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Steve Leimberg's Estate Planning
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Subject: Austin Bramwell & Katie Lynagh - How to Increase Estate Tax Exclusion Without Using Up Bonus BEA

"Final anti-clawback regulations confirm that by making taxable gifts before 2026, wealthy individuals can successfully lock in the bonus exclusion available through 2025. Surprisingly, the final regulations create an additional potential benefit for individuals who happen to have inherited DSUE from a deceased spouse. Thanks to favorable technical computation rules, taxpayers in that position can enhance their exclusion amounts, even if they never make gifts that use up any of the bonus exclusion. This newsletter explains how."

Austin Bramwell and **Katie Lynagh** provide members with commentary that examines the final anti-clawback regulations' computational rules and describes how individuals with DSUE can time gifts in a way that artificially enhances their gift and estate tax exclusion amounts.

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Here is their commentary:

EXECUTIVE SUMMARY:

Final anti-clawback regulations confirm that by making taxable gifts before 2026, wealthy individuals can successfully lock in the bonus exclusion available through 2025. Surprisingly, the final regulations create an additional potential benefit for individuals who happen to have inherited DSUE from a deceased spouse. Thanks to favorable technical computation rules, taxpayers in that position can enhance their exclusion amounts, even if they never make gifts that use up any of the bonus exclusion. This newsletter explains how.

FACTS:

Under the Tax Cuts and Jobs Act ("TCJA"), the federal gift and estate tax basic exclusion amount ("BEA") has temporarily doubled from $5 million to $10 million, adjusted for inflation. After 2025, the BEA will revert to $5 million per U.S. citizen or resident, again adjusted for inflation. We call the $5 million exclusion that was available before TCJA and will continue to be available after 2025 the "original exclusion." The additional $5 million available through 2025 we call the "bonus exclusion."

Final regulations released November 22, 2019 pursuant to the mandate of section 2001(g)(2) of the Internal Revenue Code (the "Code") adopt the same anti-clawback rule proposed in 2018. Thus, if an individual makes gifts that use up the bonus exclusion but dies after the exclusion amount has returned to its pre-TCJA levels, the gifts will still be shielded from estate tax, even if the BEA at death is less than the BEA used up during lifetime. The final regulations also clarify that, to preserve the bonus exclusion past 2025, an individual must first use up his or her original exclusion amount, as well as any Deceased Spousal Unused Exclusion ("DSUE") that he or she may have inherited from a deceased spouse. The lock-in effect of using up the bonus exclusion does not begin until taxable gifts have first used up the original exclusion amount.[1]

In addition, the final regulations provide technical rules for computation of the credit applicable to gifts that use up BEA. Under these rules, an estate is allowed a credit equal to the greater of (i) the credit available for the year of death, based solely on the BEA, or (ii) the credit used up during lifetime, also based solely on the BEA. We call these two credit amounts, respectively, the “BEA-based credit for the year of death” and the “BEA-based credit used during lifetime.”

Surprisingly, the BEA-based credit for the year of death is computed as if no DSUE were available. This rule artificially reduces the BEA-based credit for the year of death – which in turn makes it easier to cause the BEA-based credit used during lifetime to exceed the BEA-based credit for the year of death. For example, suppose that a U.S. citizen or resident dies after 2025 in a year when the BEA is $6.8 million. Suppose further that he or she had inherited $6.8 million of DSUE from a prior deceased spouse. Assuming no gifts and the rate schedule currently in effect, the total applicable credit would be $5,385,800. The BEA-based credit for the year of death would be $2,665,800, which is less than half the total credit. The reason that the BEA-based credit is a smaller portion of the total credit is that the first $1 million of credit is computed at lower marginal rates set forth in the section 2001(c) rate table.

In contrast to the BEA-based credit for the year of death, the BEA-based credit used during lifetime is computed using a fraction. Specifically, for each year in which gifts were made, the BEA-based credit used during lifetime is equal to the total applicable credit used during the year, multiplied by the BEA divided by total applicable exclusion. For example, assume that a decedent made a $13.6 million taxable gift, which used up $6.8 million DSUE and $6.8 million BEA. The BEA-based credit used by the gift is equal to $5,385,800 (the total applicable credit for a $13.6 million taxable gift) multiplied by the fraction $6.8 million divided by $13.6 million, or $2,692,900.

Note that the BEA-based credit used by the gift in this case is greater than credit that would be computed on $6.8 million of BEA at death. As discussed, if the BEA is $6.8 million, then the BEA-based credit for the year of death is only $2,665,800. A $13.6 million gift that uses up equal parts DSUE and BEA, by contrast, generates a BEA-based credit of $2,692,900. In other words, the gift during lifetime creates an additional $27,100 of credit, compared to when the identical exclusion amounts are used at death.

Now suppose that at least $1 million of DSUE had already been used up in prior years. In that case, under the computational rules of section 2505(a) of the Code, the BEA-based credit should be computed entirely at the highest taxable rate (40%). Thus, even if taxable gifts do no more than use up the original exclusion amount, and do not even use up any bonus exclusion, the BEA-based credit will be greater than if the individual had not made any gifts.

For example, assume that in year 1, a decedent made a $1 million taxable gift that used up $1 million DSUE out of a total DSUE of $6.8 million, and in year 2 the decedent made a $12.6 million taxable gift that used up the remaining $5.8 million of DSUE, plus $6.8 million of BEA. The BEA-based credit used by the gift in this case is $2,720,000.[2] This amount applies at death rather than the $2,665,800 BEA-based credit for the year of death. In other words, an additional $64,200 of credit is artificially generated by the use of $1 million of DSUE in a prior year and staging of the gifts.

The final regulations also provide that the BEA-based credits are computed using the rates applicable at death. Thus, if rates increase, the tax savings from making gifts that use up the original exclusion (even when no bonus exclusion is used) will potentially be even greater.

COMMENT:

Given how the BEA-based credits are computed, individuals with DSUE should almost always – if not always – use up at least $1 million of DSUE first (or whatever amount is needed to push taxable gifts into the highest bracket thresholds). Only in later years should the individual start using up the original exclusion. If an individual stages gifts in this way, he or she can artificially generate approximately an additional $135,500 of exclusion, even if he or she never uses any bonus exclusion. All that is needed, given the current rate structure, is $1 million of DSUE.

To claim this benefit, married couples should also consider relying on portability rather than a traditional credit shelter trust plan. This is a new, previously unidentified factor favoring portability.[3]

A final comment on using DSUE: To the surprise of nobody who read the comments on the proposed anti-clawback regulations, the final regulations reserve for additional rules that will address the impact of taxable gifts that use BEA during lifetime but are pulled back into the gross estate at death. (Indeed, the final regulations adopt nearly all of the recommendations of the New York State Bar Association Tax Section's report, including to reserve for what Treasury calls "anti-abuse rules".[4]) It is likely that anti-abuse rules will also target gifts whose value is artificially inflated by section 2701 of the Code, even if those gifts are not pulled back into the gross estate. Given the pending anti-abuse rules, practitioners should advise against making artificially increased gifts for the purpose of locking in the bonus exclusion amount.

There is no indication, however, that the forthcoming anti-abuse rules will target taxable gifts that merely use up DSUE. Indeed, as explained in detail by Bramwell and Socash in a 2015 Real Property, Trust and Estate Law Journal article, portability regulations confirm that gifts that exploit chapter 14 valuation rules or are pulled back into the gross estate can successfully prevent a clawback tax on gifts that use up DSUE, even if the donor remarries and survives a successor spouse.[5] Gifts that might be considered abusive in locking in BEA, in other words, are not considered to be an abuse when locking in DSUE. Thus, taxpayers who have DSUE should consider making painless taxable gifts, such as through grantor retained income trusts (GRITs) or gifts-by-promise, in order to use up the DSUE. Although there are no guarantees, it seems that DSUE can be used up in this manner, even if the bonus exclusion can only be used up by gifts that escape gross estate inclusion and do not exploit the valuation rules of chapter 14 of the Code.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Austin Bramwell

Katie Lynagh

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LISI Estate Planning Newsletter #2771 (December 19, 2019) at http://www.leimbergservices.com

CITES:

IRC §§ 2001, 2505, 2701

CITATIONS:

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[1] See Bramwell and Lynagh, "The Paradoxical New Gift Splitting Calculus," LISI Estate Planning Newsletter #2713 (April 1, 2019) at http://www.LeimbergServices.com.

[2] Technically, this amount is computed as follows: $5,040,000 x $6,800,000 million / $12,600,000 = $2,720,000. The $5,040,000 multiplicand is the amount of credit used by the gift under section 2505 of the Code. Given that the $1 million gift in year 1 used up credit computed at the lower marginal rates, the entire credit used by the $12.6 million gift in year 2 is computed at the highest marginal rate of 40%.

[3] For a comparison of the advantages of portability versus fractional credit shelter trust planning, and the reasons that many of the supposed downsides of portability can be overcome, see Bramwell, "The Death of the Credit Shelter Trust," January 16, 2013 (lecture outline available on request from author). See also Blattmachr, Bramwell, and Zeydel, "Portability or No: The Death of the Credit-Shelter Trust?," Journal of Taxation, Volume 118, Number 05 (May 2013).

[4] See New York State Bar Association Tax Section Report on the Proposed Section 2010 Regulations, February 20, 2019, available at https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1410_Report.html.

[5] For a comprehensive discussion, see Bramwell and Socash, "Preserving Inherited Exclusion Amounts: The New Planning Frontier," Real Property, Trust and Estate Law Journal, Volume 50, No. 1 (Spring 2015).