which sometimes happens after the death of a key owner). That approach would apparently also tax the realization event at whatever the tax rates happen to be at the time. But if the cessation of family ownership results from the family's sale of the business, that postponed realization approach would be the same as current law in subjecting any sale like that to tax, except apparently for the loss of a stepped-up basis at intervening deaths.

The enactment of this proposal or any close variation of it in a tightly divided Congress is by no means certain, and the long-term durability of such a provision enacted in such a political climate would not be guaranteed. That could create special challenges in cases where a tax on the succession of the family businesses is nominally imposed, but is suspended for many years, decades, or even generations.

And of course the statutory language implementing this Greenbook proposal should be expected to include definitions of a "business," "family-owned," and "family-operated," as well as rules for the identification of assets that should be excluded from the deferral because they are not used in the business, and such rules might also create or aggravate challenges over a long-term suspension.

In addition, like the STEP Act and the Obama Administration Greenbooks (and broader than H.R. 2286), the Greenbook proposal would allow "a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made." Details about start dates and interest rates are not provided, but the proposal might resemble the STEP Act's proposed section 6168, which in turn resembles section 6166 without the 35-percent-of-gross-estate requirement to qualify, with an interest rate equal to 45 percent of the normal annual rate as in section 6601(j)(1)(B), but without the "2-percent portion" as in section 6601(j)(1)(A).

As in H.R. 2286 and the STEP Act, the IRS would be authorized to require reasonable security at any time from any person and in any form acceptable to the IRS.

(12) **Administrative Provisions.** Following the Obama Administration Greenbooks, with a few additions, the Greenbook envisions (but without details) a number of other legislative features, covering topics such as a deduction for the full cost of related appraisals, the imposition of liens, the waiver of penalties for underpayment of estimated tax attributable to deemed realization of gains at death (which, of course, could not have been foreseeable), a right of recovery of the tax on unrealized gains, rules to determine who selects the return to be filed, consistency in valuation for transfer and income tax purposes, and coordination of the changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed.

(13) **Regulations.** Treasury would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including reporting requirements that could permit reporting on the decedent's final income tax return, which would be especially useful if an estate tax return is not otherwise required to be filed. In a tacit acknowledgment of the harshness of proceeding with such a proposal without a "fresh start" for basis as in 1976, the Greenbook explicitly contemplates that the regulations will include "rules and safe harbors for determining the basis of assets in cases where complete records are unavailable."

(14) **Revenue Estimate.** Taxing capital gains at the same rate as ordinary income for taxpayers with adjusted gross income greater than $1 million and the proposed "deemed realization" of capital gains together are estimated to raise $322.485 billion over the next 10 fiscal years. This includes $1.241 billion estimated for Fiscal Year 2021, which ended September 30, 2021. That presumably results from the proposed retroactive effective date for taxing capital gains at the same rates as ordinary income, but evidently also contemplates increased estimated income tax payments by

September 30. (This is the only proposal in the Greenbook that is estimated to have an effect on revenues in Fiscal Year 2021.)

Overall, the tax increases proposed by the Greenbook are estimated to raise revenue over the next 10 fiscal years by about $3.6 trillion.

26. Fiscal 2022 Budget Reconciliation

a. Budget Resolution

On August 24, 2021, the House of Representatives agreed to the Senate-approved Concurrent Resolution on the Budget for Fiscal Year 2022 (S. Con. Res. 14), establishing spending priorities of about $3.5 trillion for the fiscal year beginning October 1, 2021, and ending September 30, 2022. The votes were strictly partisan. In the Senate on August 11 the vote was 50-49, with all Democrats in favor and all Republicans opposed except Senator Mike Rounds (R-South Dakota), who did not vote. In the House on August 24 the vote was 220-212, with all Democrats in favor and all Republicans opposed. The resolution left the House Ways and Means Committee and the Senate Finance Committee with flexibility to develop tax changes to pay for the contemplated expenditures.

b. Ways and Means Committee Action

On September 15, 2021, the House Ways and Means Committee approved the "Build Back Better Act" (H.R. 5376), a package of tax changes pursuant to the budget resolution. Only one Democratic member of the Committee, Rep. Stephanie Murphy (D-Florida), joined all the Republicans in voting against it. The bill, with revisions as discussed below, was approved by the House. The Ways and Means Committee's bill included the following:

(1) **No Deemed Realization.** The Ways and Means Committee omitted any deemed realization proposals like those made in the current Congress and in the Administration's Fiscal Year 2022 Greenbook (see Parts 25.c and 25.e above).

(2) **Early Sunset for Doubled Basic Exclusion Amount.** The sunset of the 2017 Tax Act's doubling of the $5 million basic exclusion amount (indexed for inflation since 2012) would have been accelerated **from January 1, 2026, to January 1, 2022**. Thus, the basic exclusion amount would return to $5 million, indexed for inflation since 2012, which the Joint Committee on Taxation (JCT) staff projected would be $6,020,000 for 2022. This was estimated to raise $54 billion over 10 years (mostly in the first five years before the original 2026 sunset).

(3) **Closer Alignment of Grantor Trust and Transfer Tax Rules.** The bill approved by the Ways and Means Committee would have created a new chapter 16, consisting solely of a new section 2901, effectively linking the grantor trust rules and the transfer tax rules so that a trust designed as a grantor trust would continue to be exposed to gift or estate tax with respect to the grantor. Thus the bill picked up, with some significant changes, the proposals in section 8 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Part 25.b(8) above), which in turn track the Obama Administration Greenbooks. With respect to a trust or portion of a trust that is not otherwise includable in the grantor's gross estate and is funded **on or after the date of enactment** (either upon initial formation or by a contribution to an existing trust), section 2901 would

(a) include the value of such portion in the grantor's gross estate for estate tax purposes,

(b) subject to gift tax any distribution from such portion during the grantor's life, other than distributions to the grantor or the grantor's spouse or in discharge of an obligation of the grantor, and

(c) treat as a gift by the grantor, subject to gift tax, all of such portion at any time during the grantor's life if the grantor ceases to be treated as the owner of such portion for income tax purposes.

Unlike the "For the 99.5 Percent Act," this proposal would apply only to "any portion of a trust with respect to which **the grantor** is the deemed owner." It omits the additional explicit application in the "For the 99.5 Percent Act" to the extent a deemed owner engages in a leveraged "sale, exchange, or comparable transaction with the trust" that appears to have been aimed at the technique known as a "Beneficiary Defective Inheritor's Trust" ("BDIT"). (Compare Part 25.b(8)(b)ii above.)

The creation of, or addition to, such a grantor trust would not escape gift tax, but, in determining future gift or estate taxes upon one of the events described in paragraphs (a), (b), and (c) above, "amounts treated previously as taxable gifts" would be "account[ed] for" with a "proper adjustment."

(4) **Certain Sales Between Deemed Owned Trust and Deemed Owner.** Going a step beyond the "For the 99.5 Percent Act," the bill would have added a new section 1062 providing:

> In the case of any transfer of property between a trust and a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.

The result would be that gain would be recognized by the deemed owner or by the trust, as the case may be, or possibly by both of them (in the case of a substitution of assets or other in-kind exchange, for example). Rev. Rul. 85-13, 1985-1 C.B. 184, the hinge on which almost all grantor trust planning swings, would be nullified. The new rule would not apply to a trust that is fully revocable by the deemed owner.

The bill would also amend section 267 to disallow losses between "[a] grantor trust and the person treated as the owner of the trust (or portion thereof)."

Like the closer alignment of grantor trust and transfer tax rules in section 2901, this rule, as written, would apparently apply only to a trust created, and any portion of an existing trust attributable to a contribution made, **on or after the date of enactment**. The Ways and Means Committee report stated that it "is intended to be effective for sales and other dispositions after the date of enactment" – that is, regardless of when the trust was created or funded – but it adds in a footnote (footnote 935) that "[a] technical correction may be necessary to reflect this intent."

Section 1062 and section 2901 together were estimated to raise $8 billion over 10 years.

(5) **Valuation of Certain Nonbusiness Assets in Entities.** In a proposal traceable at least to the Reagan and Clinton Administrations (see Parts 1.d(1)(d) and 1.e(1) above) and virtually identical to section 6 of Senator Sanders' "For the 99.5 Percent Act" (see Part 25.b(6) above), the Ways and Means Committee bill would in effect have required the valuation of nonbusiness assets in an entity by **a look-through method**. The proposal would add a new section 2031(d) to the Code, **applicable to transfers (by gift or upon death) after the date of enactment**. Section 2031(d)(1) would read as follows:

> (d) VALUATION RULES FOR CERTAIN TRANSFERS OF NONBUSINESS ASSETS—For purposes of this chapter [estate tax] and chapter 12 [gift tax]—
>
> > (1) IN GENERAL—In the case of the transfer of any interest in an entity other than an interest which is actively traded (within the meaning of section 1092) [*see*, *e.g.*, Reg. §1.1092(d)-1(a) & (b)]—
> >
> > > (A) the value of any nonbusiness assets held by the entity with respect to such interest shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets), and
> > >
> > > (B) such nonbusiness assets shall not be taken into account in determining the value of the interest in the entity.

Like the "For the 99.5 Percent Act," the proposal included a detailed list of what are considered "passive assets," detailed rules about passive assets that might be used in a business, and "look-thru rules" for entities that are at least 10 percent owned by another entity. The proposal also included a broad grant of regulatory authority, specifically including the issues of whether a passive asset is used in the active conduct of a trade or business or is held as part of the reasonably required working capital needs of a trade or business.

Unlike the "For the 99.5 Percent Act," however, the proposal does not also include a general prohibition on "minority discounts" in family owned or controlled entities, a prohibition that in the "For the 99.5 Percent Act" (see Part 25.b(6)(c) above) is not limited to "nonbusiness" entities or assets and thus would arguably have a much broader and harsher impact on family businesses.

In addition, new section 2031(d)(2)(A) would provide that "[t]he term 'nonbusiness asset' means any passive asset which (i) is held for the production or collection of income, and (ii) is not used in the active conduct of a trade or business." That implies that, for example, a vacation home that is not rented would not be valued under the proposed look-through rule, which is a bit surprising.

Also surprising, despite that broad definition of a "nonbusiness asset" (which is repeated in the Ways and Means Committee's report), a summary titled "Tax Changes for Estates and Trusts in the Build Back Better Act (BBBA)," published by the Congressional Research Service on October 22, 2021, limited its description of the proposal to only "cash and readily marketable securities," without explanation.

This proposal was estimated to raise $20 billion over 10 years.

(6) **Increased Benefit of Special Use Valuation.** In contrast to the preceding provisions that would make the estate and gift tax more burdensome, the Ways and Means Committee bill, **effective January 1, 2022**, would have increased the limit on the reduction under section 2032A in the estate tax value of real property used in a family farm or other family business resulting from valuing the real property in that farm or business use, even if that is not its "highest and best use." Currently the limit on that reduction is $750,000, indexed for inflation since 1998 ($1,190,000 in 2021 and $1,230,000 in 2022). Such an increase in the limit has often been offered by lawmakers opposed to across-the-board repeal or reduction of the estate tax as a way to target relief to the family farms and businesses that are often cited as justifications for such repeal or reduction. An example is the opposition of Ways and Means Committee Democrats to the "Death Tax Repeal Act of 2015" (H.R. 1105) discussed in Part 16.a above. Unlike section 3 of Senator Sanders' "For the 99.5 Percent Act" (see Part 25.b(3) above), which would increase the limit to only $3 million, indexed for inflation going forward, the Ways and Means Committee proposal would raise the limit to $11.7 million (which happened to be the 2021 basic exclusion amount), indexed going forward. Even so, the proposal would not really reduce the estate tax on a family farm or business as such; it would merely prevent a tax, for example, on a speculative prospect of development that is faced by such businesses very unevenly. Thus, this proposal should not have been expected to be viewed by owners of family farms and businesses as much of a consolation. It was estimated to decrease revenues by $317 million over 10 years.

(7) **Other Income Tax Proposals**

(a) **Individual Income Tax Rates.** Beginning **January 1, 2022**, the 39.6 percent top individual income tax rate, suspended for eight years by the 2017 Tax Act, would have been reinstated for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses) and $12,500 indexed ($13,450 in 2022) for trusts and estates. In addition, a **new section 1A** would apply a 3 percent surcharge to "modified adjusted gross income" (defined as AGI minus any investment interest deducted "below the line," not deducted in determining AGI) over $5 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately). For trusts and estates the threshold is $100,000, and AGI is determined as provided in section 67(e) (that is, after deducting certain unique fiduciary expenses, the personal exemption of section 642(b), and the distribution deduction of section 651 or 661), with a further deduction for charitable payments and set-asides under section 642(c) that was helpfully added in the November 3 update mentioned in Part 26.d below.

(b) **Capital Gain Tax Rates.** The rate of income tax on capital gains would have been increased from 20 percent to 25 percent to the extent the taxpayer is subject to the reinstated 39.6 percent top rate – that is, for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses and $12,500 indexed [$13,450 in 2022] for trusts and estates). Notably, this provision was designed to take effect **on September 14, 2021**, with an exception for gains recognized in 2021 pursuant to written binding contracts entered into before September 14, 2021.

(c) **Expansion of Tax on Net Investment Income.** Beginning **January 1, 2022**, the 3.8 percent tax on net investment income would have been expanded by effectively eliminating the "trade or business" exception in section 1411(c)(1)(A) for individuals with "modified adjusted gross income" (in this case already defined in section 1411(d) as AGI plus, in effect, net foreign earned income excluded under section 911) over $400,000 ($500,000 for joint returns and surviving spouses) and for trusts and estates with adjusted gross income in excess of the threshold for the highest income tax bracket for trusts and estates ($13,450 in 2022).

(d) **Limitation of Qualified Business Income Deduction.** Beginning **January 1, 2022**, the qualified business income deduction of section 199A (added by the 2017 Tax Act) would have been capped at $400,000 for individuals ($500,000 for joint returns and surviving spouses) and $10,000 for trusts and estates.

c. **Administration's "Build Back Better Framework"**

On October 28, 2021, the White House released a short document titled "Build Back Better Framework." It was widely viewed as reflecting negotiations among the Administration and members of Congress in both parties. The Framework added that its spending proposals would be "more than fully paid for by asking the wealthiest Americans and most profitable corporations to pay their fair share," including a "new surtax on multi-millionaires and billionaires." But it omitted any reference to many of the proposals that had been in the Ways and Means Committee's version of H.R. 5376, including changes to the basic exclusion amount, the treatment of grantor trusts, and the valuation of nonbusiness assets in entities.

d. **House Rules Committee Version Passed by House**

On the same day, October 28, 2021, the House Rules Committee released a new version of H.R. 5376, mirroring the White House Framework and omitting the transfer tax and grantor trust provisions the Ways and Means Committee had previous approved. An updated version, with both technical and substantive additions, was released on November 3, 2021.

The White House Framework's "new surtax on multi-millionaires and billionaires" proved to be the retention of the new section 1A of the original Ways and Means Committee version, effective January 1, 2022, with some significant changes in the numbers. The **threshold** for imposition of the surcharge would be **doubled** to $10 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately), and $200,000 for trusts and estates. But the ultimate **rate** of the surtax would be **almost tripled**, beginning at that threshold at 5 percent (rather than 3 percent) and then increasing to 8 percent at a level of $25 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately) and $500,000 for trusts and estates. And, as noted above, the November 3 update helpfully added a provision allowing the deduction for charitable payments and set-asides under section 642(c) in calculating the threshold for the surcharge.

The Rules Committee version keeps the limitation on the "trade or business" exception for the 3.8 percent tax on net investment income, but it omits the limitation of the qualified business income deduction.

The House of Representatives passed the Rules Committee version on November 19, 2021. The vote was 220-213, with no Republicans voting for it and only one Democrat (Representative Jared Golden of Maine) voting against it. The bill became stalled in the closely divided Senate.

e. **Senator Wyden's Mark-to-Market "Billionaires Income Tax"**

Other approaches to increasing taxes on the very wealthy have also been offered or revived during this time of negotiation, adaptation, and uncertainty. An example is Finance Committee Chair Ron Wyden's "Treat Wealth Like Wages" proposal, rolled out on October 27, 2021, as the "Billionaires

Income Tax." Although the proposal was not well received, including by some Democrats, and was not included in the bill the House passed on November 19, 2021, it will remain "on the shelf" for possible future retrieval for its revenue-raising potential, as it appears to be a rather thorough drafting job. Indeed, the draft of statutory language is 107 pages long, and the following is just a simplified summary of how it would work in general if it ever were enacted.

Effective January 1, 2022, the Billionaires Income Tax would add a new Part IV, consisting of sections 490 through 498, to subchapter E of the Internal Revenue Code, which is titled "Accounting Periods and Methods of Accounting." The core provisions of Part IV would tax the appreciation of "**covered assets**" held by "**applicable taxpayers**." (Other provisions of the Billionaires Income Tax would, for "applicable taxpayers," tighten the rules applicable to deferred compensation, private placement life insurance or annuity contracts, qualified small business stock, and qualified opportunity funds.)

(1) **"Applicable Taxpayer."** An "applicable taxpayer" includes an individual taxpayer who has **either** modified adjusted gross income exceeding $100 million (the "income test") **or** covered assets with an aggregate value exceeding $1 billion (the "asset test") in **each** of the three preceding years. Either the income test or the asset test must be met in each of those three years; it is not necessary that the same test be met each year. In applying the income test, "modified adjusted gross income" means AGI plus tax-exempt interest, excluded social security benefits, and foreign or offshore earned income excluded under sections 911, 931, and 933. In applying the asset test, values are determined under guidelines in the proposal and reduced by the taxpayer's debt. Once acquired, "applicable taxpayer" status is not terminated until the taxpayer meets **neither** the income text **nor** the asset test (applying those tests with only one-half of their respective thresholds) for **all** of the three consecutive years and has made an election (as and when the IRS prescribes) for the first of those three years.

   (a) **Married Couples.** Married couples are treated as one taxpayer, and a newly married couple is an applicable taxpayer if either spouse was an applicable taxpayer before the marriage. The thresholds of the tests are halved for a married person filing separately, but both spouses are treated as applicable taxpayers if one of them meets the tests.

   (b) **Trusts.** A nongrantor trust (including a trust deemed-owned under section 678 by someone other than the grantor) is an applicable taxpayer if it likewise meets one of the two tests in each of the three preceding years, but the thresholds for those tests are one-tenth of what they are for individuals – that is, $10 million for the income test (applied before any distribution deduction) and $100 million for the asset test. There are exceptions for certain charitable trusts and other trusts favored under the Internal Revenue Code. A grantor trust cannot be an applicable taxpayer, but the assets of a grantor trust (as well as the income, of course) are taken into account in applying the asset test to the grantor.

   (c) **Estates.** A decedent's estate is an applicable taxpayer if the decedent was an applicable taxpayer for the year of death or any of the three preceding years. In other words, a decedent's estate will not suddenly become subject to these rules when the decedent was not. This is in contrast to some other changes in the law under consideration, such as the 3 and 8 percent surcharge on trusts, where the threshold applicable to the estate would be $200,000 instead of the $10 million threshold applicable to the decedent. (Of course, a decedent's estate will typically receive appreciated assets, whether tradable or not, with a stepped-up basis, either under current law or under the deemed realization provisions of this proposal (see paragraph (4) below), and therefore these rules might not have immediate significance for estates anyway.)

(2) **"Covered Asset."** A "covered asset" is basically any asset except a retirement plan or similar account favored under the Internal Revenue Code, cash or a cash equivalent, or a private placement life insurance or annuity contract (as defined in a new section 72(e)(12) that the proposal would add to the Code). There are special rules, including attribution rules and reporting requirements, regarding certain entities in which an applicable taxpayer holds an interest. A covered asset is a **"tradable covered asset"** if it is traded or tradable on an established market

(or the substantial equivalent thereof) or electronic platform or if there otherwise is a reasonable basis to annually determine the asset's fair market value. Any covered asset that is not thereby considered "tradable" is viewed for purposes of the proposed legislation as a **"nontradable covered asset."**

(3) **Mark-to-Market for Tradable Covered Assets.** In general, a tradable covered asset (and, generally, at the owner's election, any nontradable covered asset) would be marked to market – that is, gain or loss would be recognized for income tax purposes – at the end of each year, or at any time during the year immediately before a nontaxable transfer such as an exchange for stock under section 351 or a like-kind exchange under section 2031.

(4) **Deemed Realization upon Gift or at Death.** Recalling other deemed realization proposals (see Parts 25.c and 25.e above), the proposal would provide that if an applicable taxpayer (or a defined related entity) transfers a covered asset "by gift, upon death, or in trust" (including specified in-kind distributions by estates or trusts), gain is recognized as if the asset had been sold at its fair market value. Loss is similarly recognized, but only for such transfers at death. There are certain exceptions for transfers to or for a spouse or charity.

(5) **Deferral Recapture for Nontradable Covered Assets.** If an applicable taxpayer transfers a nontradable covered asset either in a sale, exchange, disposition, or other transfer in which gain is recognized or in a nontaxable transfer such as an exchange for stock under section 351 or a like-kind exchange under section 2031, the taxpayer must pay a "deferral recapture amount" to generally emulate what would have been the interest on the tax owed if the asset had been marked to market annually throughout the taxpayer's holding period like a tradable covered asset, using an interest rate that is two percentage points lower than the rate on underpayments under section 6621(a)(2).

f. **Other Suggestions**

(1) **Wealth Tax.** Another suggestion, which has been in print a little longer than Senator's Wyden's Billionaires Income Tax, is the "Ultra-Millionaire Tax Act of 2021" introduced in this Congress on March 1, 2021, by Senator Elizabeth Warren of Massachusetts (S. 510) and Congressional Progressive Caucus Chair Pramila Jayapal of Washington (H.R. 1459). Beginning in 2023, the Ultra-Millionaire Tax Act would impose an annual tax on the net worth of individuals (treating married individuals as one) and trusts. The tax would be 2 percent over a threshold of $50 million and an additional 1 percent (totaling 3 percent) over a threshold of $1 billion.

(2) **"For the 99.5 Percent Act."** And then of course there are the proposals focusing on the transfer tax in the many editions of Senator Sanders' bill, currently called the "For the 99.5 Percent Act." (See Part 25.b above.)

27. The Administration's Fiscal Year 2023 Budget Proposals

The Treasury Department released its "General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals" (popularly called the "Greenbook") on March 28, 2022. See **https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf**. Many of its proposals resemble legislative proposals made last year (including in the Fiscal Year 2022 Greenbook) that were not included in the "Build Back Better Act" (H.R. 5376) stalled in the Senate after being passed by the House of Representatives on November 19, 2022.

In an election year with a sharply divided Congress, it is possible – if not likely – that **none** of the Greenbook proposals will be acted on. On March 15, 2022, President Biden signed the Consolidated Appropriations Act, 2022 (Public Law 117-105), which provides funding for the federal government for the fiscal year ending September 30, 2022. That Act was not a budget reconciliation act, however, leaving open the theoretical **possibility** that the budget reconciliation process could still be used to enable the Senate, without needing 60 votes to end debate, to pass a presumably trimmed-down version or replacement of the "Build Back Better Act," **possibly** including some of these Greenbook proposals. On the other hand, the funding of the government through September 30 removes one of the motivations that has produced last-minute congressional tax legislation in the past to prevent a politically embarrassing government shutdown. After September 30, with the November 8 elections even closer, and after November 8, with a "lame-duck" Congress, such legislation seems even less likely.

So it is **possible** that some of the following proposals could be picked up and added to some pending bill for a number of reasons – including policy, revenue, conformity and balance, negotiation, inattention, or a combination of these. But it would not be easy.

Even so, whenever we see legislative proposals articulated like this, it is important to pay attention, because they are constantly evolving and could be pulled from the shelf and enacted, if not this year then in the future when the political climate is different. Such proposals never completely go away. And each time they are refined and updated, we can learn more about what to watch for and how to react.

a. **Individual Income Tax Rates, Including Capital Gains**

Like last year's Greenbook (discussed in Part 25.e above), the current Greenbook proposes (at page 29) to accelerate the return of the top marginal individual income tax rate to 39.6 percent (as it was before 2018 and will be again in 2026 under the 2017 Tax Act), effective January 1, 2023. Unlike last year, however, it would lower the levels of taxable incomes at which that rate would apply to $450,000 for joint returns, $400,000 for unmarried individuals (other than surviving spouses), $425,000 for heads of households, and $225,000 for married individuals filing separate returns. After 2023, the thresholds would be indexed for inflation using the "Chained CPI" ("C-CPI-U") that was introduced in the 2017 Tax Act. This proposal is estimated to raise approximately $187 billion over the next 10 fiscal years. (Overall, the tax increases proposed by the Greenbook are estimated to raise revenue over the next 10 fiscal years by about $2.5 trillion.)

Also mirroring last year's Greenbook, the current Greenbook proposes (at page 31) to tax capital gains and qualified dividends at the same rate as ordinary income (that is, 37 percent under current law or 39.6 percent as proposed). This would apply to taxpayers with taxable income (not adjusted gross income as in last year's proposal) over $1 million ($500,000 for married individuals filing separately). It would be effective for gains "required to be recognized" and dividends received on or after the date of enactment (not the puzzling "date of announcement" as in last year's proposal).

b. **Deemed Realization of Capital Gains**

In terms almost identical to last year's budget proposal, the Greenbook (at pages 30-33) again advocates the "deemed realization" of capital gains upon transfers by gift and at death.

(1) **Effective Date.** The proposal would take effect on January 1, 2023. But it would apply to pre-2023 appreciation; there would be no "fresh start" as, for example, in the 1976 carryover basis legislation.

(2) **Realization Events.** Gain would be explicitly recognized on transfers by gift or at death, equal to the excess of an asset's fair market value on the date of the gift or death over the donor's or decedent's basis in that asset. The Greenbook does not mention holding periods or distinguish short-term and long-term gain. The Greenbook also does not specifically incorporate the alternate valuation date for transfers at death, although it does state generally that a transfer "would be valued at the value used for gift or estate tax purposes."

(3) **Taxpayer, Return, and Deductibility.** The Greenbook states that the gain would be reported "on the Federal gift or estate tax return or on a separate capital gains return." Reassuringly, however, the Greenbook confirms that the gain "would be taxable income to the decedent" and, consistently with that characterization, explicitly adds that "the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any)." That means that, after all exclusions are used, the proposed 39.6 percent capital gains rate and the current 40 percent estate tax rate would produce a combined tax rate on appreciation of 63.76 percent ($0.396 + 0.4 \times (1 - 0.396)$).

(4) **Exclusion for Tangible Personal Property.** The Greenbook would exclude "tangible personal property such as household furnishings and personal effects (excluding collectibles)."

(5) **Exclusion for Transfers to Spouses.** The Greenbook would exclude "[t]ransfers to a U.S. spouse." There is no elaboration of the term "U.S. spouse" (for example, citizen or resident), and there are no special provisions targeted to spousal trusts. Transfers to a spouse would carry over the transferor's basis. Thus, the effect of excluding transfers to spouses would be simply to defer the application of the deemed realization rules until the spouse's disposition of the asset or the spouse's death.

(6) **Exclusion for Transfers to Charity.** The Greenbook would exclude "[t]ransfers … to charity." It adds that "[t]he transfer of appreciated assets to a split-interest trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes." Like transfers to a spouse, transfers to charity would carry over the transferor's basis.

(7) **Other Exclusions.** The Greenbook proposes a unified exclusion of capital gains for transfers both by gift and at death of $5 million per person (up from $1 million last year), indexed for inflation after 2022 and "portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes." The Greenbook adds that this would "result … in a married couple having an aggregate $10 million exclusion," but, like last year's Greenbook, it does not explain exactly how that would be accomplished for lifetime gifts when there has been no "decedent" or "surviving spouse." The Greenbook does not address whether the use of the exclusion for lifetime gifts is mandatory or elective. But it adds, quixotically and without further elaboration, that the $5 million exclusion "would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift." Could it be saying, in effect, that a lifetime gift must actually generate a gift tax liability for the donor to use this $5 million exclusion of gain during life? So the first $12 million or so of gifts would trigger recognition of gain, and after that gifts with $5 million of appreciation would escape deemed realization, and after that gifts would trigger gain again? Odd.

But in an apparent reversal of last year's Greenbook (see Part 25.e(7) above), the current Greenbook states that "[t]he recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death" (except, presumably, for excluded transfers to spouses and to charity discussed above). Last year's Greenbook, not surprisingly, included the caveat that "the donee's basis in property received by gift during the donor's life would be the donor's basis in that property at the time of the gift to the extent the unrealized gain on that property counted against the donor's $1 million exclusion from recognition." Could it be that the current Greenbook would increase that proposed $1 million exclusion to $5 million and at the same time allow a stepped-up basis even if the gain is excluded? Although surprising, that would be a significant simplification.

In addition, the Greenbook confirms that the exclusion of $250,000 per person of gain from the sale or exchange of a taxpayer's principal residence under section 121 would apply to the gain realized under this proposal with respect to all residences, and it adds that that exclusion would be made "portable to the decedent's surviving spouse." In this case the application of the portability model to lifetime gifts may be less of an issue because section 121(b)(2) itself doubles the exclusion to $500,000 for joint returns involving jointly used property.

The Greenbook also confirms that the exclusion under current law for capital gain on certain small business stock under section 1202 would apply.

(8) **Netting of Gains and Losses.** For transfers at death, capital losses and carry-forwards would be allowed as offsets against capital gains and up to $3,000 of ordinary income, mirroring the current income tax rules for lifetime realization events in sections 1211 and 1212. There is no mention of relaxing the rules of section 267 prohibiting the deduction of losses from sales or exchanges between related persons, but it seems almost certain that those rules would be relaxed in any provision for taking losses into account at death, where transfers to related persons are the norm.

(9) **Valuation.** As noted above, the Greenbook contemplates that a transfer generally "would be valued at the value used for gift or estate tax purposes." The Greenbook adds that "a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property." In other words, no entity-level discounts. But, elaborating the word "generally," which is new this year, the Greenbook also helpfully adds that "this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business."

(10) **Special Rules for Trusts and Entities.** The Greenbook provides that transfers into, and distributions in kind from, a trust would be recognition events, unless the trust is a grantor trust deemed wholly owned and revocable by what the Greenbook calls "the donor." Again there is no exclusion or exemption for pre-2023 gain, and indeed the Greenbook explicitly states that the proposal would apply to "certain property owned by trusts … on January 1, 2023." In other words, this proposed recognition treatment would apply to distributions of appreciated assets to both current and successive or remainder beneficiaries of preexisting trusts, including, for example, both the grantor (or grantor's spouse) and the remainder beneficiaries of a pre-2023 GRAT, DAPT, or SLAT. With regard to revocable trusts, the deemed owner would recognize gain on the unrealized appreciation in any asset distributed (unless in discharge of the deemed owner's obligation) to anyone other than the deemed owner or the deemed owner's "U.S. spouse" (again undefined), and on the unrealized appreciation in all the assets in the trust when the deemed owner dies or the trust otherwise becomes irrevocable.

Last year's Greenbook went a lot farther and, surprisingly, provided that the rules about transfers into and distributions in kind from a trust would also apply to a "partnership" or "other non-corporate entity," without further explanation. The current Greenbook clarifies that this extension to such entities applies "if the transfers have the effect of a gift to the transferee."

The Greenbook also proposes, in effect, a 90-year mark-to-market rule:

> Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. This provision would apply to property not subject to a recognition event since December 31, 1939, so that the first recognition event would be deemed to occur on December 31, 2030.

Again assets of partnerships and other entities are included, in this case without a gift-equivalent requirement or other explanation. Because December 31, 2030, is 91, not 90, years from December 31, 1939, it appears that the Greenbook contemplates recognition only at the end of the year, but the Greenbook does not clarify that. And, because it does not depend on any arguable recognition "event" like a gift, death, or other transfer, this 90-year mark-to-market rule is probably the feature of this proposal that would most likely attract a constitutional challenge.

(11) **Deferral of Tax.** The Greenbook also provides that "[t]axpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated." This is a helpful clarification of last year's Greenbook, which provided only that the "[p]ayment of tax … would not be due." Deferral could increase the amount of tax if there is more appreciation, but it could also prevent the payment of tax to the extent the value of the business declines (which sometimes happens after the death of a key owner). That approach would apparently also tax the realization event at whatever the tax rates happen to be at the time, which might sometimes be a vexing consideration in the executor's decision to make this election.

If that election is made, would it still be true, as the Greenbook states in the context of exclusions immediately before its discussion of deferral, that "[t]he recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death"? Probably not, because mere deferral of deemed realization (regardless of the amount of gain deferred) is much different from the total escape from realization provided by the limited exclusion. Thus, the loss of a stepped-up basis at intervening deaths could make this ultimate income tax liability much more severe than under current law.

And of course the statutory language implementing this Greenbook proposal should be expected to include definitions of a "business," "family-owned," and "family-operated" and possibly rules for the identification of assets that should be excluded from the deferral because they are not used in the business, and such definitions and rules might also create or aggravate challenges over a long-term deferral. The IRS would also be authorized to require reasonable security at any time from any person and in any form acceptable to the IRS, which could be another complication for the family business, for example in raising capital, over a long-term deferral.

In addition, the Greenbook would allow "a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made." Details about start dates and interest rates are not provided, but the proposal appears much broader and more robust than, for example, section 6166 with its multiple qualification tests.

(12) **Administrative Provisions.** The Greenbook envisions (but without details) a number of other legislative features, covering topics such as a deduction for the full cost of related appraisals, the waiver of penalties for underpayment of estimated tax attributable to deemed realization of gains at death (which, of course, would not have been foreseeable), a right of recovery of the tax on unrealized gains, rules to determine who selects the return to be filed, consistency in valuation for transfer and income tax purposes, and coordination of the changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed.

(13) **Regulations.** Treasury would be granted authority to issue any regulations necessary or appropriate to implement the proposal, including reporting requirements that could permit reporting on the decedent's final income tax return, which would be especially useful if an estate tax return is not otherwise required to be filed. In a tacit acknowledgment of the harshness of enacting such a proposal without a "fresh start" for basis as in 1976, the Greenbook explicitly contemplates that the regulations will include "rules and safe harbors for determining the basis of assets in cases where complete records are unavailable."

(14) **Revenue Estimate.** Taxing capital gains at the same rate as ordinary income for taxpayers with taxable income over $1 million and the proposed "deemed realization" of capital gains together are estimated to raise approximately $174.5 billion over the next 10 fiscal years.

c. **Minimum Tax on the Wealthiest Taxpayers**

This provision, new in the current Greenbook (at pages 34-36), is an adaptation of Senator Wyden's "Treat Wealth Like Wages" proposal, rolled out to a very lukewarm reception as his "Billionaires Income Tax" on October 27, 2021. See Part 26.e above. The Greenbook version proposes a minimum tax, effective January 1, 2023, of 20 percent of total income, generally including unrealized capital gains, for taxpayers with "wealth" (that is, assets minus liabilities) greater than $100 million. Taxpayers could choose to pay the minimum tax liability in equal annual installments over nine years for the first year of minimum tax liability and over five years for subsequent years. The minimum tax payments would be treated as a prepayment to be credited against subsequent taxes on realized gains to avoid taxing the same amount of gain more than once.

Taxpayers with tradable assets constituting less than 20 percent of their wealth would be treated as "illiquid" and could elect to include the unrealized gain only for tradable assets in determining the annual minimum tax, "subject to a deferral charge upon, and to the extent of, the realization of gains on any non-tradable assets" (not to exceed 10 percent of unrealized gains). No estimated payments would be required for the minimum tax. Taxpayers with wealth over the $100 million threshold would have to report annually the total basis and total estimated value of assets in each specified asset class, with alternatives to appraisals available for valuing non-tradable assets.

This proposal is estimated to raise approximately $361 billion over the next 10 fiscal years. The constitutionality of such a new tax on unrealized appreciation would likely be challenged in court.

d. **Modify Income, Estate and Gift Tax Rules for Certain Grantor Trusts**

The Greenbook (at page 40) laments that "[i]ndividuals who own assets expected to appreciate in value use two common techniques for reducing estate taxes that exploit the gift and income tax features of grantor trusts to remove value from their gross estates." Those two exploitative techniques turn out to be GRATs (which many would point out were created by Congress in section 2702(b)(1)) and sales of appreciating assets to grantor trusts (which, likewise, many would point out are facilitated by Congress's use of the phrase "treated as the owner" in sections 673 through 677 and its treatment of income tax as a liability of that owner under section 671). Be that as it may, the Greenbook (at pages 40-42) invites Congress to blaze a new trail.

(1) **GRATs.** Like the Obama Administration Greenbooks, and similarly to section 7 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Part 25.b(7) above), the Greenbook would impose on GRATs

- a minimum term of 10 years,
- a maximum term of the life expectancy of the annuitant plus 10 years,
- a prohibition on any decrease in the annuity during the GRAT term (which otherwise might be used to reduce the amount includable in the grantor's gross estate if the grantor dies before the end of the GRAT term),
- a minimum remainder value equal to the greater of 25 percent of the assets contributed to the GRAT or $500,000 (but not more than the value of assets contributed to the GRAT), which would put an end to the very common and effective technique of zeroed-out or nearly-zeroed-out GRATs, and
- a prohibition on the grantor's acquisition of any asset from the GRAT in an exchange without recognizing gain or loss on the exchange.

This proposal would apply to GRATs created on or after the date of enactment. If this proposal gained traction and was given a reasonable chance of being enacted, that might encourage the creation and funding of GRATs before enactment, which would avoid the first four limitations, particularly the huge fourth limitation of a minimum 25 percent remainder value. But merely creating a GRAT before enactment would not necessarily avoid the fifth limitation, because the proposals discussed in Part 27.b(10) above and paragraph (2) below would apparently also require a GRAT to recognize gain if the annuity payments were made with appreciated assets. (The gain recognition risk might be minimized, if feasible, by using a longer term GRAT in which the annuity amounts were low enough that they could be satisfied out of income, not with in-kind distributions.)

(2) **Recognition of Gain on Sales Transactions with Grantor Trusts.** For trusts not fully revocable by the deemed owner, "the transfer of an asset for consideration between a grantor trust and its deemed owner" would result in the recognition of gain. The proposal uses the term "deemed owner" (which implies that it includes a person other than the grantor under section 678) and also the term "grantor trust" (which sometimes implies that a trust treated as owned by a person other than the grantor is not included). The proposal would apply both to sales and to transfers in satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. It would apply to transactions on or after the date of enactment. And it would significantly overlap with the deemed realization proposals for trusts discussed in Part 27.b(10) above.

(3) **Payment of Income Tax by Deemed Owner as Gift.** The payment by the "deemed owner" of income tax on the income of a "grantor trust" would be a gift by the deemed owner "unless the deemed owner is reimbursed by the trust during that same year" in which the tax is paid. Again, the proposal uses the clashing terms "deemed owner" and "grantor trust."

The Greenbook states that the gift would generally occur "on December 31 of the year in which the income tax is paid." Acknowledging the need for some exceptions to that rule, the

Greenbook adds "if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year." But even that addition does not specifically provide for cases where the reimbursement is made only in the trustee's discretion and not as the deemed owner's "right," or where the "reimbursement right" terminates other than by the owner's renunciation, or when grantor trust (or "deemed owned") status itself terminates other than by the owner's death. Likewise, the Greenbook does not address how to determine the year in which the deemed owner pays the income tax on the trust's income when some of the deemed owner's income tax liability is paid by quarterly estimated payments, three of which have been made in the year before the income tax return is filed, or by overpayments applied from the previous year's return. It is almost certain, however, that all such payments would be treated as made in the year the tax is due, because otherwise the notion of being "reimbursed by the trust during that same year" would make no sense.

And of course the annual reimbursement of such taxes pursuant to either a requirement or an exercise of discretion pursuant to an understanding or prearrangement would create a risk of including the value of the trust assets in the grantor's gross estate under section 2036 as applied in Rev. Rul. 2004-64, 2004-2 C.B. 7.

This proposal would apply to all trusts created on or after the date of enactment (which, if the proposal gains any traction, could provide an incentive to create and fund grantor trusts before the date of enactment).

(4) **Revenue Estimate.** These proposals together are estimated to raise approximately $41.5 billion over the next 10 fiscal years.

e. **Consistent Valuation of Promissory Notes**

(1) **Background.** Loans with an interest rate equal to the applicable federal rate (AFR) incorporated into section 7872 are not treated as gifts, but the lender may take the position that the note should be discounted for gift tax purposes on a later re-transfer or for estate tax purposes at death because the interest rate is lower than a commercial rate at the time. Section 7872, added to the Code by the Deficit Reduction Act of 1984 (Public Law 98-369, July 18, 1984), authorized the issuance of regulations to address the estate tax valuation of notes, and proposed regulations were promptly promulgated but have never been finalized. Meanwhile, although the note is included in the decedent's gross estate, it is possible that it could be valued **for estate tax purposes** at less than its face amount, under general valuation principles, because section 7872 is not an **estate tax** valuation rule. That would be especially true if interest rates rise between the date of the sale and the date of death.

Section 7872(i)(2) states:

> Under regulations prescribed by the Secretary, any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans].

Proposed Reg. §20.7872-1 (published on August 20, 1985, barely a year after the enactment of section 7872) states:

> For purposes of chapter 11 of the Internal Revenue Code, relating to estate tax, a gift term loan … that is made after June 6, 1984, shall be valued at the lesser of:
>
> > (a) the unpaid stated principal, plus accrued interest; or
> >
> > (b) the sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.
>
> No discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectibility of the loan have changed significantly since the time the loan was made. This section applies with respect to any term loan made with donative intent after June 6, 1984 [the effective date of section 7872], regardless of the interest rate under the loan agreement, and regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made.

The estate planner's answers to the proposed regulation would include the arguments that

- the proposed regulation is not effective unless and until it is finalized,
- the loan represented by the installment note is not a "gift term loan" because it uses an interest rate calculated to avoid below-market treatment under section 7872(e), and
- with respect to both this proposed regulation and section 7872(i)(2) itself, the loan is not made "with donative intent" because the transaction is a sale, not a gift.

With respect to the first point, it is arguable that section 7872(i)(2) itself requires consistency even in the absence of regulations (although it still might be unclear what "consistency" means in that context). Tax Court Judge Tannenwald distinguished between "how" regulations and "whether" regulations in *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996). Section 2663(2) provides that "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this chapter, including … regulations (consistent with the principles of chapters 11 and 12) providing for the application of this chapter [the GST tax] in the case of transferors who are nonresidents not citizens of the United States." This, Judge Tannenwald held, refers to a "how" regulation that is not a necessary condition to the imposition of the GST tax on transfers by nonresident noncitizens. Similar results with reference to the phrase "under regulations" (which is the phrase also used in section 7872(i)(2)) were reached in *Francisco v. Commissioner*, 119 T.C. 317 (2002), and *Flahertys Arden Bowl, Inc. v. Commissioner*, 115 T.C. 269 (2000). Compare section 465(c)(3)(D), which provides that a special rule "shall apply only to the extent provided in regulations prescribed by the Secretary." *Alexander v. Commissioner*, 95 T.C. 467 (1990). Also compare *Frazee v. Commissioner*, 98 T.C. 554 (1992), and *Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd*, 390 F.3d 1210 (10th Cir. 2004), discussing other proposed regulations under section 7872.

Under section 7805, the proposed regulations could probably be expanded even beyond the strict mandate of section 7872(i)(2), and, under section 7805(b)(1)(B) such expanded final regulations might even be made effective retroactively to the publication date of the proposed regulations in 1985. But, unless and until that happens, most estate planners have seen no reason why the estate tax value should not be fair market value, which, after all, is the general rule, as elaborated in Reg. §20.2031-4:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

The 2015-2016 Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2015, released on July 31, 2015, included a project, new that year, titled "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872." It was retained in the 2016-2017 Priority Guidance Plan but dropped from the slimmed-down 2017-2018 Plan published October 20, 2017, by the Trump Administration. It is not clear that this guidance project was related to Proposed Reg. §20.7872-1, which it does not cite. This project was joined in the 2016-2017 Plan by an item under the subject of "Financial Institutions and Products" described as "Regulations under §7872. Proposed regulations were published on August 20, 1985." When the promissory notes project was dropped from the subject of "Gifts and Estates and Trusts" in the 2017-2018 Plan, that item under "Financial Institutions and Products" remained. It was carried over to the 2018-2019 Plan, but dropped from the 2019-2020 Plan.

(2) **The Current Greenbook Proposal.** Rather than following through on the existing statutory authority to adopt regulations addressing the issue, however, Treasury is now proposing in the Greenbook (at pages 43-44) a legislative solution that would limit the discount rate used to value the note for estate tax purposes to "the greater of the actual rate of interest of the note, or the

applicable minimum interest rate for the remaining term of the note on the date of death." The Greenbook adds:

> The Secretary and her delegates (Secretary) would be granted regulatory authority to establish exceptions to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note. In addition, the term of the note would be treated as being short term regardless of the due date, or term loans would be valued as demand loans in which the lender can require immediate payment in full, if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.

Exceptions "to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note" would certainly be appropriate. Otherwise, for example, a note with a commercially reasonable interest rate, such as a note a seller of a home might take back from an unrelated buyer, might be artificially overvalued for estate tax purposes if its true value was depressed because market interest rates had risen.

Subject to what such regulations might provide, it appears that valuing a note by discounting future payments of principal and interest at a discount rate equal to that interest rate would be tantamount to simply valuing the note at its face amount of unpaid stated principal plus accrued interest, the same as in Proposed Reg. §20.7872-1(a) or, for that matter, the general rule in Reg. §20.2031-4 (both quoted above).

The Greenbook states that "[t]he proposal would apply to valuations as of a valuation date on or after the date of introduction." Presumably that means the introduction of legislation specifically drafted to implement proposals in this Greenbook, but it is left to the legislation itself to clarify that. In any event, the date of introduction is a rather bold effective date approach, usually reserved for cases where Congress perceives a particular abuse or other need for urgency. An argument for urgency, of course, could be somewhat awkward in a context that includes proposed regulations that have been pending since 1985. On the other hand, the argument described above that section 7872(i)(2) itself already requires consistency could make it awkward to object to that effective date as a surprise or as unfair.

This proposal is estimated to raise approximately $6.4 billion over the next 10 fiscal years.

f. **Limited Duration of GST Exemption**

The Greenbook (at page 48) muses that "[a]t the time of the enactment of the GST provisions, the law of most States included the common law Rule Against Perpetuities (RAP) or some statutory version of it …" It's easy to see where that is headed.

The Greenbook (at pages 48-49) proposes that

> the GST exemption would apply only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor [for example, to grandchildren but not great-grandchildren of the transferor], and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust.

Therefore, trusts would continue to be exempt, not for the full life of the trust (for example, throughout the entire applicable rule against perpetuities period), but only for the life of any first- or second-generation beneficiary or any younger generation beneficiary who was alive at the creation of the trust. The "reset" rule of section 2653(a) would not apply. The Greenbook states that the special rule in section 2653(b)(2) for "pour-over trusts" created from a trust (whether under the trust instrument or under a decanting authority) would continue to apply, with such pour-over trusts deemed to have the same date of creation as the initial trust for purposes of determining the duration of the GST exemption.

This provision limiting the duration of the allocation of GST exemption would apply retroactively to existing trusts, but for purposes of determining the duration of the GST exemption "a pre-enactment trust would be deemed to have been created on the date of enactment."

By allowing allocation of GST exemption and only limiting how long it lasts, the Greenbook proposal could be less harsh than, for example, section 9 of Senator Sanders' "For the 99.5 Percent Act" (discussed in Part 25.b(9) above), which in effect would deny any exemption **allocation** if the trust **could** last longer than 50 years.

Not surprisingly, this proposal focused on trust distributions to great-grandchildren is not projected to affect revenue over the next 10 fiscal years.

g. **Miscellaneous Trust and Estate Tax Provisions**

A section of the Greenbook (at pages 45-47) titled "Improve Tax Administration for Trusts and Decedents' Estates" proposes a number of changes, none of which were included in last year's Greenbook.

(1) **Expanded Definition of Executor.** The definition of executor would be moved from section 2203 to section 7701, and the authorized party could act for all tax purposes (including with respect to pre-death tax liabilities). This would apply after enactment regardless of a decedent's date of death.

(2) **Increased Benefit of Special Use Valuation.** As in the House Ways and Means Committee's version of the "Build Back Better Act" (discussed in Part 26.b(6) above), the Greenbook proposes to increase the limit on the reduction in value of special use property from $750,000 (indexed, $1.23 million in 2022) to $11.7 million, applicable for decedents dying on or after the date of enactment. As noted in Part 26.b(6), however, despite this proposal's family-business-friendly curb appeal, it would not really reduce the estate tax on a family farm or business as such; it would merely prevent a tax, for example, on a speculative prospect of development that is faced by such businesses very unevenly.

(3) **Extension of 10-Year Estate and Gift Tax Lien.** The automatic 10-year lien for estate and gift tax would be extended during any deferral or installment period for unpaid estate and gift taxes. This provision would apply for existing 10-year liens and for the automatic lien that applies for gifts made or estates of decedents dying on or after the date of enactment.

(4) **Reporting of Estimated Value of Trust Assets.** In a change that could be very burdensome and very significant, trusts would be required to file with the IRS annual reports including the name, address, and taxpayer identification number (TIN) of each trustee and grantor of the trust, and general information with regard to the nature and estimated total value of the trust's assets (which might be satisfied by identifying an applicable range of estimated total value on the trust's income tax return). The reporting requirement would apply to taxable years ending after the date of enactment for trusts valued over $300,000 or with gross income over $10,000.

(5) **Revenue Estimate.** These proposals together are estimated to decrease revenue by $326 million over the next 10 fiscal years, probably attributable to the relaxation of the limit on the availability of special use valuation.

h. **Not Included in the Greenbook**

The Fiscal Year 2023 Greenbook proposals do not include the following measures that were in the September 15, 2021, House Ways and Means Committee version of the "Build Back Better Act" (discussed in Part 26.b above):

- A reduction of the estate and gift tax exclusion amount prior to 2026.
- A new section 2901 aligning the income tax and transfer tax treatment of grantor trusts (although, as discussed above, the Greenbook would remove two huge tax advantages of grantor trusts – (1) the grantor's payment of income taxes as a transfer free of gift tax and (2) the grantor's ability to enter into sales, swaps, or other transactions with the trust without an income tax recognition event).
- Look-through valuation rules for nonbusiness assets in entities.

28. Requirements of the Regulatory Process

a. Effects of Executive Orders

(1) Executive Order 13789 of April 21, 2017, famous for ordering the action that led to the withdrawal in October 2017 of the August 2016 proposed section 2704 regulations, also directed the Treasury Department and the Office of Management and Budget (OMB) to "review and, if appropriate, reconsider the scope and implementation of the existing exemption for certain tax regulations from the review process set forth in Executive Order 12866 and any successor order."

(2) Executive Order 12866, which was signed by President Clinton on September 30, 1993, requires generally that Treasury

(a) periodically provide the Office of Information and Regulatory Affairs (OIRA) within OMB with a list of its planned regulatory actions, including those it believes are "significant regulatory actions" (section 6(a)(3)(A) of Executive Order 12866),

(b) for each "significant regulatory action," provide to OIRA "(i) [t]he text of the draft regulatory action, together with a reasonably detailed description of the need for the regulatory action and an explanation of how the regulatory action will meet that need; and (ii) [a]n assessment of the potential costs and benefits of the regulatory action, including an explanation of the manner in which the regulatory action is consistent with a statutory mandate and, to the extent permitted by law, promotes the President's priorities and avoids undue interference with State, local, and tribal governments in the exercise of their governmental functions" (section 6(a)(3)(B) of Executive Order 12866), and

(c) for each "significant regulatory action" that is likely to have an annual effect on the economy of $100 million or more, include the following regulatory impact assessment (section 6(a)(3)(C) of Executive Order 12866, emphasis added):

> (i) An assessment, *including the underlying analysis*, of *benefits* anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets, the enhancement of health and safety, the protection of the natural environment, and the elimination or reduction of discrimination or bias) together with, to the extent feasible, a *quantification* of those benefits;
>
> (ii) An assessment, *including the underlying analysis*, of *costs* anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets (including productivity, employment, and competitiveness), health, safety, and the natural environment), together with, to the extent feasible, a *quantification* of those costs; and
>
> (iii) An assessment, *including the underlying analysis*, of costs and benefits of potentially effective and reasonably feasible *alternatives* to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable nonregulatory actions), and *an explanation why the planned regulatory action is preferable to the identified potential alternatives*.

(3) Under section 3(f) of Executive Order 12866, a "significant regulatory action" to which the requirements described in paragraphs (b) and (c) above apply is defined as

> any regulatory action that is likely to result in a rule that may:
>
> (1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;
>
> (2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;
>
> (3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; or
>
> (4) Raise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order.

(4) The regulatory impact assessment, along with a draft of the proposed regulations, must be reviewed within OMB before a proposed regulation is published for public comment. In addition, the public must be informed of the content of the regulatory impact assessment and of any substantive changes made in the draft of the proposed regulations after that draft was submitted to OMB for review (section 6(a)(3)(E) of Executive Order 12866).

(5) Obviously, that is not information we are accustomed to seeing in connection with tax regulations. Since a Memorandum of Agreement between Treasury and OMB in 1983, most tax regulations were viewed as exempt from rigorous OMB review, partly because they were viewed as interpreting a statute, and any burden on the economy therefore was attributable to the statute, not to the regulations.

(6) A new Memorandum of Agreement, signed by the Administrator of OIRA and the General Counsel of the Treasury Department on April 11, 2018, supersedes the 1983 Memorandum of Agreement and generally affirms the application of Executive Order 12866 to tax regulatory actions.

   (a) Under paragraph 3 of the new Memorandum of Agreement, the frequency of providing the list of planned tax regulatory actions referred to in paragraph (2)(a) above is quarterly.

   (b) Under paragraph 8, the new Memorandum of Agreement was effective immediately, except that the regulatory impact assessment described in paragraph (2)(c) above was not required until the earlier of April 11, 2019, or "when Treasury obtains reasonably sufficient resources (with the assistance of OMB) to perform the required analysis."

   (c) Under paragraph 4, the time allowed for OIRA review is generally 45 days, with the opportunity for Treasury and OIRA to agree to 10 business days "[t]o ensure timely implementation of the Tax Cuts and Jobs Act of 2017."

(7) This did not work too badly in the tax context in the Trump Administration. For example, there did not appear to have been excessive delays. And there has been some bipartisan support for this type of oversight. So it is possible – but not certain – that it will continue in some form throughout the Biden Administration.

b. **Cases Construing the Administrative Procedure Act**

In *Hewitt v. Commissioner*, 128 AFTR 2d 2021-7033 (11th Cir. Dec. 29, 2021), *rev'g and rem'g* T.C. Memo. 2020-89, the Court of Appeals for the Eleventh Circuit held that the proceeds formula in Reg. §1.170A-14(g)(6)(ii), applicable upon judicial extinguishment of a conservation easement, was invalid because the IRS had failed to comply with the Administrative Procedure Act ("APA") by failing in the preamble to the final regulations to address a comment on the proposed regulations that the appellate court considered significant. The Tax Court and a three-judge panel of the Sixth Circuit have rejected that argument and have held that the formula is valid. *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180 (reviewed by the Court) (2020), *aff'd*, 129 AFTR 2d 2022-1031 (6th Cir. March 14, 2022). See Nancy A. McLaughlin, *Conservation Easements and The Proceeds Regulation*, 56 REAL PROP., TRUST & EST. LAW J. (Summer 2021), and The Top Ten Estate Planning and Estate Tax Developments of 2020 (January 2021) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**). If this difference of opinion is ultimately resolved as the Eleventh Circuit sees it, the burden of preparing final regulations and the preambles thereto might significantly increase. The effect on the regulatory process, especially in light of the additional burdens already imposed under the executive orders discussed above, is hard to predict.

29. 2021-2022 Priority Guidance Plan

On September 9, 2021, the Treasury Department and the IRS released the first Priority Guidance Plan in the Biden Administration (**https://www.irs.gov/pub/irs-utl/2021-2022-pgp-initial.pdf**) for the plan year from July 1, 2021, through June 30, 2022. The introduction to the 2021-2022 Plan states:

> We are pleased to announce the release of the 2021-2022 Priority Guidance Plan.

> In Notice 2021-28, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (Service) solicited recommendations for items to be included in the plan from all interested parties, including taxpayers, tax practitioners, and industry groups. The Treasury Department and the Service recognize the importance of public input in formulating a Priority Guidance Plan that focuses resources on guidance items that are most important to taxpayers and tax administration. Solicitation of input on, and issuance of, this plan reflects an emphasis on taxpayer engagement with the Treasury Department and the Service through a variety of channels, consistent with the directive of the Taxpayer First Act, Pub. L. 116-25, 133 Stat. 981.
>
> The 2021-2022 Priority Guidance Plan contains 193 guidance projects that are priorities for allocating Treasury Department and Service resources during the 12-month period from July 1, 2021, through June 30, 2022 (the plan year). The projects on the plan will be the focus of our efforts during the plan year. However, the plan does not provide any deadline for completing the projects.
>
> Some projects that were on the 2020-2021 Priority Guidance Plan have not been included on the 2021-2022 plan because they are no longer considered priorities for purposes of allocating resources during the 2021-2022 plan year. Some of those projects may be considered for inclusion on a future priority guidance plan. …
>
> We intend to update the 2021-2022 plan during the plan year to reflect additional items that have become priorities, guidance that we have published during the plan year, and projects that may result from legislative developments. The periodic updates allow us flexibility throughout the plan year to consider comments received from taxpayers and tax practitioners relating to additional projects and to respond to developments arising during the plan year.

The 2021-2022 Plan abandons the multi-part format used during the Trump Administration and goes back to the traditional format of divisions only by subject. It includes the following nine items under the subject heading of "Gifts and Estates and Trusts":

a. **Item 1: User Fee for Estate Tax Closing Letters**

(1) Item 1 is described as "Final regulations establishing a user fee for estate tax closing letters. Proposed regulations were published on December 31, 2020." It was new in the 2020-2021 Plan, as Item 2 under Gifts and Estates and Trusts.

(2) Before June 1, 2015, the IRS routinely issued a closing letter (sometimes referred to as IRS Letter 627, not the same as a formal "closing agreement") when the examination of an estate tax return was closed, except returns that were not required for estate tax purposes but were filed solely to elect portability. The "Frequently Asked Questions on Estate Taxes" on the IRS website was updated on June 16, 2015, to state that for such returns filed on or after June 1, 2015, closing letters would be issued only upon request. Notice 2017-12, 2017-5 I.R.B. 742, confirmed that and also confirmed that an estate tax account transcript that includes the transaction code "421" and the explanation "Closed examination of tax return" can, as the Notice put it, "serve as the functional equivalent of an estate tax closing letter."

(3) Many estate planning professionals were frustrated with efforts to obtain such transcripts and in any event have not found that a transcript has the same dignity as a closing letter for purposes of obtaining the approval of courts and the release of liens and otherwise documenting the propriety of making distributions, closing accounts, and taking other financial actions.

(4) The IRS released proposed regulations on December 31, 2020, and finalized them on September 27, 2021, establishing a $67 user fee for issuing an estate tax closing letter, effective October 28, 2021. Reg. §300.13, T.D. 9957, 86 Fed. Reg. 53539 (Sept. 28, 2021), 2021-41 I.R.B. 452.

(a) The preamble to the proposed regulations acknowledged the importance of closing letters to executors, but added:

> The practice of issuing estate tax closing letters to authorized persons is not mandated by any provision of the Code or other statutory requirement. Instead, the practice is fundamentally a customer service convenience offered to authorized persons in view of the unique nature of estate tax return filings and the bearing of an estate's Federal estate tax obligations on the obligation to administer and close a probate estate under applicable State and local law.

That is not persuasive at all. Surely the "unique nature of estate tax return filings" includes the IRS's benefit from liens, transferee liability, priority over other creditors, and other advantages, and with such power should come some level of responsibility. The preamble to the final regulations states that the IRS received comments opposing the establishment of a user fee, but it reaffirms the notion of the previous preamble that a user fee is appropriate because an estate tax closing letter is "the provision of a service that confers special benefits, beyond those accruing to the general public," without any acknowledgment of the fact that "the general public" does not face those liens, liabilities, and other burdens.

(b) The preamble to the proposed regulations stated:

> In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the IRS has identified the provision of estate tax closing letters as an appropriate service for which to establish a user fee to recover the costs that the government incurs in providing such letters. Accordingly, the Treasury Department and the IRS propose establishing a user fee for estate tax closing letter requests.

The preamble added that the practice of issuing closing letters for every filed estate tax return was changed in 2015 primarily for two reasons – (1) the increase in the volume of filed returns since the enactment of portability and (2) the availability of the transcript alternative described in Notice 2017-12.

i. Regarding the first reason, the preamble noted that in 2016 approximately 20,000 optional estate tax returns were filed solely to elect portability, compared to approximately 12,000 mandatory returns. (A closing letter in the case of a portability-only return is arguably not as serious a matter, because no estate tax liability is at stake, and because the return may in effect be audited under section 2010(c)(5)(B) upon the surviving spouse's death anyway.)

ii. Regarding the second reason, the availability of a transcript alternative that Notice 2017-12 described as "the functional equivalent of an estate tax closing letter" actually seems to undermine the concern for "resource constraints." It is not at all clear why the same amount of diligence and review needed to issue a closing letter would not also be required for that "functional equivalent" of a notation in the transcript. Indeed, it is likely that the IRS computers could simply have been programmed to issue a closing letter automatically upon entry of the code "421" and the explanation "Closed examination of tax return."

(c) The preamble to the proposed regulations also included a detailed description of the calculation of the user fee, based on fiscal year 2017 and 2018 data, culminating in the determination of a full annual cost to the IRS (including direct labor and non-labor costs and a 74.08 percent overhead factor) of $1,160,058, divided by an estimated volume of 17,249 requests to produce the proposed user fee of $67 (rounded from $67.25). The calculations included an average of one-half hour of quality assurance review by a senior staff member applied to 5 percent of mailed closing letters.

(d) The regulations do not explain how to request a closing letter and pay the user fee, but the preamble to the proposed regulations stated:

> The Treasury Department and the IRS expect to implement a procedure that will improve convenience and reduce burden for authorized persons requesting estate tax closing letters by initiating a one-step, web-based procedure to accomplish the request of the estate tax closing letter as well as the payment of the user fee. As presently contemplated, a Federal payment website, such as http://www.pay.gov, will be used and multiple requests will not be necessary. The Treasury Department and the IRS believe implementing such a one-step procedure will reduce the current administrative burden on authorized persons in requesting estate tax closing letters and will limit the burden associated with the establishment of a user fee for providing such service.

(5) On October 6, 2021, the IRS posted frequently asked questions, confirming the use of Pay.gov and addressing other procedural issues. See **https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-the-estate-tax-closing-letter**. On December 2, 2021, the IRS announced updates to its Internal Revenue Manual 4.25.2.5.10 to reflect the new estate tax closing letter and transcript request procedures.

(6) A closing letter does not preclude reopening an estate tax examination in some cases, as noted in Chief Counsel Advice 202142010 (issued April 1, 2021; released Oct. 22, 2021). That CCA also

confirms that if there has not been an examination of the estate tax return at all, then an examination may be begun without complying with the "reopening" protocols of Rev. Proc. 2005-32, 2005-1 C.B. 1206, under section 7605(b), and notwithstanding the issuance of a closing letter (Letter 627).

b. **Item 2: The Consistent Basis Rules**

(1) Item 2 is described as "Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016." In the 2020-2021 Plan, this was Item 14 of Part 3, which was titled "Burden Reduction."

(2) On July 31, 2015, the day that funding for the Highway Trust Fund was scheduled to expire, President Obama signed into law the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41), extending that infrastructure funding for three months, with the $8 billion cost funded by various tax compliance measures. One of those was section 2004 of the Act, labelled "Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent," which of course has nothing to do with highways or veterans' health care other than raising money. The provision added new provisions to the Code.

(a) New section 1014(f) requires in general that the basis of property received from a decedent "whose inclusion in the decedent's estate increased the liability for the tax" may not exceed the value as finally determined for estate tax purposes, or, if there is no final determination (as in the case of property sold while an estate tax audit is still in progress or, within the statutory period for assessments, has not begun) the value reported on the estate tax return.

(b) New section 6035 requires every executor (or person in possession of property with the statutory duties of an executor) who is required to file an estate tax return – that is, in general, if the gross estate plus adjusted taxable gifts exceeds the applicable filing threshold – to furnish to the IRS and to the recipients of property interests included in the decedent's gross estate a statement setting forth the value of those property interests reported on the estate tax return. This statement is due 30 days after the estate tax return is filed or, if the return is filed after its due date (including extensions), 30 days after that due date. Every such statement must be supplemented if a value is adjusted, for example on audit.

(c) There are also penalties for failure to file a required statement and for reporting basis inconsistently with such a statement.

(3) Previously (and **still the law** unless an estate tax return was or is filed after July 31, 2015), under section 1014(a)(1), the basis of property acquired from a decedent is simply "the fair market value of the property at the date of the decedent's death," with appropriate adjustments in section 1014 for the alternate valuation date and so forth. It is possible for the recipient of property from a decedent to claim, for income tax purposes, that the executor somehow just got the estate tax value too low, and that the heir's basis should be greater than the estate tax value. Usually, of course, such claims are made after the statute of limitations has run on the estate tax return. Such claims can be accompanied by elaborate appraisals and other evidence of the "real" date-of-death value that, long after death, is hard to refute. Invoking principles of "privity," the Service is able to insist on using the lower estate tax value when the recipient was one of the executors who signed the estate tax return, but otherwise it has had no tool to enforce such consistency.

(4) *Van Alen v. Commissioner*, T.C. Memo. 2013-235, however, created confusion about the role of a duty of consistency in determining the basis of heirs.

(a) In *Van Alen*, a brother and sister had inherited a cattle ranch from their father in 1994, with a low "special use" estate tax value under section 2032A. They were not executors; their stepmother was. The heirs sold a conservation easement on the land in 2007 and argued that their basis for determining capital gain should be higher than the estate tax value. The court held their basis to the low estate tax value.

(b) A key to the outcome was that section 1014(a)(3) describes the basis of property acquired from a decedent as "in the case of an election under section 2032A, its value *determined* under such section." This contrasts with the general rule of section 1014(a)(1), which describes the basis as merely "the fair market value of the property at the date of the decedent's death," which arguably opens up the opportunity for a non-executor heir to argue that the value "determined" for estate tax purposes was simply too low. In addition, the court pointed to the special use valuation agreement, which the two heirs (one, a minor, by his mother as his guardian *ad litem*) had signed. Consistently with this rationale for its holding, the court cited Rev. Rul. 54-97, 1954-1 C.B. 113 ("the value of the property as determined for the purpose of the Federal estate tax … is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence"), and observed that "it might be reasonable for taxpayers to rely on this revenue ruling if they were calculating their basis under section 1014(a)(1)."

(c) Surprisingly, however, the court also seemed to view heirs *who were not executors* as bound by a "duty of consistency" to use the value determined for estate tax purposes as their basis for income tax purposes. The court spoke of a "sufficient identity of interests" between the heirs and the executor and concluded that "[w]e rest our holding on the unequivocal language of section 1014(a)(3) …. And we rest it as well on a duty of consistency that is by now a background principle of tax law."

(d) While "consistency" is superficially an appealing objective, the notion that it might apply generally to the basis of an heir who was not an executor may be more novel and more troubling than the court seems to have realized. The court acknowledged that "[t]here are lots of cases that hold that the duty of consistency binds an estate's beneficiary to a representation made on an estate-tax return if that beneficiary was a fiduciary of the estate." But the court then went on to say: "But the cases don't limit us to that situation and instead say that the question of whether there is sufficient identity of interests between the parties making the first and second representation depends on the facts and circumstances of each case." The problem is that the court cited the same three cases for both propositions, and all three cases involved the basis of an heir who *was* a co-executor. Thus, *Van Alen* appears to stand alone for applying a duty of consistency to the basis of an heir who was not an executor, although the *Van Alen* holding does have the alternative ground of the word "determined" in section 1014(a)(3), applicable only in special use valuation cases.

(5) In the Obama Administration, the Treasury Department's annual "General Explanations" of revenue proposals associated with the President's budget proposals (popularly called the "Greenbook") included a provision, last found on pages 195-96 in the 2015 Greenbook (see **http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf**), to require the income tax basis of property received from a decedent or donor to be equal to the estate tax value or the donor's basis. The Greenbooks provided that the executor or donor would be required to report the necessary information to both the recipient and the Service.

(a) The Greenbook proposal would have been effective

i. "as of the date of enactment" in the 2009, 2010, and 2011 Greenbooks,

ii. "for transfers on or after the date of enactment" in the 2012 and 2013 Greenbooks, and

iii. "for transfers after the year of enactment" in the 2014 and 2015 Greenbooks.

(b) Statutory language for this proposal appeared

i. in section 6 of the Responsible Estate Tax Act, S. 3533 (introduced on June 24, 2010, by Senator Bernie Sanders (I-Vermont)) and H.R. 5764 (introduced on July 15, 2010, by Congresswoman Linda Sanchez (D-California)), applicable **"to transfers for which**

returns are filed after the date of the enactment of this Act" and requiring a statement by the executor or donor on or before the due date of the return;

ii. in section 5 of the "Sensible Estate Tax Act of 2011," H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D-Washington), also applicable "to transfers for which returns are filed after the date of the enactment of this Act" but requiring a statement by the executor or donor **within 30 days after filing the return**;

iii. in section 1422 of Ways and Means Committee Chairman Dave Camp's Discussion Draft released February 26, 2014, also applicable to transfers for which returns are filed after the date of enactment and requiring a statement by the executor or donor within 30 days after filing the return but **applicable only to estate tax values and with the changes to section 1014 (but not the reporting requirement) applicable only to property that increases the estate tax**;

iv. in section 5 of the "Sensible Estate Tax Act of 2015," H.R. 1544, introduced on March 23, 2015, by Congressman McDermott, similar to the Camp Discussion Draft except that it did not exclude property that did not increase the estate tax; and

v. then as a "pay-for" in the "Highway and Transportation Funding Act of 2015, Part II" (Public Law 114-41), endorsed by then Ways and Means Committee Chairman Ryan on July 13, 2015, which became the Surface Transportation and Veterans Health Care Choice Improvement Act (with a 10-year revenue estimate of $1.542 billion).

(6) The statute that was enacted followed the Camp Discussion Draft. As a result, compared to the 2014 and 2015 Greenbook proposals, new subsection (f) of section 1014 includes some twists.

(a) Like the Camp Discussion Draft and the 2015 "Sensible Estate Tax Act" (H.R. 1544), it applies only to property acquired from a decedent, not to gifts.

(b) Under section 1014(f)(2), like the Camp Discussion Draft, it "shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate." In other words, these new rules apparently do not apply to property that passes to a surviving spouse or to charity, or to property that does not pass to the surviving spouse but is reported on an estate tax return filed only to elect portability. **(But, as in the Camp Discussion Draft, there is no such exception to the reporting requirement of section 6035.)**

(c) While the Greenbook versions, since 2014, would have been effective for transfers – that is, for gifts made and decedents dying – after the year of enactment, section 1014(f) (as in all the above introduced bills since the Responsible Estate Tax Act of 2010 and consistently with the 2009, 2010, and 2011 Greenbook proposals) is applicable to property with respect to which an estate tax return is filed after the date of enactment – that is, on or after August 1, 2015. A return filed after the date of enactment might have been due, and filed, on August 1, 2015, **making the statement due August 31, 2015**.

(7) In response to that accelerated application, Notice 2015-57, 2015-36 I.R.B. 294, released on August 21, 2015, extended to February 29, 2016, the due date of any statements required by section 6035 that otherwise would be due before February 29, 2016. The Notice cited section 6081(a), which allows extensions of time only for up to six months except in the case of taxpayers who are abroad. February 29, 2016, is the closest date the calendar allows to six months after August 31, 2015. So Notice 2015-57 implied that it was the only extension there would be.

(a) Notice 2015-57 also stated that "[t]he Treasury Department and the IRS expect to issue additional guidance to assist taxpayers with complying with sections 1014(f) and 6035."

(b) Notice 2016-19, 2016-9 I.R.B. 362, released on February 11, 2016, provided: "Statements required under sections 6035(a)(1) and (a)(2) to be filed with the IRS or furnished to a beneficiary before March 31, 2016, need not be filed with the IRS and furnished to a beneficiary until March 31, 2016."

i. In other words, the "due date" is not "extended" (confirming the implication of Notice 2015-57), but executors "need not" comply with any due date earlier than March 31, 2016.

ii. Indeed, Notice 2016-19 affirmatively added that "[t]he Treasury Department and IRS recommend that executors and other persons required to file a return under section 6018 wait to prepare the statements required by section 6035(a)(1) and (a)(2) until the issuance of proposed regulations by the Treasury Department and the IRS addressing the requirements of section 6035" and that "[t]he Treasury Department and the IRS expect to issue proposed regulations under sections 1014(f) and 6035 very shortly."

(c) Notice 2016-27, 2016-15 I.R.B. 576, released on March 23, 2016 (three weeks after the publication of the proposed regulations discussed in paragraph (10) below), extended the same relief through June 30, 2016. The stated rationale was that "[t]he Treasury Department and the IRS have received numerous comments that executors and other persons have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A."

(8) Meanwhile, the IRS developed Form 8971 (January 2016) for reporting the information for which the due date was originally August 31, 2015, then was February 29, 2016, and then "need not" be observed before June 30, 2016. Form 8971 itself is to be filed only with the IRS. It includes a Schedule A that is to be given to each respective beneficiary (like a K-1), as well as to the IRS.

(a) With respect to the biggest problem with the reporting deadline – namely, that executors, especially of estates large enough to be required to file an estate tax return, will not know just one month after filing the estate tax return which beneficiaries will receive which assets – Schedule A of Form 8971 states (emphasis in original):

> **Notice to Beneficiaries:**
>
> You have received this schedule to inform you of the value of property you received from the estate of the decedent named above. **Retain this schedule for tax reporting purposes.** If the property increased the estate tax liability, Internal Revenue Code section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional.

(b) The Instructions to Form 8971 (September 2016) candidly state (emphasis added):

> All property acquired (*or expected to be acquired*) by a beneficiary must be listed on that beneficiary's Schedule A. If the executor hasn't determined which beneficiary is to receive an item of property as of the due date of the Form 8971 and Schedule(s) A, *the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution* on that beneficiary's Schedule A. (*This means that the same property may be reflected on more than one Schedule A.*) A supplemental Form 8971 and corresponding Schedule(s) A may, but aren't required to, be filed once the distribution to each such beneficiary has been made.

(c) It is striking that the Instructions refer to property "expected to be acquired" while Schedule A refers to "property you received." This interchangeability of "acquired" and "received" could have been used as the basis for regulations that construed the requirement to file Form 8971 to apply only when property had been distributed by the estate or otherwise "received." See Part 29.b(10)(b)i below.

(9) Certain regulations were explicitly contemplated and authorized by the statute.

(a) Section 1014(f)(4) states that "[t]he Secretary may by regulations provide exceptions to the application of this subsection."

(b) Section 6035(b) states that "[t]he Secretary shall prescribe such regulations as necessary to carry out this section, including regulations relating to (1) the application of this section to property with regard to which no estate tax return is required to be filed, and (2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property."

(10) Proposed regulations were released on March 2, 2016. Proposed Reg. §§1.1014-10 & 1.6035-1 (REG-127923-15).

(a) The proposed regulations provided some welcome, albeit modest, clarifications.

i. Only the "initial" basis of property received from a decedent would be subject to these rules. Proposed Reg. §1.1014-10(a)(1). Subsequent authorized adjustments are not precluded. Proposed Reg. §§1.1014-10(a)(2) & 1.6662-8(b).

ii. The consistency rules would not apply to tangible personal property for which an appraisal is not required under Reg. §20.2031-6(b) – generally household and personal effects other than "articles having marked artistic or intrinsic value of a total value in excess of $3,000." Proposed Reg. §1.1014-10(b)(2). Such assets will rarely be sold at a gain, and any loss on a sale of such personal property would be nondeductible in any event.

iii. In addition to such tangible personal property, Proposed Reg. §1.6035-1(b)(1) would exclude from the Form 8971 reporting requirement:

a. cash (other than a coin collection or other coins or bills with numismatic value), which ordinarily has no basis apart from its face amount anyway;

b. income in respect of a decedent, which ordinarily would be reported as such on the beneficiary's income tax return anyway; and

c. property that is sold (and therefore not distributed to a beneficiary) in a transaction in which capital gain or loss is recognized, which ordinarily would therefore be reported as a taxable sale on the fiduciary's income tax return anyway.

iv. The term "executor" is given its usual expanded meaning in section 2203. Proposed Reg. §1.1014-10(d).

v. Form 8971 would not be required if the estate tax return was not required for **estate tax** purposes and was filed solely to make a portability election ("notwithstanding §20.2010-2(a)(1)") or a GST tax election or exemption allocation. Proposed Reg. §1.6035-1(a)(2).

vi. If a beneficiary is a trust, estate, or business entity, Form 8971 would be furnished only to the entity and not to its beneficiaries or owners. Proposed Reg. §1.6035-1(c)(2).

vii. An executor could state on Form 8971 that a beneficiary cannot be located, although the executor must also state the efforts taken to locate the beneficiary. Proposed Reg. §1.6035-1(c)(4).

viii. A supplemental Form 8971 to report a change in value or otherwise correct or complete information on an original Form 8971 would not be required to be filed until 30 days after the property is distributed. Proposed Reg. §1.6035-1(e)(4)(ii). (That, of course, should have been acknowledged as the appropriate occasion for **any** reporting under section 6035. See paragraph (8) above.)

ix. Indeed, a supplemental Form 8971 is not needed at all merely to report a distribution of property if a previous Form 8971 included that property as property that *might* be used to satisfy the beneficiary's interest. Proposed Reg. §1.6035-1(e)(3)(i)(B) & (ii), *Examples 1 & 2*.

(b) The proposed regulations also included some surprising or disappointing features.

i. Echoing the Form 8971 Instructions, Proposed Reg. §1.6035-1(c)(3) states:

> If, by the due date [of Form 8971], the executor has not determined what property will be used to satisfy the interest of each beneficiary, the executor must report on the Statement for each such

beneficiary all of the property that the executor could use to satisfy that beneficiary's interest. Once the exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement.

This is asserted even though a beneficiary who has not yet received (and may never receive) the property has no use for basis information and providing such information serves no discernable purpose of section 1014(f), and even though, like the Instructions, the preamble to the proposed regulations refers to "each beneficiary who has acquired (**or will acquire**) property from the decedent" and the statutory requirement of section 6035(a)(1) itself attaches only "to each person **acquiring** any interest in property." It seems that the regulations could have carried that linguistic comparison to its logical conclusion by requiring Form 8971 and Schedule A only with respect to property that is distributed – in other words, "received" – or "acquired." In that case, section 6035(a)(3) would be construed to require reporting for property **passing upon death or distributed before its value is reported on an estate tax return** within 30 days after the estate tax return is filed, whereas property **distributed after the estate tax return is filed** would be reported on a supplemented Form 8971 and Schedule A within 30 days after the distribution or perhaps on a year-by-year basis. That would be a much more workable rule.

ii. After-discovered and omitted property that is not reported on an (initial or supplemental) estate tax return before the estate tax statute of limitations runs (thus including all property and omissions discovered after the statute runs) would be given a value, and therefore an initial basis, of zero. Proposed Reg. §1.1014-10(c)(3)(i)(B). Moreover, if the after-discovered or omitted property would have increased the gross estate enough to cause an estate tax return to be required, but no estate tax return was filed, the estate tax value of **all** property subject to the consistency rule would be considered to be zero. Proposed Reg. §1.1014-10(c)(3)(ii). **Thus, a very innocent omission by the executor could result in a very harsh penalty for beneficiaries. The statutory support for these zero basis rules is very questionable, because such property appears to be neither "property the final value of which has been determined for purposes of the [estate] tax" within the meaning of section 1014(f)(1)(A) nor property "with respect to which a statement has been furnished under section 6035(a)" within the meaning of section 1014(f)(1)(B).**

iii. Proposed Reg. §1.6035-1(f) would impose a seemingly open-ended requirement on a recipient of a Schedule A to in turn file a Schedule A when making any gift or other retransfer of the property that results wholly or partly in a carryover basis for the transferee. The preamble again cites the regulatory authority granted in section 6035(b)(2) and also a concern "that opportunities may exist in some circumstances for the recipient of such reporting to circumvent the purpose of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family)." While such property does indeed continue to have a basis determined in part with reference to the value at the time of someone's death in the past, section 6035 imposes the reporting requirement only on an "executor," and section 1014(a) itself applies only to property acquired "from a decedent," creating great doubt about the statutory authority for Proposed Reg. §1.6035-1(f), especially when one of the explicit changes Congress made to Treasury's Greenbook proposal was to apply it only to transfers at death, not to lifetime gifts.

iv. The Greenbook proposals since 2009 explicitly contemplated a grant of regulatory authority "for situations in which the surviving joint tenant or other recipient may have better information than the executor." Congress seems to have captured that notion in section 6035(b)(2). Some observers read this as authorizing Treasury to relieve the tension between an executor and beneficiaries that a strict consistency rule might otherwise create by permitting beneficiaries to prove a higher value in some cases.

   a. In the preamble to the proposed regulations, Treasury recites that regulatory authority in section 6035(b)(2), but construes it in effect to apply only to a person with a legal or beneficial interest in property who is required to file an estate tax return under section 6018(b) in some cases.

b. In addition, the preamble to the proposed regulations states:

> One commenter requested the creation of a process to allow an estate beneficiary to challenge the value reported by the executor. There is no such process under the Federal law regarding returns described in section 6018. The beneficiary's rights with regard to the estate tax valuation of property are governed by applicable state law. Accordingly, the proposed regulations do not create a new Federal process for challenging the value reported by the executor.

In other words, the preamble not only confirms the potential for these rules to create tension within families (see paragraph (11) below), it documents Treasury's indifference to it.

(c) A public hearing on the proposed regulations was held on June 27, 2016, and most of the foregoing points were made.

(11) But no administrative guidance will or can address what many observers consider the fundamental flaw of the statute – it has the potential, especially when an estate tax return is audited, to pit family members and other beneficiaries against each other in an intolerable tension.

(a) The *Van Alen* opinion itself, discussed in paragraph (4) above, reveals how mischievous a "consistency" requirement might be in this context.

(b) The court describes how the audit "went back and forth" and the low value of the ranch could have been a trade for higher values of three other properties. Indeed, the court said: "The bottom line was that the IRS got an increase in the total taxable value of the estate … and an increase in the estate tax" (although later the court said, with specific reference to the ranch, that "[b]oth Shana and Brett [the heirs], and their father's estate, benefited from a reduced estate tax."

(c) If the heirs benefited from the special use valuation, it was a coincidental detail that is affected by tax apportionment rules and other factors and may not be present in every estate. And, as *Van Alen* illustrates, executors often settle estate tax audits by trade-offs and for strategic reasons that could have nothing to do with an effort to find the "true" "fair market value" for purposes of section 1014(a)(1).

(d) To bind heirs who do not participate in that audit seems quite unfair, and to give the heirs a role in the audit would be monstrously impractical. Yet, enchanted by the Siren Song of "consistency" – not to mention the temptation of a conjectural revenue gain – Congress seems not to have thought this through.

(12) The 2016 Greenbook renewed the proposal of past Greenbooks to also apply the consistency rules to property qualifying for an estate tax marital deduction and to gifts reportable on a gift tax return.

(13) Executive Order 13789 of April 21, 2017, directed the identification of tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on United States taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the Internal Revenue Service, and the recommendation of specific actions to mitigate the burdens identified. Notice 2017-38, 2017-30 I.R.B. 147, identified eight regulations that meet at least one of the first two criteria specified by the Executive Order, including the proposed section 2704 regulations, but not including the consistent basis regulations.

(14) The Trump Administration Priority Guidance Plans suggested that Treasury and the IRS would revisit the proposed basis consistency regulations in the context of "burden reduction." The Office of Information and Regulatory Affairs' Unified Agenda of Regulatory and Deregulatory Actions confirmed that "[t]he final regulations will provide less burdensome guidance to taxpayers enabling them to satisfy the requirements of sections 1014(f) and 6035." In light of the surprising and unnecessarily burdensome requirements of the proposed regulations identified in

paragraph (10)(b) above, this placement of the regulation project under "burden reduction" provided some encouragement that some or all of those requirements would be relaxed in the final regulations. Although the 2021-2022 Priority Guidance Plan does not have a separate "burden reduction" category, there is no reason to think that the civil servants in the Treasury Department and IRS would have changed their view. In fact, the Fall 2021 Unified Agenda of Regulatory and Deregulatory Actions released by the Office of Information and Regulatory Affairs on December 10, 2021, confirms that "[t]he final regulations will provide less burdensome guidance to taxpayers enabling them to satisfy the requirements of sections 1014(f) and 6035." **Treasury and the IRS cannot undo the ill-advised statute, but they could apply the statute in a reasonable way to provide a more practical reporting date and could reconsider the zero-basis rule and continuous reporting requirement that the statute does not appear to authorize. That would in fact be "burden reduction."**

c. **Item 3: "Anti-Abuse" Addition to the "Anti-Clawback" Regulations**

Item 3 is described as "Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c)."

Regulations to prevent "clawback" were proposed in November 2018 (REG-106706-18, 83 Fed. Reg. 59343 (Nov. 23, 2018)) and finalized in November 2019. The proposed "anti-abuse" addition to the regulations contemplated by this Priority Guidance Plan project was published in the Federal Register on April 27, 2022 (REG-118913-21, 87 Fed. Reg. 24918). Although neither the statute nor the regulations use the word "clawback," the regulations carry out the mandate of the 2017 Tax Act in new section 2001(g)(2), which provides that Treasury

> shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

(1) **The Problem Under the 2017 Tax Act.** The concern that prompted that mandate for regulations is that the remedy added in 2010 as subsection (g) (now paragraph (1) of subsection (g)) addressed only changes in tax **rates**, and the 2017 Tax Act did not change any rates when it **doubled the basic exclusion amount ("BEA")**. New paragraph (2) obviously contemplated that regulations would reach a similar result for the potential sunset of the doubled exclusion amount, but left the details to the IRS and Treasury.

(a) To illustrate the concern, assume that an unmarried individual made a **$9 million gift** (the donor's only lifetime gift) in 2019 when the indexed exclusion amount was $11.4 million. With no change in the law, the donor dies in 2026 with a **taxable estate of $20 million**. Assume further that the 2026 $5 million exclusion amount (indexed) is $6.8 million. (These numbers – $9 million, $11.4 million, and $6.8 million – are the same numbers that are used in the assumed scenarios illustrated in the 2019 regulations and the 2022 proposed addition to the regulations.) With a 40 percent rate and the exclusion amount used up, the **intuitively correct estate tax** is 40 percent of $20 million, or **$8 million**. But, as illustrated in **the table below**, without anti-clawback relief the estate tax turns out to be **$8,880,000**, producing a **"clawback penalty" of $880,000**.

(b) Other ways to look at this $880,000 million are:

i. 40 percent of the amount by which the $9 million gift exceeded the $6.8 million date-of-death exclusion amount; or

ii. the gift tax on the gift if the gift had been made in 2026; or

iii. the additional estate tax on a taxable estate of $29 million **if the gift had not been made at all**.

In other words, all the benefit the 2017 Tax Act apparently promised this donor for making a gift before the sunset would be wiped out by the sunset.

(2) **The Solution Under Reg. §20.2010-1(c).** Pursuant to section 2001(g)(2) and corresponding guidance projects identified in the 2017-2018, 2018-2019, and 2019-2020 Treasury-IRS Priority Guidance Plans, proposed anti-clawback regulations were published in November 2018 (REG-106706-18, 83 Fed. Reg. 59343, Nov. 23, 2018), and final regulations were released November 22, 2019 **(T.D. 9884, 84 Fed. Reg. 64995, Nov. 26, 2019)**. New Reg. §20.2010-1(c) (with the former paragraphs (c), (d), and (e) re-lettered (d), (e), and (f)) states the heart of the anti-clawback rule, applicable to the extent the credit is based on the basic exclusion amount (emphasis added):

> If the total of the **amounts allowable as a credit in computing the gift tax** payable on the decedent's post-1976 gifts … **exceeds** the credit allowable within the meaning of section 2010(a) in computing the estate tax, … then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate … is **the sum of the amounts … allowable as a credit in computing the gift tax payable** on the decedent's post-1976 gifts.

In other words, in the example above (which has the same facts as Example 1 in the regulations), because $9 million of basic exclusion amount used for the 2019 gift (the only post-1976 lifetime gift) is greater than the $6.8 million basic exclusion amount otherwise allowable in computing the 2026 estate tax, that larger amount of $9 million is used for estate tax purposes instead of the $6.8 million. (This is simplified for the sake of readability; technically, the credits based on the exclusion amounts are compared under the regulation.) The elimination of the clawback penalty under that rule is illustrated in the following table, by changing the entry on line 9a from $6.8 million (the 2026 basic exclusion amount) to $9 million (the amount of the 2019 basic exclusion amount used for computing the gift tax).

Calculation of the Estate Tax with and without Clawback
Using the Estate Tax Return, Form 706 (August 2019) as a Template

Line		Illustrating Clawback	Under Reg. §20.2010-1(c)*
3c	Taxable estate	20,000,000	20,000,000
4	Adjusted taxable gifts	9,000,000	9,000,000
5	Add lines 3c and 4	29,000,000	29,000,000
6	Tentative tax on the amount on line 5	11,545,800	11,545,800
7	Total gift tax paid or payable	0	0
8	Gross estate tax (subtract line 7 from line 6)	11,545,800	11,545,800
9a	**Basic exclusion amount**	**6,800,000**	*** 9,000,000**
9b	DSUE amount [not applicable]	0	0
9c	Restored exclusion amount [not applicable]	0	0
9d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	6,800,000	9,000,000
9e	Allowable credit amount (tentative tax on line 9d)	2,665,800	3,545,800
10	Adjustment [not applicable]	0	0
11	Allowable applicable credit amount	2,665,800	3,545,800
12	Subtract line 11 from line 8	8,880,000	8,000,000
16	Net estate tax [same as line 12 in this case]	8,880,000	8,000,000
	Intuitively correct tax	8,000,000	8,000,000
	Clawback penalty	880,000	0

(3) **Comment on This Approach**

(a) The approach of the 2010 explicit statutory anti-clawback rule in section 2001(g)(1) – specifically section 2001(g)(1)(A) – was that the rates in effect at the time of death would be used to calculate the hypothetical "tax imposed by chapter 12" on pre-2026 adjusted taxable gifts – in other words, the "total gift tax paid or payable" that is deducted on line 7 of the return. Before the proposed regulations were released, therefore, there was speculation that the regulations under section 2001(g)(2) would mirror the regulations under section 2001(g)(1) and provide (using the above table as an example) that line 7 would be changed from zero to $880,000 (which is what the 2019 gift tax would have been if 2026 law had applied in 2019). After subtracting that amount, line 8, and therefore line 12, would be $880,000 smaller, which would exactly eliminate the clawback penalty.

(b) But the regulations take a different approach. The preamble to the proposed regulations implies that other approaches were considered, but concludes that "in the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit in … the estate tax determination required to be applied against the net tentative estate tax."

(c) By increasing the amount on line 9a, rather than the amount on line 7, the regulations achieve the same result, of course, because both line 7 and line 9a are subtractions in the estate tax calculation. But line 7 already required two pages of instructions, including a 24-line worksheet, to complete. An incremental increase of complexity in what already had a reputation for being a challenge might have been easier to process than adding a new challenge to line 9a, which previously required only 21 words of instructions. Needless to say, IRS personnel see more returns than any member of the public does, they see the mistakes, and they hear the complaints. Presumably – hopefully – they contributed to the assessment that the line 9a approach is "the most administrable solution."

(d) That approach should work fine if the law is not changed and sunset occurs January 1, 2026. But, although the examples in Reg. §20.2010-1(c)(2) assume that the donor's "date of death is after 2025," the substantive rule in Reg. §20.2010-1(c) applies by its terms whenever "changes in the basic exclusion amount … occur between the date of a donor's gift and the date of the donor's death." It is not limited to 2026 or to any other particular time period. The 2010 statutory rule in section 2001(g)(1) and the 2017 statutory rule in section 2001(g)(2) are not limited to any time period either. Therefore, if Congress makes other changes in the law, particularly increases in rates or decreases in exemptions, and doesn't focus on the potential clawback issue in the context of those changes, the generic anti-clawback regime of section 2001(g)(1) and (2) and these regulations could produce a jigsaw puzzle of adjustments going different directions that may strain the notion of administrability cited in the preamble.

(4) **The "Off the Top" Option.** There had also been speculation that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary "bonus" exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion "off the top," still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. Example 2 was added to the final regulations to illustrate what the preamble to the final regulations acknowledges is the **"use or lose"** nature of the doubled exclusion amount when a donor uses some but not all of the exclusion amount available from 2018 through 2025.

(5) **Preservation of Portability Elections**

(a) The text of the regulations and the examples (particularly the original Example (1) of the proposed regulations) are painstakingly limited in all cases to the amount of the credit that is attributable to the basic exclusion amount – that is, the amount (indexed since 2012) defined in section 2010(c)(3). Regarding portability, for example, that approach makes it clear that the deceased spousal unused exclusion amount (DSUE amount) defined in section 2010(c)(4) is not affected by this special rule and is still added under section 2010(c)(2)(B), in effect thereby generating an additional credit of its own in cases in which the anti-clawback rule applies. But the proposed regulations still left open the possibility that the words "lesser of" in section 2010(c)(4) would limit the DSUE amount after 2025 (assuming no change in the law) to the sunsetted basic exclusion amount of $5,000,000 indexed for inflation in effect at the time of the death of the surviving spouse referred to in section 2010(c)(4)(A), despite the assertion in Reg. §20.2010-2(c)(1) that "the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts – (i) The basic exclusion amount in effect in the year of the death of the decedent" (presumably the predeceased spouse), and despite the statement in the preamble to the June 2012 temporary regulations that "the 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." The limiting words "lesser of" in section 2010(c)(4) reflect the notion held by congressional drafters that portability should not be allowed to more than double what would otherwise be the survivor's exemption, although that limitation might be viewed as unfair and inapplicable in the case of a predeceased spouse whose estate plan and executor's election forgo the immediate use of the larger exemption allowed before 2026.

(b) In that light, it is not particularly reassuring, standing alone, that the preamble to the final regulations stated:

> The regulations in §§ 20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse.

or even that the preamble to the 2012 temporary regulations (T.D. 9593) rather logically explained:

> The 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. Generally, only the basic exclusion amount of the decedent, as in effect in the year of the decedent's death, will be known at the time the DSUE amount must be computed and reported on the decedent's estate tax return. Because section 2010(c)(5)(A) requires the executor of an estate electing portability to compute and report the DSUE amount on a timely-filed estate tax return, and because the basic exclusion amount is integral to this computation, the term "basic exclusion amount" in section 2010(c)(4)(A) necessarily refers to such decedent's basic exclusion amount.

What **is** helpful and reassuring is that the final 2019 regulations themselves (not just the preamble) add Examples (3) and (4), which illustrate scenarios where a DSUE amount from a predeceased spouse who dies before 2026 is applied to the surviving spouse's gifts before 2026 and to the calculation of the estate tax when the surviving spouse dies after 2025.

(6) **A Possibly Surprising Collateral Result.** If large amounts of the increased credit attributable to the new doubled basic exclusion amount are used to shelter gifts from gift tax before 2026 (like the $9 million gift in the example), then after 2025 the donor might have to wait for many years or even decades for the indexed $5 million amount to catch up so there can be more credit available for gift tax purposes.

(7) **An Anti-Abuse Warning**

(a) The preamble to the 2019 final regulations adds:

> A commenter recommended consideration of an anti-abuse provision to prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes. Examples include transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code. The purpose of the special rule is to ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes. Arguably, the possibility of inconsistent treatment does not arise with regard to transfers that are treated as part of the gross estate for estate tax purposes, rather than as adjusted taxable gifts. An anti-abuse provision could except from the application of the special rule transfers where value is included in the donor's gross estate at death. Although the Treasury Department and the IRS agree that such a provision is within the scope of the regulatory authority granted in section 2001(g)(2), such an anti-abuse provision would benefit from prior notice and comment. Accordingly, this issue will be reserved to allow further consideration of this comment.

(b) The commenter the preamble cites is the Tax Section of the New York State Bar Association, in its February 20, 2019, letter to Treasury and the IRS available at **https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Section%20Reports%202019/1410%20Report.pdf**.

(c) For an in-depth discussion of this issue, see Lynagh, *Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion*, 45 Tax Mgmt. Est., Gifts & Tr. J. 183 (May 14, 2020).

(d) To illustrate the circumstances in which such an anti-abuse rule might apply, consider again the example above, a $9 million gift in 2019 and an otherwise taxable estate of $20 million and basic exclusion amount of $6.8 million in 2026, except that the gift is of such nature that the value of the property is included in the donor's gross estate under, for example, section 2036, thereby making the taxable estate $29 million (assuming no intervening change in value), **while the gift itself is excluded from "adjusted taxable gifts" (line 4 of the estate tax return) under the last phrase of section 2001(b)**. In that case, the **intuitively correct estate tax** seems to be the tax on a taxable estate of $29 million, which is **$8,880,000** (as shown under "Illustrating Clawback" in the above table, calculated on the tax base of $29,000,000 on line 3 after adding adjusted taxable gifts in that case). Two ways of computing that are:

i. $11,545,800 (the tax on $29,000,000 under the section 2001(c) rate schedule) minus $2,665,800 (the applicable credit amount, which is the tax on the applicable exclusion amount of $6,800,000 under the section 2001(c) rate schedule) = $8,880,000, or

ii. 40 percent times (the taxable estate of $29,000,000 minus the applicable exclusion amount of $6,800,000) = 0.4 × $22,200,000 = $8,880,000.

Thus, application of the anti-clawback calculation in this case would not eliminate an $880,000 clawback penalty, it would in effect produce an $880,000 bonus, as the following table indicates.

Calculation of the Estate Tax with and Without the Anti-Clawback Regulations Again Using the Estate Tax Return, Form 706 (August 2019) as a Template

Line		Without Reg. §20.2010-1(c)	Under Reg. §20.2010-1(c)*
3c	Taxable estate	29,000,000	29,000,000
4	Adjusted taxable gifts	0	0
5	Add lines 3c and 4	29,000,000	29,000,000
6	Tentative tax on the amount on line 5	11,545,800	11,545,800
7	Total gift tax paid or payable	0	0
8	Gross estate tax (subtract line 7 from line 6)	11,545,800	11,545,800
9a	**Basic exclusion amount**	**6,800,000**	*** 9,000,000**
9b	DSUE amount [not applicable]	0	0
9c	Restored exclusion amount [not applicable]	0	0
9d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	6,800,000	9,000,000
9e	Allowable credit amount (tentative tax on line 9d)	2,665,800	3,545,800
10	Adjustment [not applicable]	0	0
11	Allowable applicable credit amount	2,665,800	3,545,800
12	Subtract line 11 from line 8	8,880,000	8,000,000
16	Net estate tax [same as line 12 in this case]	8,880,000	8,000,000
	Intuitively correct tax	8,880,000	8,880,000
	Unintended anti-clawback bonus	0	880,000

That "bonus" is undoubtedly what prompted the IRS and Treasury to consider an "anti-abuse provision."

(8) **The Proposed "Anti-Abuse" Addition.** The April 2022 proposal would do what the 2019 preamble foretold and would address the "anti-clawback bonus" the preceding table illustrates.

The proposal would add a new subparagraph (3) to the anti-clawback paragraph (c) that was added in 2019. The new subparagraph (3) provides exceptions from the anti-clawback rules of paragraph (c) for "transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b)." It elaborates such transfers as "**including without limitation**" four specific types of transfers:

(a) "Transfers includible in the gross estate pursuant to section 2035 [gifts made within three years of death], 2036 [transfers with a retained life estate], 2037 [transfers taking effect at death], 2038 [revocable transfers], or 2042 [life insurance proceeds], regardless of whether all or any part of the transfer was deductible pursuant to section 2522 [charitable gifts] or 2523 [gifts to the donor's spouse]." This is as forecast in the 2019 preamble. It would simply preserve the "clawback," in effect, that provisions like section 2036 have been designed to achieve since at least the 1930s.

(b) "Transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death." Such transfers were not explicitly targeted in the 2019 preamble. But, because the donor/promisor keeps the enjoyment of the property until the promise is satisfied, there certainly is a resemblance to section 2036. As the preamble observes, such transfers have been excluded from adjusted taxable gifts under Rev. Rul. 84-25, 1984-1 C.B. 191.

(c) "Transfers described in §25.2701-5(a)(4) or §25.2702-6(a)(1)" of the regulations. This fulfills the explicit attention of the 2019 preamble to "certain transfers within the purview of chapter 14 of subtitle B of the Code." In two helpful paragraphs, the current preamble explains why Treasury and the IRS did not consider it necessary to also amend Reg. §25.2701-5 (as the comments of the Tax Section of the New York State Bar Association had recommended) or, similarly, Reg. §25.2702-6(b).

(d) Transfers that would have fit one of those three categories "but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or **by any other person**" (emphasis added), unless "effectuated by the termination of the durational period described in the original instrument of transfer by either the mere passage of time or the death of any person." While similar to the existing three-year rule of section 2035, this provision is conspicuously extended to affirmative actions not by the decedent but "by any other person." The exception for "the termination of the durational period described in the original instrument of transfer" may encourage more attention to the provision of such durational periods in transfer documents.

Of course, the phrase "including without limitation" leaves open the possibility that scenarios other that the four scenarios spelled out would also be excepted from the anti-clawback rules. But the description "includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b)" ought to be quite objective and easy to apply in most cases.

This exception from the anti-clawback rules would not apply to "[t]ransfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer." The preamble explains this limitation by comparison to similar rules applicable to reversionary interests in sections 2037(a)(2) (estate tax consequences of the retention of a reversionary interest), 2042(2) (estate tax consequences of the possession of an "incident of ownership" in a life insurance policy) , and 673(a) (consequences of a reversionary interest on the determination of grantor trust treatment). That makes sense because the types of transfers targeted by the exception do resemble reversionary interests. The preamble adds that "[t]his bright-line exception … is proposed in lieu of a facts and circumstances determination of whether a particular transfer was intended to take advantage of the increased BEA without depriving the donor of the use and enjoyment of the property."

The proposed addition to the regulations includes seven reasonably helpful, but not particularly surprising, examples, illustrating the treatment of various combinations and amounts of gifts of cash and promissory notes, gifts to GRATs and GRITs, and use of DSUE amounts. Among other things, the examples confirm the results of the examples in the 2019 regulations (see paragraph (5) above) that in the case of a portability election the DSUE amount is applied before the surviving spouse's basic exclusion amount.

(9) **Effective Date.** The contemplated addition to the regulations would apply only prospectively – that is, only to the estates of decedents dying on or after April 27, 2022, the date the proposed addition was published in the Federal Register. But it should also be noted that it would apply to the calculation of the future **estate tax**, even if the **gift** includible, or treated as includible, in the gross estate was made before April 27, 2022. Thus, it should be expected to first apply to the estate of someone who dies after December 31, 2025, when the "sunset" enacted in 2017 occurs, which the preamble to the proposed addition acknowledges. In that way, it would achieve the "anti-abuse" outcome described above with respect to gifts made and other lifetime actions taken since 2017 that result in estate includability, even if those lifetime actions were taken before April 27, 2022.

The Ways and Means Committee's proposal (see Part 26.b(2) above) to accelerate the "sunset" to January 1, 2022, could have meant that, unless the "anti-abuse" addition was made before the end of 2021, some persons who had made post-2017 gifts with potential for inclusion in the gross estate might die before the regulations were effective. Those persons' estates might have benefited from the unintended anti-clawback bonus. Or the regulations might have provided for retroactive application to those estates, which is sometimes done in true "abuse" cases. Such planning after December 31, 2017, by persons who die on or after April 27, 2022, would have been caught in any event.

d. **Item 4: Effect of Events Between Death and the Alternate Valuation Date**

(1) Item 4 is described as "Regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011." This project first appeared in the 2007-2008 Plan.

(2) The first set of proposed regulations related to this project, Proposed Reg. §20.2032-1(f) (REG-112196-07), was published on April 25, 2008. The preamble appeared to view these regulations as the resolution of "[t]wo judicial decisions [that] have interpreted the language of section 2032 and its legislative history differently in determining whether post-death events other than market conditions may be taken into account under the alternate valuation method."

(3) In the first of these cases, *Flanders v. United States*, 347 F. Supp. 95 (N.D. Calif. 1972), after a decedent's death in 1968, but before the alternate valuation date, the trustee of the decedent's (formerly) revocable trust, which held a one-half interest in a California ranch, entered into a land conservation agreement pursuant to California law.

(a) The conservation agreement reduced the value of the ranch by 88 percent. Since that reduced value was the value of the ranch at the alternate valuation date (which until 1971 was one year after death), the executor elected alternate valuation and reported the ranch at that value.

(b) Citing the Depression-era legislative history to the effect that alternate valuation was intended to protect decedents' estates against "many of the hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries," the court held that "the value reducing result of the post mortem act of the surviving trustee" may not be considered in applying alternate valuation.

(4) The second of these cases was *Kohler v. Commissioner*, T.C. Memo. 2006-152, *nonacq.*, 2008-9 I.R.B. 481, involving the estate of a shareholder of the well-known family-owned plumbing fixture manufacturer. The executor had received stock in a tax-free corporate reorganization that had been under consideration for about two years before the decedent's death but was not completed until about two months after the decedent's death.

(a) The court rejected the IRS's attempt to base the estate tax on the value of the stock *surrendered* in the reorganization (which had been subject to fewer restrictions on transferability), on the ground that Reg. §20.2032-1(c)(1) prevents that result by specifically refusing to treat stock surrendered in a tax-free reorganization as "otherwise disposed of" for purposes of section 2032(a)(1).

(b) The court also noted that the exchange of stock must have been for equal value or the reorganization would not have been tax-free as the parties had stipulated (although, ironically, the executor's own appraiser had determined a value of the pre-reorganization shares of $50.115 million and a value of the post-reorganization shares of $47.010 million – a difference of about 6.2 percent). The court distinguished *Flanders*, where the post-death transaction itself reduced the value by 88 percent.

(c) The Tax Court in *Kohler* viewed the 1935 legislative history relied on in *Flanders* as irrelevant, because Reg. §20.2032-1(c)(1) (promulgated in 1958) was clear and unambiguous and because "the legislative history describes the general purpose of the statute, not the specific meaning of 'otherwise disposed of' in the context of tax-free reorganizations."

(5) The 2008 proposed regulations would have made no change to Reg. §20.2032-1(c)(1), on which the *Kohler* court relied. But they invoked "the general purpose of the statute" that was articulated in 1935, relied on in *Flanders* but bypassed in *Kohler*, to beef up Reg. §20.2032-1(f) and to clarify and emphasize, with both text and examples, that the benefits of alternate valuation are limited to changes in value due to "market conditions." The 2008 proposed regulations would specifically add "post-death events other than market conditions" to changes in value resulting from the "mere lapse of time," which are ignored in determining the alternate value under section 2032(a)(3).

(6) New proposed regulations (REG-112196-07) were published on November 18, 2011. The preamble stated:

> … Some commentators expressed concern that the proposed regulations (73 FR 22300) would create administrative problems because an estate would be required to trace property and to obtain appraisals based on hypothetical property.…
>
> …
>
> Many commentators … suggested that the IRS and Treasury Department would better serve taxpayers and address any potential abuse [of the section 2032 election] by ensuring that the regulations address the issues described in this preamble rather than finalizing the approach taken in the proposed regulations.
>
> In view of the comments, the Treasury Department and the IRS are withdrawing the proposed regulations (73 FR 22300) by the publication of these proposed regulations in the Federal Register.

(7) In contrast to the 2008 approach of ignoring certain intervening events – and thereby potentially valuing assets six months after death on a hypothetical basis – the new approach is to expand the description of intervening events that are regarding as dispositions, triggering alternate valuation as of that date. The expanded list, in Proposed Reg. §20.2032-1(c)(1)(i), includes distributions, exchanges (whether taxable or not), and contributions to capital or other changes to the capital structure or ownership of an entity, including "[t]he dilution of the decedent's ownership interest in the entity due to the issuance of additional ownership interests in the entity." Proposed Reg. §20.2032-1(c)(1)(i)(I)(*1*). But under Proposed Reg. §20.2032-1(c)(1)(ii), an exchange of interests in a corporation, partnership, or other entity is not counted if the fair market values of the interests before and after the exchange differ by no more than 5 percent (which would still subject a 6.2 percent difference as in *Kohler* to the new rules).

(a) If the interest involved is only a fraction of the decedent's total interest, an aggregation rule in Proposed Reg. §20.2032-1(c)(1)(iv) values such interests at a pro rata share of the decedent's total interest.

(b) The proposed regulations also include special rules for coordinating with annuities and similar payments (§20.2032-1(c)(1)(iii)(B)) and excepting qualified conservation easements (§20.2032-1(c)(4)), and also many more examples (§20.2032-1(c)(5), (e) *Example (2)*, (f)(2)(B) & (f)(3)).

(8) While the 2008 proposed regulations were referred to as the "anti-*Kohler* regulations," the most significant impact of these proposed regulations may fall on efforts to bootstrap an estate into a valuation discount by distributing or otherwise disposing of a minority or other noncontrolling interest within the six-month period after death (valuing it as a minority interest under section 2032(a)(1)) and leaving another minority or noncontrolling interest to be valued six months after death (also valued as a minority interest under section 2032(a)(2)).

(a) Examples 7 and 8 of Proposed Reg. §20.2032-1(c)(5) specifically address the discount-bootstrap technique – Example 8 in the context of a limited liability company and Example 7 in the context of real estate – and leave no doubt that changes in value due to "market conditions" do not include the valuation discounts that might appear to be created by partial distributions.

(b) And perhaps most significantly, Example 1 reaches the same result with respect to the post-death formation of a limited partnership.

(9) The Office of Information and Regulatory Affairs' Spring 2020 Unified Agenda of Regulatory and Deregulatory Actions, released on June 30, 2020, offered the following concise summary of the scope of the proposed regulations:

> In cases where section 2032 election has been made, the regulations would provide guidance on: (1) The effect of certain post-death transactions on assets includible in the decedent's gross estate; (2) the treatment of assets the title to which is transferred at death by contract; (3) the determination of the portion of trusts in which the decedent retained an interest that are includible in the decedent's gross estate under section 2036; (4) the effect of the grant of a qualified conservation easement under section 2031(c) during the 6-month period after the date of death; and (5) the types of factors, the impact of which affect the fair market value of assets includible in the decedent's gross estate, that will be recognized under section 2032.

(10) The 2008 proposed regulations were to be effective April 25, 2008, the date the proposed regulations were published. The 2011 proposed regulations, more traditionally, state that they will be effective when published as final regulations.

e. **Item 5: Effect of Guarantees and Present Value Concepts on Estate Tax Deductions**

(1) Item 5 is described as "Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate."

(2) This project first appeared in the 2008-2009 Plan as an outgrowth of the project that led to the final amendments of the section 2053 regulations in October 2009. The significance of present value concepts is elaborated in this paragraph in the preamble to the 2009 regulations (T.D. 9468, 74 Fed. Reg. 53652 (Oct. 20, 2009)):

> Some commentators suggested that the disparate treatment afforded noncontingent obligations (deduction for present value of obligations) versus contingent obligations (dollar-for-dollar deduction as paid) is inequitable and produces an inconsistent result without meaningful justification. These commentators requested that the final regulations allow an estate to choose between deducting the present value of a noncontingent recurring payment on the estate tax return, or instead deducting the amounts paid in the same manner as provided for a contingent obligation (after filing an appropriate protective claim for refund). The Treasury Department and the IRS find the arguments against the disparate treatment of noncontingent and contingent obligations to be persuasive. The final regulations eliminate the disparate treatment by removing the present value limitation applicable only to noncontingent recurring payments. The Treasury Department and the IRS believe that the issue of the appropriate use of present value in determining the amount of the deduction allowable under section 2053 merits further consideration. The final regulations reserve § 20.2053-1(d)(6) to provide future guidance on this issue.

(3) But it is easy to see how the Treasury Department's and the IRS's "further consideration" of "the appropriate use of present value" could turn their focus to the leveraged benefit in general that can be obtained when a claim or expense is paid long after the due date of the estate tax, but the additional estate tax reduction is credited as of, and earns interest from, that due date.

(a) *Graegin* loans (see *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477) could be an obvious target of such consideration.

(b) If this project results in a deduction of only the present value of payments, as of the due date of the tax, *and* the discount rate used in the calculation of the present value is the same as the rate of interest on the tax refund, *and* the interest is not subject to income tax (or the discount rate is also reduced by the income tax rate), then the invocation of "present value concepts" might make very little difference on paper. But it might require legislation to accomplish all these things.

(c) Since claims or expenses are rarely paid exactly on the due date of the tax, or anniversaries thereof, the *precise* application of such principles might be exceedingly complicated.

f. **Items 6 and 7: Allocation of GST Exemption**

(1) Item 6 is described as "Regulations under §2632 providing guidance governing the allocation of generation-skipping transfer (GST) exemption in the event the IRS grants relief under §2642(g), as well as addressing the definition of a GST trust under §2632(c), and providing ordering rules when GST exemption is allocated in excess of the transferor's remaining exemption."

(a) It is the only item under the heading of "Gifts and Estates and Trusts" in the 2021-2022 Plan that has not been in a Priority Guidance Plan before.

(b) It is evidently related to Item 7 and is intended to address not only the consequences of the relief described in Item 7 but also, as the description says, the definition of a "GST trust" for purposes of the deemed allocation rules of section 2632(c) and ordering rules when too much GST exemption is ostensibly allocated.

(2) Item 7 is described as "Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption." This project first appeared in the 2007-2008 Plan.

(3) The background of this project is section 564(a) of the 2001 Tax Act, which added subsection (g)(1) to section 2642, directing Treasury to publish regulations providing for extensions of time to allocate GST exemption or to elect out of statutory allocations of GST exemption (when those actions are missed on the applicable return or a return is not filed).

(a) Before the 2001 Tax Act, similar extensions of time under Reg. §301.9100-3 (so-called "9100 relief") were not available, because the deadlines for taking such actions were prescribed by the Code, not by the regulations.

(b) The legislative history of the 2001 Tax Act stated that "[n]o inference is intended with respect to the availability of relief from late elections prior to the effective date of [section 2642(g)(1)]," and section 2642(g)(1)(A) itself directs that the regulations published thereunder "shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of [section 2642(g)(1)]." Section 2642(g)(1)(B) adds:

> In determining whether to grant relief under this paragraph, the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

(c) Shortly after the enactment of the 2001 Tax Act, Notice 2001-50, 2001-2 C.B. 189, acknowledged section 2642(g)(1) and stated that taxpayers may seek extensions of time to take those actions under Reg. §301.9100-3. The Service has received and granted many requests for such relief over the years since the publication of Notice 2001-50.

(4) In addition, Rev. Proc. 2004-46, 2004-2 C.B. 142, provides a simplified method of dealing with pre-2001 gifts that meet the requirements of the annual gift tax exclusion under section 2503(b) but not the special "tax-vesting" requirements applicable for GST tax purposes to gifts in trust under section 2642(c)(2).

(a) Gifts subject to Crummey powers are an example.

(b) In such cases, GST exemption may be allocated on a Form 709 labeled "FILED PURSUANT TO REV. PROC. 2004-46," whether or not a Form 709 had previously been filed for that year.

(c) Post-2000 gifts are addressed by the expanded deemed allocation rules of section 2632(c), enacted by the 2001 Tax Act.

(5) Proposed Reg. §26.2642-7 (REG-147775-06) was released on April 16, 2008. When finalized, it will oust Reg. §301.9100-3 and become the exclusive basis for seeking the extensions of time Congress mandated in section 2642(g)(1) (except that the simplified procedure for dealing with pre-2001 annual exclusion gifts under Rev. Proc. 2004-46 will be retained). In addition to an "extension of time … to allocate GST exemption," as the Priority Guidance Plan cites, the proposed regulations would also apply to elections out of deemed allocations under section 2632(b)(3) for direct skips and section 2632(c)(5)(A)(i) for indirect skips and transfers made to a GST trust, and elections under section 2632(c)(5)(A)(ii) to treat any trust as a GST trust for purposes of section 2632(c)).

(6) The proposed regulations resemble Reg. §301.9100-3, but with some important differences. Under Proposed Reg. §26.2642-7(d)(1), the general standard is still "that the transferor or the executor of the transferor's estate acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government."

(a) Proposed Reg. §26.2642-7(d)(2) sets forth a "nonexclusive list of factors" to determine whether the transferor or the executor of the transferor's estate acted reasonably and in good faith, including (i) the intent of the transferor to make a timely allocation or election, (ii) intervening events beyond the control of the transferor or the executor, (iii) lack of awareness of the need to allocate GST exemption to the transfer, despite the exercise of reasonable diligence, (iv) consistency by the transferor, and (v) reasonable reliance on the advice of a qualified tax professional.

(b) Proposed Reg. §26.2642-7(d)(3) sets forth a "nonexclusive list of factors" to determine whether the interests of the Government are prejudiced, including (i) the extent to which the request for relief is an effort to benefit from hindsight, (ii) the timing of the request for relief, and (iii) any intervening taxable termination or taxable distribution.

(c) Noticeably, the proposed regulations seem to invite more deliberate weighing of all those factors than the identification of one or two dispositive factors as under Reg. §301.9100-3.

(7) "Hindsight," which could be both a form of bad faith and a way the interests of the Government are prejudiced, seems to be a focus of the proposed regulations. This is probably explained by the obvious distinctive feature of the GST tax – its effects are felt for **generations**, in contrast to most "9100 relief" elections that affect only a current year or a few years. There simply is more opportunity for "hindsight" over such a long term. Thus, the greater rigor required by the proposed regulations seems to be justified by the nature of the GST tax and consistent with the mandate of section 2642(g)(1)(B) to "take into account all relevant circumstances."

(8) Proposed Reg. §26.2642-7(h)(3)(i)(D) requires a request for relief to be accompanied by "detailed affidavits" from "[e]ach tax professional who advised or was consulted by the transferor or the executor of the transferor's estate with regard to any aspect of the transfer, the trust, the allocation of GST exemption, and/or the election under section 2632(b)(3) or (c)(5)."

(a) The references to "any aspect of the transfer" and "the trust" appear to go beyond the procedural requirement of Reg. §301.9100-3(e)(3) for "detailed affidavits from the individuals having knowledge or information about the events that led to the failure to make a valid regulatory election and to the discovery of the failure." Presumably, a professional who advised only with respect to "the transfer" or "the trust" would have nothing relevant to contribute other than a representation that they did not advise the transferor to make the election, a fact that the transferor's own affidavit could establish.

(b) Out of concern about returning to the supercharged "fall on your sword" days before the reformation of the 9100 rules reflected in Rev. Proc. 92-85, 1992-2 C.B. 490, the author of this outline recommended the relaxation of that requirement in a comment letter dated July 3, 2008.

(9) Section 2642(g)(1) itself, having been enacted by the 2001 Tax Act, was once scheduled to "sunset" on January 1, 2011, then on January 1, 2013, and is now permanent.

(10) These regulations ought to have been close to completion for a long time now.

(a) The current Item 7 last appeared in the 2015-2016 Plan. It was removed in the 2016-2017 Plan, perhaps so these regulations could be issued at the same time as the ETIP-related regulations envisioned by the project discussed in Part 29.i(5)(a) below. Or it might have been thought that the consistent basis and section 2704 regulations alone may have kept Treasury and the IRS busy through June 2017, while most of the objectives of the section 2642(g) regulations were being served anyway by Reg. §301.9100-3.

(b) Then these regulations were revived in the 2017-2018 Plan as a "burden reduction" project. How can this be, when the proposed regulations would generally be more burdensome than Reg. §301.9100-3, which Notice 2001-50 now allows to be used? **Perhaps the extensive experience of the IRS with ruling requests under Notice 2001-50 and Reg. §301.9100-3 has shown that less onerous requirements may be sufficient, especially with respect to the excessive requirements of affidavits.**

(c) Like the consistent basis regulations of Item 2 discussed in paragraph b above, there is no reason to assume that whatever "burden-reducing" changes Treasury and the IRS have had in mind would not continue to be their objective when finalizing these regulations, even though "burden reduction" has been dropped as a separate category of projects.

(11) In addition, Item 25 of the 2021-2022 Plan under the heading of "General Tax Issues" is described simply and broadly as "Guidance under §301.9100 regarding relief for late regulatory elections." Like the project aimed particularly at section 2642(g) elections, it appeared under the heading of "Burden Reduction" in the Priority Guidance Plans during the Trump Administration.

g. **Item 8: Taxation of Transfers from Certain Expatriates**

(1) Item 8 is described as "Final regulations under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. Proposed regulations were published on September 10, 2015." This project first appeared on the 2008-2009 Priority Guidance Plan, but was dropped from the Plans during the Trump Administration.

(2) The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART" Act) enacted a new income tax "mark to market" rule (section 877A) when someone expatriates on or after June 17, 2008, and a new succession tax on the receipt of certain gifts or bequests from someone who expatriated on or after June 17, 2008. The new succession tax is provided for in section 2801, comprising all of new chapter 15.

(3) Referring to the guidance contemplated by this project, Announcement 2009-57, 2009-29 I.R.B. 158 (released July 16, 2009), helpfully stated:

> The Internal Revenue Service intends to issue guidance under section 2801, as well as a new Form 708 on which to report the receipt of gifts and bequests subject to section 2801. The due date for reporting, and for paying any tax imposed on, the receipt of such gifts or bequests has not yet been determined. The due date will be contained in the guidance, and the guidance will provide a reasonable period of time between the date of issuance of the guidance and the date prescribed for the filing of the return and the payment of the tax.

Nevertheless, it seems likely that the longer it takes to finalize these regulations consistently with the June 17, 2008, effective date the harder it is going to be, and that the harder it is the longer it might take. A dilemma that has led some to think that this provision of the HEART Act will never take effect, and that Congress must intervene to provide a more workable approach.

(4) When this project first appeared on the 2008-2009 Plan, Treasury and IRS personnel referred to it as a top priority. Evidently the implementation of what amounts to a succession tax on

transferees, not transferors or their estates, is quite complicated and challenging. Perhaps the interest in broader deemed realization legislation (see Parts 25.c, 25.e, and 27.b above) has given this project new cause for optimism, or pessimism, as the case may be.

(5) The regulations proposed in 2015 (§§28.2801-1 through -7 and related procedural sections, REG-112997-10) are about 18,000 words long and were accompanied by a preamble of about 8,600 words. The preamble included the estimate that there would be 1,000 respondents annually.

(6) Proposed Reg. §28.6011-1(a) provides that "covered" gifts and bequests must be reported by the recipient on Form 708, "United States Return of Tax for Gifts and Bequests from Covered Expatriates."

(a) Under Proposed Reg. §28.6071-1(a)(1), Form 708 is generally due on the 15th day of the 18th month following the close of the calendar year in which the transfer was received. But, fulfilling the promise of Announcement 2009-57, Proposed Reg. §28.6071-1(d) states that no Form 708 will be due before the date specified in the final regulations.

(b) Under Proposed Reg. §28.2801-3(c)(1) and (2), if a gift or bequest is reported by the expatriate donor or executor of the expatriate decedent on a Form 709 or 706, and gift or estate tax is paid, it is not a covered gift or bequest and need not be reported on Form 708.

(7) Proposed Reg. §28.2801-3(b) confirms that covered bequests include the receipt of assets the value of which would be included in a U.S. citizen's gross estate under section 2036, 2037, 2038, 2040, 2042, or 2044.

(8) There are some oddities and surprises in the calculation of the tax.

(a) Under Proposed Reg. §28.2801-4(b)(2), the sum of both covered gifts and covered bequests is reduced by the annual exclusion amount provided for gift tax purposes under section 2503(b). But only one such reduction is allowed, regardless of the number of donors. In the case of a gift to a spouse who is not a U.S. citizen, that amount is determined under section 2523(i) (see Proposed Reg. §28.2801-3(c)(4) and -3(f), *Example 1*) and is 10 times the unrounded amount determined under section 2503(b).

(b) Under section 2801(b), the tax is an obligation of the recipient. Nevertheless, under the calculation rules in Proposed Reg. §28.2801-4(b), the gift tax the recipient pays is not deducted from the amount subject to tax, as it would be in the case of a typical "net gift." The section 2801 tax, whether on a gift or a bequest, is "tax-inclusive."

(c) Proposed Reg. §28.2801-4(a)(2)(iii) provides rules for computing the tax in the case of a covered transfer to a charitable remainder trust. The value of the transferred property is allocated between the noncharitable interest and the charitable remainder interest in the usual way and the tax is calculated on the noncharitable portion. Although the payment of the tax by the trust does not reduce the value of the gift for purposes of the calculation of the section 2801 tax (see paragraph (b) above), it does reduce the value of the charitable remainder and therefore might actually *increase* the value of the covered gift.

(d) Under Proposed Reg. §28.2801-6(a), the recipient's payment of the tax does not increase the basis of the transferred property.

(9) One of the most vexing issues regarding the section 2801 tax has been figuring out how the recipient will know when a gift or bequest is a "covered" gift or bequest from a "covered" expatriate. Gifts and bequests normally have no tax consequences to the recipient.

(a) Proposed Reg. §28.2801-7(a) provides this ominous, but probably unavoidable, confirmation:

> (a) *Responsibility of recipients of gifts and bequests from expatriates*. It is the responsibility of the taxpayer (in this case, the U.S. citizen or resident receiving a gift or bequest from an expatriate or a distribution from a foreign trust funded at least in part by an expatriate) to ascertain the taxpayer's obligations under section 2801, which includes making the determination of whether the transferor is a covered expatriate and whether the transfer is a covered gift or covered bequest.

(b) Apparently doing the best it can to be helpful, Proposed Reg. §28.2801-7(b) adds:

> (b) *Disclosure of return and return information* – (1) *In general*. In certain circumstances, the Internal Revenue Service (IRS) may be permitted, upon request of a U.S. citizen or resident in receipt of a gift or bequest from an expatriate, to disclose to the U.S. citizen or resident return or return information of the donor or decedent expatriate that may assist the U.S. citizen or resident in determining whether the donor or decedent was a covered expatriate and whether the transfer was a covered gift or covered bequest. The U.S. citizen or resident may not rely upon this information, however, if the U.S. citizen or resident knows, or has reason to know, that the information received from the IRS is incorrect. The circumstances under which such information may be disclosed to a U.S. citizen or resident, and the procedures for requesting such information from the IRS, will be as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b)).
>
> (2) *Rebuttable presumption*. Unless a living donor expatriate authorizes the disclosure of his or her relevant return or return information to the U.S. citizen or resident receiving the gift, there is a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift. A taxpayer who reasonably concludes that a gift or bequest is not subject to section 2801 may file a protective Form 708 in accordance with §28.6011-1(b) to start the period for the assessment of any section 2801 tax.

(c) The preamble further explains:

> Section 28.2801-7 provides guidance on the responsibility of a U.S. recipient, as defined in §28.2801-2(e), to determine if tax under section 2801 is due. The Treasury Department and the IRS realize that, because the tax imposed by this section is imposed on the U.S. citizen or resident receiving a covered gift or covered bequest, rather than on the donor or decedent covered expatriate making the gift or bequest, U.S. taxpayers may have difficulty determining whether they are liable for any tax under section 2801. Nevertheless, the same standard of due diligence that applies to any other taxpayer to determine whether the taxpayer has a tax liability or a filing requirement also applies to U.S. citizens and residents under this section. Accordingly, it is the responsibility of each U.S. citizen or resident receiving a gift or bequest, whether directly or indirectly, from an expatriate (as defined in section 877A(g)(2)) to determine its tax obligations under section 2801. Thus, the burden is on that U.S. citizen or resident to determine whether the expatriate was a covered expatriate (as defined in section 877A(g)(1)) and, if so, whether the gift or bequest was a covered gift or covered bequest.

(d) In other words, if a family member expatriates, life will be tougher for other family members (or any objects of the expatriate's bounty) who do not expatriate.

(e) Proposed Reg. §28.6011-1(b)(i) does provide that a recipient who reasonably concludes that a gift or bequest is not a "covered" gift or bequest may file a protective Form 708, and that such a filing will start the period for assessment of tax with respect to any transfer reported on that return.

(10) Section 2801(e)(1) provides that a "covered gift or bequest" includes any property acquired "directly or indirectly." Section 2801(e)(4)(A) provides that a covered transfer includes a transfer to a U.S. domestic trust. Section 2801(e)(4)(B)(i) provides that in the case of a covered gift or bequest to a foreign trust, the tax is imposed on distributions *from* the trust "attributable to such gift or bequest."

(a) Proposed Reg. §28.2801-5(c)(1)(i) provides that the amount of any distribution attributable to covered gifts and bequests is determined by applying a "section 2801 ratio" to the value of the distribution. Tracing of particular trust assets is not allowed.

(b) Under Proposed Reg. §28.2801-5(c)(1)(ii), the "section 2801 ratio," representing the portion of the trust and of each distribution that is deemed to be attributable to covered transfers, is redetermined after each contribution to the trust in a manner resembling the calculation of the inclusion ratio for GST tax purposes.

(c) Proposed Reg. §28.2801-5(c)(3) provides:

> If the trustee of the foreign trust does not have sufficient books and records to calculate the section 2801 ratio, or if the U.S. recipient is unable to obtain the necessary information with regard to the foreign trust, the U.S. recipient must proceed upon the assumption that the entire distribution for purposes of section 2801 is attributable to a covered gift or covered bequest.

This encourages the expatriate transferor to cooperate with transferees.

(d) Proposed Reg. §28.2801-5(d) permits a foreign trust to elect to be treated as a U.S. trust.

i. Thereby the section 2801 tax is imposed on the value of the trust multiplied by the section 2801 ratio and on all current and future transfers to the trust from covered expatriates, but *not* on future distributions *from* the trust.

ii. The trustee of an electing foreign trust must designate and authorize a U.S. agent solely for purposes of section 2801. Proposed Reg. §28.2801-5(d)(3)(iv) states:

> By designating a U.S. agent, the trustee of the foreign trust agrees to provide the agent with all information necessary to comply with any information request or summons issued by the Secretary. Such information may include, without limitation, copies of the books and records of the trust, financial statements, and appraisals of trust property. … Acting as an agent for the trust for purposes of section 2801 includes serving as the electing foreign trust's agent for purposes of section 7602 ("Examination of books and witnesses"), section 7603 ("Service of summons"), and section 7604 ("Enforcement of summons") with respect to … [a]ny request by the Secretary to examine records or produce testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the electing foreign trust and distributions attributable to such contributions; and … [a]ny summons by the Secretary for records or testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the electing foreign trust and distributions attributable to such contributions.

Under such a rule, care would be advisable in agreeing to be a U.S. agent.

h. **Item 9: Actuarial Tables**

(1) Item 9 is described as "Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests." This item was new in the 2018-2019 Plan.

(2) The previous mortality tables, based on 2000 census data, became effective May 1, 2009. Before that, mortality tables had taken effect on May 1, 1989, and May 1, 1999. Section 7520(c)(2) mandates revision of the tables at least once every 10 years. This project is that routine revision, to reflect 2010 census data, even though it was not completed by May 1, 2019.

(3) New tables, based on 2010 census data, are applied in lengthy proposed regulations (REG-122770-18) released on May 4, 2022, and published in the Federal Register on May 5, 2022 (87 Fed. Reg. 26806). The new tables are available on the IRS website at **https://www.irs.gov/retirement-plans/actuarial-tables**.

(4) In view of the tardiness of these tables, the proposed regulations include special effective date and transitional rules.

(a) The new tables will generally take effect on what is described as "the applicability date of the Treasury decision adopting these regulations as final regulations."

(b) That date is "**proposed**" to be "the first day of the month following the date on which the Treasury decision adopting these regulations as final regulations is published in the Federal Register." (The implication of the word "proposed" is that the final regulations could provide differently, although that seems unlikely.)

(c) For transfers or dates of death on or after January 1, 2021, and before the "applicability date," the taxpayer (that is, the transferor or the executor) "may choose" to determine **the mortality component** of any applicable value, including a charitable deduction, under **either the 2000 tables or these new 2010 tables**. That choice must be the same choice with respect to all valuation elements of the same transfer.

i. The **interest rate** will be the applicable rate under section 7520 (which rates have continued to be published monthly without interruption) in effect for the month of the transfer or death. (Valuations based on a fixed term and not life expectancies are affected only by the monthly section 7520 rate and will not be affected by these new tables.)

ii. If, in the case of a charitable deduction, the taxpayer elects under section 7520(a) to use the rate for one of the two preceding months, and that elected month is "prior to January

1, 2021" (in other words, it is November 2020 or December 2020), then **only the 2000 mortality tables** may be used to compute **the mortality component**.

(d) The proposed regulations say nothing about transfers or deaths on or after May 1, 2019, and before January 1, 2021, thus implying that all valuations in such cases must be made under the 2000 mortality tables.

(5) The proposed regulations are subject to a period of public comment and perhaps (if requested) a public hearing. Comments are due July 5, 2022. Thus, there is no guarantee when the final regulations will be issued, or will be effective.

i. **Notable Omissions from the Priority Guidance Plan**

(1) **Basis of Grantor Trust Assets Under Section 1014**

(a) A project described as "Guidance on basis of grantor trust assets at death under §1014" was new in 2015, but dropped in the 2021-2022 Plan

(b) In Letter Ruling 200434012 (April 23, 2004), involving a sale from one grantor trust to another, the Service included the caveat (emphasis added) that "when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 **by reason of A's death** or the waiver or release of any power under § 675, **no opinion is expressed or implied** concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), **a change in the basis of any property** under § 1012 or § 1014, or any deductible administration expense under § 2053."

(c) An installment note received by the grantor from a grantor trust in connection with a sale to a grantor trust receives a new basis – presumably a stepped-up basis – under section 1014 when the grantor dies. The note is not an item of income in respect of a decedent ("IRD") under section 691, which would be excluded from the operation of section 1014 by section 1014(c), because the fact, amount, and character of IRD are all determined in the same manner as if "the decedent had lived and received such amount" (section 691(a)(3); *cf.* section 691(a)(1)), and the decedent would not have realized any income in that case, as confirmed by Rev. Rul. 85-13, 1985-1 C.B. 184). See the analysis in Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 Tax Mgmt. Ests., Gifts & Tr. J. 3 (1999).

(d) Chief Counsel Advice 200923024 (Dec. 31, 2008) opined that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust [by reason of the replacement of an independent trustee with a related or subordinate party] results in taxable income to the grantor." After citing and discussing Reg. §1.1001-2(c), Example 5, *Madorin v. Commissioner*, 84 T.C. 667 (1985), and Rev. Rul. 77-402, 1977-2 C.B. 222 (which addressed the reverse conversion to nongrantor trust status), the Chief Counsel's office noted (emphasis added) that "the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner *which is generally not treated as an income tax event*." Because of the interrelationship with certain partnership transactions and section 754 basis elections, however, the Chief Counsel's office viewed the overall transaction as "abusive" and wanted to explore other ways to challenge it. But it nevertheless believed that "asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations."

(e) This guidance project may somehow be related to the analytical gymnastics found in those authorities.

(f) On the other hand, this proposal may simply be aimed at a clarification of the rules for foreign trusts.

i. Rev. Proc. 2015-37, 2015-26 I.R.B. 1196, added "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code" to the list of "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." That designation was continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126, section 5.01(10) of Rev. Proc. 2017-3, 2017-1 I.R.B. 130, section 5.01(8) of Rev. Proc. 2018-3, 2018-1 I.R.B. 130, section 5.01(8) of Rev. Proc. 2019-3, 2019-1 I.R.B. 130, section 5.01(9) of Rev. Proc. 2020-3, 2020-1 I.R.B. 131, section 5.01(11) of Rev. Proc. 2021-3, 2021-1 I.R.B. 140, and section 5.01(11) of Rev. Proc. 2022-3, 2022-1 I.R.B. 144.

ii. Meanwhile, Letter Ruling 201544002 (June 30, 2015), similar to Letter Ruling 201245006 (July 19, 2012), held that assets in a revocable trust created by foreign grantors for their U.S. citizen children would receive a stepped-up basis under section 1014(b)(2) at the grantors' deaths. The ruling acknowledged the no-rule policy of Rev. Proc. 2015-37, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced.

iii. It is hard to believe that it is a coincidence that Rev. Proc. 2015-37 was published in the Internal Revenue Bulletin on June 29, 2015, the *day before* Letter Ruling 201544002 was issued. If those two contemporaneous events are related, then the no-rule position of Rev. Procs. 2015-37, 2016-3, 2017-3, 2018-3, 2019-3, 2020-3, and 2021-3 might have been aimed only at foreign trusts, and so might this proposal first announced in the 2015-2016 Priority Guidance Plan a month later on July 31, 2015.

(g) It is also possible that, even if the project originally had such a narrow focus, it was expanded in the Trump Administration. But this item apparently was not mentioned in the Office of Information and Regulatory Affairs' Spring 2020 Unified Agenda of Regulatory and Deregulatory Actions, which was released on June 30, 2020. In any event, it is now dropped, and there does not seem to be any reason to expect its revival.

(2) **Valuation of Promissory Notes**

(a) A project described as "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872" first appeared in the 2015-2016 Plan, but was dropped in the 2017-2018 Plan (the first Plan in the Trump Administration).

(b) This project was joined in the 2016-2017 Plan by an item under the subject of "Financial Institutions and Products" described as "Regulations under §7872. Proposed regulations were published on August 20, 1985." When the promissory notes project was dropped from the subject of "Gifts and Estates and Trusts" in the 2017-2018 Plan, that item under "Financial Institutions and Products" remained. It was carried over to the 2018-2019 Plan, but dropped from the 2019-2020 Plan.

(c) It is well known that the Tax Court has held that section 7872 is the applicable provision for valuing an intra-family promissory note – specifically for determining that a note carrying the section 7872 rate may be valued at its face amount. *See Frazee v. Commissioner*, 98 T.C. 554 (1992). *See also Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

(d) But Judge Hamblen concluded his opinion in *Frazee* by stating:

> We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept.

98 T.C. at 590. Perhaps this project was intended to resolve that anomaly, probably by regulations.

(e) Section 7872(i)(2) states:

> Under regulations prescribed by the Secretary [of the Treasury], any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans].

i. Proposed Reg. §20.7872-1 (proposed in 1985) provides that a "gift term loan" shall be valued for estate tax purposes at no less than (a) its unpaid stated principal plus accrued interest or (b) the present value of all the future payments under the note using the applicable federal rate in effect at the time of death.

ii. Answers to the proposed regulation might include the arguments that (1) the proposed regulation is not effective unless and until it is finalized, (2) the loan represented by the installment note is not a "gift term loan" because it uses an interest rate calculated to avoid below-market treatment under section 7872(e), and (3) with respect to section 7872(i)(2) itself, the loan is not made "with donative intent" because the transaction is a sale.

iii. Under section 7805, the proposed regulations could probably be expanded even beyond the strict mandate of section 7872(i)(2), and under section 7805(b)(1)(B) such expanded final regulations might even be made effective retroactively to the publication date of the proposed regulations in 1985 (although that would be an aggressive choice that undoubtedly would be roundly criticized). But, unless and until that happens, most estate planners have seen no reason why the estate tax value should not be fair market value, which, after all, is the general rule, subject to Reg. §20.2031-4, which states:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

(f) It is not clear that this guidance project was related to these developments, and in any event it did not cite Proposed Reg. §20.7872-1.

i. It *is* clear that the IRS has long been interested in the valuation of promissory notes, and at times has seemed to embrace a market interest rate standard. *See* Letter Ruling 200147028 (issued Aug. 9, 2001; released Nov. 23, 2001).

ii. The interest of the IRS was especially apparent after the docketing of *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13, in which the IRS asserted $2.8 billion in estate, gift, and generation-skipping taxes owed. On July 6, 2015, the case was settled for just over $550 million. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (issued Feb. 24, 2012; released July 26, 2013) and in its answer in the Tax Court, the IRS argued that the notes should be valued, not under section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. *See also Estate of Kite v. Commissioner*, T.C. Memo. 2013-43.

(g) Promissory notes are frequently used in estate planning, and guidance could provide welcome clarity.

(h) On the other hand, Treasury and the IRS might have given up on regulatory guidance in favor of seeking new legislation. See the discussion of the Fiscal Year 2023 Greenbook proposal in Part 27.e(2) above.

(3) **Defined Value Clauses**

(a) A project described as **"Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511"** was also new in 2015 but dropped in the 2017-2018 Plan.

(b) Defined value clauses have an interesting history. See, for example, Technical Advice Memorandum 8611004 (Nov. 15, 1985) (approving a transfer of "such interest in X Partnership … as has a fair market value of $13,000"); *Knight v. Commissioner*, 115 T.C. 506 (2000) (disregarding the use of such a technique to transfer "that number of limited partnership units in [the partnership] which is equal in value, on the effective date of this transfer, to $600,000"); *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir.

2006), *rev'g* 120 T.C. 358 (2003) (reviewed by the Court) (approving a defined value clause, with the excess going to charity); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (approving a formula disclaimer in favor of charity); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011) (approving a defined value clause, with the excess going to charity); *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (approving a defined value clause, with the excess going to charity); *Wandry v. Commissioner*, T.C. Memo. 2012-88, *nonacq.*, AOD 2012-004, 2012-46 I.R.B. (approving a type of defined value clause, with the excess remaining with the transferor).

(c) The taxpayers' actual implementation of defined value clauses (that is, returning property to the donors where it might be taxed as part of their estates) was likely an element of the settlements in *Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13, stipulated decision entered March 25, 2016) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13, stipulated decision entered March 28, 2016); and possibly in *Karen S. True v. Commissioner* (Tax Court Docket No. 21896-16, stipulated decision entered July 9, 2018) and *H.A. True III v. Commissioner* (Tax Court Docket No. 21897-16, stipulated decision entered July 6, 2018).

(d) Another example of the IRS and the taxpayer agreeing to give effect to a formula – in this case a formula for determining the annuity payments from a GRAT – is the stipulation in *Grieve v. Commissioner*, T.C. Memo. 2020-28 (Judge Kerrigan). In that case, in addition to other transfers, there was a two-year GRAT with annuity payments determined as stated percentages of what the opinion describes only as "the fair market value of assets transferred to the trust for Federal gift tax purposes." As the court noted in a footnote:

> The parties stipulated that petitioner will not owe additional gift tax if we determine that he understated the initial fair market value of assets transferred to the GRAT if, within a reasonable time, the GRAT pays to petitioner, or to his personal representative in the event of his passing, an amount equal to the difference of the properly payable annuity and the annuity actually paid.

They never had the opportunity to make such a payment, however, because the taxpayer won the case on the underlying valuation issue.

(e) *Nelson v. Commissioner*, T.C. Memo. 2020-81 (June 10, 2020, Judge Pugh), involved a gift to a trust of a limited partner interest "having a fair market value" of a specified dollar amount, "as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment," followed two days later by a sale to the same trust described in the same way, except that the time for obtaining the appraisal was 180 days instead of 90 days. The taxpayer argued unsuccessfully that this permitted an adjustment to the transfer based on the values finally determined for gift tax purposes, as in *Wandry*. Significantly, the IRS not only accepted the formulas based on appraisals within a specified time but actually advocated for them, obviously not offended by such formula transfers as it is by *Wandry* clauses. This is understandable, because by the time the IRS looks at the return the transferred quantity will already have been determined, and the IRS can contest the valuation of that quantity.

(f) For an important analysis of limitations on the effectiveness of *Wandry* clauses, see Bramwell & Dillon, "Not Another *Wandry* Article: Real Issue With *Wandry* Formulas," 41 Est. Plan. 3 (May 2014).

(g) In affirming the Tax Court in *Petter*, albeit in the context of a rather narrow subpoint of a condition precedent within the meaning of Reg. §25.2522(c)-3(b)(1), the Court of Appeals for the Ninth Circuit concluded its opinion by quoting:

> "[W]e expressly invite[ ] the Treasury Department to "amend its regulations" if troubled by the consequences of our resolution of th[is] case." *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011) (quoting *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 838 (2001)).

Maybe, in this guidance project, Treasury was proposing to accept that invitation. Meanwhile, the settlements described in paragraph (c) above, the parties' stipulation in *Grieve* quoted in paragraph (d) above, and the Tax Court's apparent respect for that stipulation in *Grieve* all might suggest that actually giving effect to defined value clauses in audit, settlement, or litigation to cut down the tax benefits of an estate planning technique might have become a "new normal."

(4) **"Material Participation" by Trusts and Estates**

(a) Also in the 2017-2018 Priority Guidance Plan, a project described as "Guidance regarding material participation by trusts and estates for purposes of §469," which had been in previous Plans under the heading of "General Tax Issues," was omitted.

(b) This guidance could have shed light on the application to trusts and estates of the "trade or business" exception in section 1411(c)(1)(A)(i) to the 3.8 percent tax on net investment income under section 1411 (enacted in 2010). Congress applied that requirement in 2010 to the "trade or business" exception by including in section 1411(c)(1)(A)(i) the qualifier "not described in paragraph (2)" and by including in subparagraph (A) of paragraph (2) "a passive activity (within the meaning of section 469)," thus incorporating into section 1411 the definition of section 469(c)(1) that "[t]he term 'passive activity' means any activity (A) which involves the conduct of any trade or business, and (B) in which **the taxpayer does not materially participate**."

(c) Chief Counsel Advice 201244017 (issued Aug. 3, 2012; released Nov. 2, 2012) took the position that

> a trust cannot meet the qualifying tests of 469(c)(7)(B) because those tests are intended to apply only to individuals. Only individuals are capable of performing "personal services" …, and the statute specifically states that the personal services must be performed <u>by the taxpayer</u>.

(d) Final regulations addressing many issues under section 1411 were issued on November 26, 2013, but did not address the issue of material participation in the context of trusts. The preamble (T.D. 9644) candidly acknowledged Treasury's sympathy with the problems of material participation and the difficulty of dealing with those problems, which it described as "very complex." The preamble to proposed regulations published on December 2, 2013, cited the preamble to the November 26, 2013, final regulations and deferred the issue of material participation by estates and trusts, including QSSTs, which it said "is more appropriately addressed under section 469."

(e) Then, in the section 469 case of *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (March 27, 2014) (discussed in Part 14.c(8) above), the Tax Court (Judge Morrison) held that the material participation by the trust in real estate operations may be determined by considering the activities of the trustees, including the activities of some of the trustees in their roles as employees of an LLC wholly owned by the trust, and that by that standard the court was "convinced that the trust materially participated in the trust's real-estate operations."

(f) There has been no acquiescence or nonacquiescence or any other formal indication of the IRS's view of this subject in light of *Aragona*. But five months after the *Aragona* decision, on August 26, 2014, the 2014-2015 Treasury-IRS Guidance Plan, under the heading of "General Tax Issues," included for the first time a project described as "Guidance regarding material participation by trusts and estates for purposes of §469." That project was repeated in two more annual Plans but was dropped from the 2017-2018 Plan, thus essentially leaving the regular published Tax Court decision in *Aragona* as the last word on the subject.

(g) And this issue might become moot if an expansion of the tax on net investment income such as the proposal described in Part 26.b(7)(c) above is enacted.

(5) **Allocation of GST Exemption at the End of an ETIP**

(a) A project described as "Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP" first appeared in the 2012-2013 Plan and then was dropped from the 2016-2017 Plan.

(b) Some context might be derived from a request for guidance from the AICPA, first made in a letter to the IRS dated June 26, 2007, which stated:

> The issues presented here are best illustrated by considering the following fact pattern:
>
> > Taxpayer creates an irrevocable trust, Trust Z, in which a qualified annuity interest (as defined in section 2702(b)) is payable to the taxpayer or his estate for 10 years. Upon the termination of the annuity interest, Trust Z is to be separated into two trusts, Trust A and Trust B. Trust A is for the exclusive benefit of Taxpayer's children and grandchildren. Trust B is for the exclusive benefit of Taxpayer's children. Trust A is to receive from Trust Z so much of the Trust Z's assets as is equal to Taxpayer's remaining GST exemption, if any. Trust B is to receive from Trust Z the balance of Trust Z's assets, if any, after funding Trust A. The taxpayer is alive at the end of the 10 years.
>
> Presumably, the transfer to Trust Z is an indirect skip to which GST exemption will be automatically allocated at the end of the ETIP. Will the automatic allocation rules apply to all the assets remaining in Trust Z at that time? If so and if the taxpayer wants to allocate GST exemption only to the assets going to Trust A, the taxpayer should timely elect out of the automatic allocation rules of section 2632(c), and then affirmatively allocate GST exemption only to the assets going into Trust A at the end of the ETIP. Is that possible?
>
> In the alternative, the automatic allocation rules may apply only to the transfer going into Trust A because Trust B is not by definition a GST trust. Because of the application of the ETIP rules, the transfer from the taxpayer for GST purposes would occur only at the time that the assets are funded into Trust A. If that is the case, then the taxpayer does not need to do anything affirmatively to ensure that GST exemption is allocated to Trust A and not Trust B as he or she desires.
>
> It has been our experience that many trusts are structured in a manner similar to the above referenced fact pattern. By letter dated November 10, 2004, the AICPA submitted comments on the proposed regulations on electing out of deemed allocations of GST exemption under section 2632(c). In that letter, guidance was requested on these issues. The preamble to the final regulations (T.D. 9208) acknowledged this request for the inclusion in the regulations of an example addressing the application of the automatic allocation rules for indirect skips in a situation in which a trust subject to an ETIP terminates upon the expiration of the ETIP, at which time the trust assets are distributed to other trusts that may be GST trusts. According to the preamble, the Treasury Department and the Internal Revenue Service believed that this issue was outside the scope of the regulation project and would consider whether to address these issues in separate guidance.

(6) **Private Trust Companies as Fiduciaries**

(a) Privately owned and operated trust companies are becoming an option that families with large trusts are turning to in increasing numbers, and state law authority for such private trust companies is being continually refined. Until 2014, every Priority Guidance Plan since 2004 had included an item referring to private trust companies.

i. When this project first appeared, in the 2004-2005 Plan, it was described as "Guidance regarding family trust companies."

ii. In the 2005-2006, 2006-2007, and 2007-2008 Plans, it was described as "Guidance regarding the consequences under various *estate, gift, and generation-skipping transfer tax* provisions of using a family-owned company as the trustee of a trust." The omission of *income tax* issues from that formulation was a source of concern because income tax issues have frequently been addressed in the relevant letter rulings. Indeed, in the first such letter rulings, Letter Rulings 9841014 and 9842007 (July 2, 1998), the only issue was whether a family-owned trust company was a "related or subordinate party" with respect to the living grantors of various trusts, within the meaning of section 672(c), an income tax rule.

iii. In the 2008-2009 and 2009-2010 Plans (published after Notice 2008-63, which is discussed below), the description was a more comprehensive "Revenue ruling regarding the consequences under various income, estate, gift, and generation-skipping transfer tax provisions of using a family owned company as a trustee of a trust."

iv. That reassurance of comprehensive treatment was maintained in the 2010-2011 Plan by describing the project as "Guidance concerning private trust companies under §§671, 2036, 2038, 2041, 2042, 2511, and 2601."

v. By dropping the reference to a revenue ruling, the 2010-2011 Plan suggested that Treasury and the IRS might be reviewing the basic approach of the proposed revenue ruling, which had attracted many diverse public comments after the publication of Notice 2008-63 (discussed below). But a revenue ruling as the vehicle for the guidance would be much easier to finalize than would, for example, amendment of the many regulations that would have to be amended.

vi. Following the first appearance of this project on the 2004-2005 Plan, the IRS identified the treatment of private trust companies for estate tax purposes under sections 2036, 2038, and 2041 as "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." Rev. Proc. 2005-3, 2005-1 C.B. 118, §§5.07, 5.08 & 5.09. This designation has continued to the present. Rev. Proc. 2022-3, 2022-1 I.R.B. 144, §§5.01(12), (13) & (14).

(b) The proposed revenue ruling in question was released with Notice 2008-63 on July 11, 2008, and published at 2008-31 I.R.B. 261 on August 4, 2008. The Notice solicited comments on the proposed revenue ruling, which affirmed favorable conclusions with respect to five tax issues faced by trusts of which a private trust company serves as trustee:

i. Inclusion of the value of trust assets in a grantor's gross estate by reason of a retained power or interest under section 2036 or 2038.

ii. Inclusion of the value of trust assets in a beneficiary's gross estate by reason of a general power of appointment under section 2041.

iii. Treatment of transfers to a trust as completed gifts.

iv. Effect on a trust's status under the GST tax either as a trust created before the effective date or as a trust to which GST exemption has been allocated.

v. Treatment of a grantor or beneficiary as the owner of a trust for income tax purposes.

While these are not the only issues that the use of private trust companies can present, these are the most common issues. It was especially encouraging to see grantor trust treatment addressed, in view of the omission of income tax from the formulation of this project on the then most recent 2007-2008 Plan.

(c) The proposed revenue ruling posited several trusts, illustrating both the introduction of a private trust company as the trustee of a preexisting trust and the creation of new trusts with a private trust company as the trustee. The trusts had the following features:

i. The trustee has broad discretionary authority over distributions of both income and principal.

ii. Each successive primary beneficiary has a broad testamentary power of appointment (although not as broad as a power to appoint to anyone other than the beneficiary's estate, creditors, and creditors of the estate).

iii. The grantor or primary beneficiary may unilaterally appoint (but not remove) trustees, with no restrictions other than on the ability to appoint oneself.

(d) The proposed revenue ruling presented two situations – Situation 1, in which the private trust company is formed under a state statute with certain limitations, and Situation 2, in which the private trust company is formed in a state without such a statute but comparable limitations are included in the governing documents of the private trust company itself.

(e) The basic premise of the proposed revenue ruling, as stated in the second paragraph of Notice 2008-63, was:

> The IRS and the Treasury Department intend that the revenue ruling, once issued, will confirm certain tax consequences of the use of a private trust company that are not more restrictive than the consequences that could have been achieved by a taxpayer directly, but without permitting a taxpayer to achieve tax consequences through the use of a private trust company that could not have been achieved

had the taxpayer acted directly. Comments are specifically requested as to whether or not the draft revenue ruling will achieve that intended result.

(f) Consistently with this basic premise, the proposed revenue ruling provided that the hypothetical private trust companies it addressed would generally avoid tax problems by the use of certain "firewall" techniques. For example:

i. A "Discretionary Distribution Committee" ("DDC") with exclusive authority to make all decisions regarding discretionary distributions "from each trust [meaning "all trusts"?] for which it serves as trustee." Anyone may serve on the DDC, but no member of the DDC may participate in the activities of the DDC with respect to a trust of which that DDC member or his or her spouse is a grantor or beneficiary, or of which the beneficiary is a person to whom that DDC member or his or her spouse owes an obligation of support.

ii. In Situation 2, an "Amendment Committee" with exclusive authority to amend the relevant sensitive limitations in the private trust company's governing documents (which are imposed by statute in Situation 1). A majority of the members of the Amendment Committee must be individuals who are neither members of the relevant family nor persons related or subordinate (within the meaning of section 672(c)) to any shareholder of the company.

(g) A paragraph near the end of the proposed revenue ruling identified three factual details that were not material to the favorable tax conclusions, explicitly confirming that the conclusions would not change if those details changed. No doubt the list of immaterial factual details could be expanded. Some likely examples (not exhaustive):

i. The designation of a "primary beneficiary" of each preexisting trust, possibly excluding so-called "pot" or "sprinkle" trusts.

ii. The possible requirement of a single independent "Discretionary Distribution Committee" for all trusts administered by the private trust company, possibly excluding a differently conceived body with a similar effect, a different committee for different trusts, and any exception for trusts for customers other than family members administered by family-owned trust companies that offer fiduciary services to the public.

iii. The explicit prohibition of certain express or implied reciprocal agreements regarding distributions, possibly excluding such prohibitions derived from general fiduciary law.

(h) The project relating to private trust companies was omitted from the 2014-2015 Priority Guidance Plan. But unlike decanting (which is discussed next), it cannot be said that private trust companies are a priority, or that the contemplated guidance may be issued soon. But meanwhile, the principles reflected in the proposed revenue ruling, including the reliance on "firewalls," will be relied on by those contemplating and organizing private trust companies and employing them as trustees of family trusts. If and when the IRS does issue guidance in this area, it is likely that such guidance will not be harsher in any material way than the guidance in the proposed revenue ruling.

(7) **Decanting**

(a) The 2011-2012 Priority Guidance Plan included "Notice on decanting of trusts under §§2501 and 2601." This project was new in 2011-2012, but it had been anticipated for some time, especially since the publication at the beginning of 2011 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111, in which new sections 5.09, 5.16, and 5.17 included decanting among the "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise." Rev. Proc. 2022-3, 2022-1 I.R.B. 144, §§5.01(8), (17) & (21) continues this designation.

(b) On December 20, 2011, the IRS published Notice 2011-101, 2011-52 I.R.B. 932. Notice 2011-101 asked for comments from the public by April 25, 2012, on the tax consequences of decanting transactions – the transfer by a trustee of trust principal from an irrevocable "Distributing Trust" to another "Receiving Trust." Notice 2011-101 asked for comments on the relevance and effect of the following 13 facts and circumstances (as well as the identification of any other factors that might affect the tax consequences):

i. A beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary);

ii. Trust principal and/or income may be used to benefit new (additional) beneficiaries;

iii. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;

iv. The transfer takes place from a trust treated as partially or wholly owned by a person under §§671 through 678 of the Internal Revenue Code (a "grantor trust") to one which is not a grantor trust, or vice versa;

v. The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust;

vi. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law;

vii. The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

viii. The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

ix. Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained;

x. The effect of state law or the silence of state law on any of the above scenarios;

xi. A change in the identity of a donor or transferor for gift and/or GST tax purposes;

xii. The Distributing Trust is exempt from GST tax under §26.2601-1, has an inclusion ratio of zero under §2632, or is exempt from GST tax under §2663; and

xiii. None of the changes described above are made, but a future power to make any such changes is created.

(c) Notice 2011-101 also "encourage[d] the public to suggest a definition for the type of transfer ('decanting') this guidance is intended to address" and encouraged responses to consider the contexts of domestic trusts, the domestication of foreign trusts, and transfers to foreign trusts.

(d) Meanwhile, Notice 2011-101 said that the IRS "generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period."

(e) There were extensive public comments, and there is little doubt that Treasury and the IRS have continued to study decanting. But decanting was omitted from the 2012-2013 Plan and from subsequent Plans.

(f) A new Uniform Trust Decanting Act (UTDA) was approved by the Uniform Law Commission at its annual conference in July 2015. The Act generally allows decanting whenever the trustee has discretion to make principal distributions, or even if the trustee does not have such discretion if it is appropriate to decant into a special-needs trust.

i. Generally decanting under UTDA may not add beneficiaries, and Section 19 of UTDA includes extensive explicit safeguards, called "tax-related limitations," to prevent decanting from jeopardizing any intended beneficial tax characteristics of the trust. The beneficial tax characteristics explicitly addressed are the marital deduction, the charitable deduction, the annual gift tax exclusion, the eligibility of the trust to hold S corporation stock, an inclusion ratio of zero for GST tax purposes, preservation of the use of the trust beneficiary's life expectancy in determining minimum required distributions from a retirement plan or IRA, and the preservation, creation, avoidance, or termination of grantor trust status as the circumstances might warrant.

ii. UTDA in effect now provides the "definition" Notice 2011-101 asked for, and its publication should now pave the way for the long-awaited tax guidance for decantings done under UTDA or substantially identical statutes. And because of the care to avoid tax problems that UTDA exhibits, that guidance should not be as hard to complete or as harsh in its application as many might have feared.