March 21, 2012

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform and simplification with respect to federal estate, gift and GST taxes. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and Section of Real Property, Trust and Estate Law and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

We would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

William M. Paul  
Chair, Section of Taxation

Andrew F. Palmieri  
Chair, Section of Real Property, Trust and Estate Law

Charles H. Egerton  
Last Retiring Chair, Section of Taxation
Enclosure

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee
    Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee
    Mr. Jon Traub, Majority Staff Director, House Ways and Means Committee
    Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee
    Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation
    Honorable Emily S. McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury
These options for tax reform ("Options") are submitted jointly on behalf of the American Bar Association Sections of Taxation and Real Property, Trusts & Estates Law and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Sections of Taxation and (in the case of this submission) the Section of Real Property, Trusts & Estates Law, the objectives of which are to improve the tax laws and to make them simpler to understand and to administer.

Principal responsibility for preparing these Options was exercised by Paul E. Van Horn, Chair of the Estate & Gift Taxes Committee of the Section of Taxation. Substantive contributions were made by Dennis I. Belcher, John F. Bergner, Douglas M. Cain, W. Birch Douglass, Derek L. Fletcher, Martin Hall, T. Randolph Harris, Brant J. Hellwig, John B. Huffaker, Laura S. Hundley, Sarah M. Johnson, George D. Karibjianian, Lawrence P. Katzenstein, James L. Kronenberg, Louis A. Mezzullo, Barbara A. Sloan and Derry W. Swanger of the Tax Section, and Stephen R. Akers, Carol A. Cantrell, Richard S. Franklin, Steven B. Gorin, Amy E. Heller, Julie K. Kwon, Lester B. Law and Tina Portuondo of the Real Property, Trusts & Estates Law Section. The Options were further reviewed by David Pratt of the Taxation Section’s Committee on Government Submissions, by Edward F. Koren of the Real Property, Trusts & Estates Law Section’s Committee on Government Submissions, and by Mary Ann Mancini, Council Director, for the Estate & Gift Taxes Committee.

Although the members of the Sections of Taxation and Real Property, Trusts & Estates Law who participated in preparing these Options have clients who might be affected by the federal tax principles addressed by these Options, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

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Date: March 21, 2012
EXECUTIVE SUMMARY

These Options are broken down into the following ten parts:

**Part I: Need for Predictability and Stability in Federal Transfer Tax System.** The Options begin in Part I with the keenly felt need for predictability and stability in the federal transfer tax system. When the transfer tax laws are unstable and unpredictable, as they have been for the past decade, responsibly planning one’s affairs is a project fraught with frustration. Taxpayer resources are spent needlessly on plans that must be constantly updated or sophisticated enough to adapt to changes in the law. A constantly changing law suggests the absence of a consistent policy and leads to arbitrary results. As an option for achieving tax reform, Congress could eliminate this uncertainty by adopting a long-term, policy-based legislative approach to the taxation of lifetime and testamentary transfers devoid of sunsets, phase-ins or changes in the transfer tax system predicated on the mere passage of time.

**Part II: Unification of the Federal Estate and Gift Tax Exclusion Amounts.** Part II of these Options applauds the reunification of the applicable credits for the federal gift and estate tax and offers as an option for achieving tax reform that the unification be maintained in future legislation.

**Part III: Portability of the Exemptions.** A welcome reform introduced by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“TRA 2010”) was allowing a deceased spouse’s unused estate tax exclusion to pass to his or her surviving spouse – commonly referred to as “portability.” While the reform was welcome because it allows a married taxpayer without a well-designed estate plan to avoid wasting his or her estate tax exclusion, effective implementation of the concept requires navigating many difficult issues. We outline nine such issues that either need to be addressed or warrant consideration: (1) expanding the concept of portability to allow a deceased spouse’s unused GST exemption to pass to his or her spouse; (2) indexing the “Deceased Spousal Unused Exclusion Amount” (“DSUEA”) for cost of living adjustments; (3) adopting an approach to the determination of the amount of the DSUEA that would not penalize a surviving spouse from remarrying a spouse with a lower DSUEA, but also would not provide a tax incentive to remarry – referred to herein as a “Combined” approach; (4) providing certainty with respect to the potential for estate and gift tax “recapture” where an individual makes lifetime gifts in reliance on his or her DSUEA; (5) resolving the discrepancy between the statute and Example 3 of the Joint Committee Report; (6) exploring alternative options to the requirement that an affirmative election for portability be made by the filing of a federal estate tax return; (7) providing certainty with respect to whether taxable gifts use a taxpayer’s inherited DSUEA prior to using his or her individual exclusion amount; (8) resolving a technical issue that could arise when a taxpayer makes gifts in excess of the gift tax exclusion amount; and (9) making portability permanent in spite of the “sunset” of TRA 2010.

**Part IV: Section 6166.** Section 6166 permits an estate owning a significant interest in a closely held business to defer the payment of the federal estate tax attributable to that interest for up to five years, followed by payment of the applicable estate tax in equal installments over the next ten years. Originally enacted in 1958, section 6166 contemplates that entities are organized
as corporations or partnerships. Given the proliferation of new business entities, Congress might consider modifying the statute to reflect a more modernized view of business planning and to apply consistent qualification criteria regardless of the legal form or tax treatment of the business entity. In addition, we offer for your consideration amendments to the statute to permit an election on a late or supplemental return and to enable an executor to provide alternative means to the special lien and bond requirements for assuring payment of the tax.

**Part V: Valuation of Interests in Closely Held Entities.** Wide acceptance of valuation discounts in the context of a closely held business has motivated taxpayers to create and fund entities with business-like structures in order to reduce the value of the property for transfer tax purposes. Where a closely held entity is created for no meaningful nontax purpose, but rather to reduce the transfer tax value of property to be transferred to family members, and where the family members who receive the interests will not actually suffer the practical detriment associated with ownership of non-controlling interests in a closely held entity, application of valuation discounts to determine the value of the transferred interest is inappropriate. Devising a practical and fair solution, however, is not a simple task. Valuation discounts are not abusive *per se*; they estimate real decreases in value that an owner would actually realize if attempting to sell a non-controlling interest in a closely held entity to a third party. We believe it is useful to distinguish between closely held entities that are active businesses and those that are not. We offer the following options for consideration, limited to interests in closely held entities that are not active businesses and to the non-business assets of active businesses: (1) denying the application of valuation discounts where a transferred interest is part of a controlling interest; (2) “aggregating” an interest in a closely held entity with the interests certain other persons hold and then valuing such interest for transfer tax purposes as equal to that interest’s *pro rata* share of the aggregated interests; (3) modifying §2704 to provide that the tax law will disregard restrictions on liquidation or withdrawal, whether imposed by state law or by partnership or limited liability company agreements, unless the restrictions are comparable to those agreed to by persons dealing at arms’ length; and (4) adopting more stringent and uniform standards for appraisals used to justify discounts.

**Part VI: “Clawback” or “Recapture” of Transfer Tax on Gifts Protected by Gift Tax Unified Credit.** Since the enactment of TRA 2010, which provides a $5 million exclusion for federal gift and estate purposes that will decrease to $1 million after December 31, 2012, there has been considerable concern that unless the law is amended or clarified, the reduction of the estate tax exclusion amount to $1 million could, in some cases, effect a post-2012 recapture of the transfer tax on taxable gifts made pre-2013 when they were protected from tax by the higher exclusion amount. We offer as an option for your consideration that Congress amend §2001 to clarify that adjusted taxable gifts are not subject to estate tax in the decedent’s estate if the applicable exclusion amount at the date of the decedent’s death is lower than the applicable exclusion amount at the date the gifts were made.

**Part VII: Annual Exclusion.** The present interest requirement for annual exclusion gifts, particularly for gifts made in trust, creates complexity and uncertainty. We offer several alternatives that Congress may consider to cure the complexity and uncertainty. The first group of alternatives presents possible revisions to the present interest requirement. The second alternative raises the possibility of eliminating the present interest requirement altogether. The
third alternative considers setting dollar limitations on the annual exclusion. The fourth and fifth alternatives provide options for an expansion of the exclusion for educational and medical expenses.

Part VIII: Generation-Skipping Transfer Tax Provisions. Part VIII of the Options addresses several diverse aspects of the federal generation-skipping transfer (“GST”) tax. First, because taxpayers must engage in sophisticated planning techniques to prevent beneficiaries from having to pay more tax under the GST tax than they would if the interests they received were subject to estate tax, we offer the option for your consideration that Congress give taxpayers the right to elect to be subject to either the GST tax or the estate tax if the GST tax would otherwise apply as a result of a taxable termination. Second, we identify and offer options for resolution in several areas where the GST tax and the estate and gift taxes are either inconsistent or could be better coordinated. Third, we present as an option that Congress consider amending §2651(d) to change the rules regarding the generation assignment of non-relatives. Fourth, we offer as an option for your consideration that Congress clarify the effect and validity after 2012 of GST planning implemented between 2001 and 2013. Finally, we ask that Congress consider retaining the many welcome changes to the procedures for allocating and administering the GST exemption that will otherwise “sunset” at the end of 2013, specifically the provisions regarding (i) deemed allocations of GST exemption, (ii) elections in and out of automatic allocations, (iii) retroactive allocation of GST exemption in the case of a death of a non-skip person, and (iv) “9100 relief.”

Part IX: Inter Vivos QTIP Elections. A marital deduction is allowed for transfers to “qualified terminable interest property” trusts (known as “QTIP trusts”) for both estate and gift tax returns, provided that an election is made on a timely filed return. In the estate tax context, the prescription that the election be made on a timely filed return is contained in the Regulations while in the gift tax context it is in the statute. As a result of this difference, the Service has taken the position that, while it has discretion under the Regulations to grant relief to taxpayers who make late elections for estate tax purposes, it does not have such discretion with respect to taxpayers who make late elections for gift tax purposes. To correct that inconsistency, we offer two alternative options for modifying the gift tax statute.

Part X: Marital Deduction and Charitable Giving. The applicable statutes provide a marital deduction for a spouse’s interest in a qualified charitable remainder trust only if, after the transfer, the donee spouse is the only non-charitable beneficiary other than the donor. This proviso amounts to a trap for the unwary and appears to lack any discernible policy rationale. We ask that Congress consider the option of amending §§2056(b)(8)(A) and 2523(g)(3) to resolve this issue. In addition, Congress might also consider amending §2056(b)(8)(A) to provide that the marital deduction rules for gifts of remainder interests in a personal residence or farm parallel the rules applicable to spousal interests in a qualified charitable remainder trust which provide an automatic marital deduction for the spouse’s survivorship interest.

I. Need for Predictability and Stability in the Federal Transfer Tax System

Present Law: Since 2001, taxpayers have experienced a significant level of instability and uncertainty in connection with the federal transfer tax system. For example, during that ten-year period, taxpayers have witnessed six different estate tax exemptions; the decoupling and
reunification of the estate and gift tax exemptions; nine estate and gift tax rate adjustments; repeal and re-enactment of the federal estate and generation-skipping transfer taxes, to name just a few.

While the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“TRA 2010”) added some clarity (particularly with respect to 2010 estates and transfers), it also created additional uncertainty and instability. Of particular concern is the fact that the changes adopted by TRA 2010, as well as those adopted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“JGTRRA”), are scheduled to “sunset” at the end of 2012.

We acknowledge that Congress does and should have the ability to modify the transfer tax system whenever it deems such modifications to be necessary or appropriate. We believe, however, that it is essential for that system to incorporate a long-term, policy-based approach to the taxation of lifetime and testamentary transfers.

**Reasons for Change:** Below are some of the complexities and inefficiencies that result from the current instability of the federal transfer tax system.

A. **Long-Term Nature of Estate Planning.** Estate planning is a long-term proposition involving the integration of a taxpayer’s personal objectives concerning the disposition of wealth with the tax implications associated with such disposition. Recurring changes in the tax laws require taxpayers to either (i) make frequent changes to their estate plans or (ii) effectively construct multiple estate plans providing alternate dispositive patterns depending on the date of death and applicable law at that time. Both solutions are unsatisfactory and increase the cost and complexity of estate planning. For taxpayers who become incapacitated during this uncertainty period and, therefore, are precluded from making changes in their estate plans, the problems, complexities and costs are even greater.

B. **Formula Clauses.** In an effort to deal with a frequently changing and unstable tax system, taxpayers are compelled to incorporate complex formulas into their estate plans. These formulas create mystery and complexity, increase the costs associated with estate planning, foster ambiguities and potential for mistakes and overall serve as a source of great frustration for taxpayers who desire a relative degree of certainty regarding their potential estate tax liabilities.

C. **Allocation Among Beneficiaries.** Changes in the transfer tax system can have a dramatic impact on the allocation of a taxpayer’s assets. For example, it can impact the allocation between (i) a surviving spouse and descendants; (ii) children and grandchildren; (iii) branches of a family; and (iv) charitable and non-charitable beneficiaries.

D. **Utilization of Trusts.** The transfer tax system has historically encouraged the utilization of “credit shelter trusts” to preserve the benefits of a deceased spouse’s applicable exclusion amount. TRA 2010 introduced the concept of portability which enables (under certain circumstances) a surviving spouse to utilize the unused exemption of the first spouse to die. Portability of a deceased spouse’s exemption amount can greatly reduce the complexity of a couple’s estate plan. Because portability will sunset at the end of 2012, however, it has no planning benefit for anyone save the terminally ill.
E. Liquidity Planning. Life insurance is often utilized to provide liquidity for the payment of a decedent’s estate tax liability. The decision as to whether to invest in a life insurance policy and the economics of such a decision can be substantially impacted by changes in the transfer tax system.

F. Business Succession. Liquidity pressures are particularly acute when an estate consists of closely held business interests. In an effort to alleviate such pressures, closely held business owners might consider gifting a portion of their ownership interests during their lifetime. Alternatively, the business owner might contemplate a lifetime sale of the business in order to maximize the value to the family. These decisions become particularly more complex and difficult for the business owner to make in an unstable tax environment.

G. Lifetime Transfers. Taxpayers often employ a lifetime gifting strategy as a method for transferring property to family members in a tax-efficient manner. The advisability of any such transfer (as well as the tax implications), however, becomes less clear in an unstable tax system. For clients who desire to take advantage of the reunification of the gift and estate tax exemptions, the implications are made even more complex by the potential of “clawback” or “recapture” of the transfer tax (an issue separately addressed in section VI of these Options).

Options for Consideration: We request that Congress eliminate the uncertainty created by an unstable and unpredictable transfer tax system. Specifically, we offer as an option to achieve tax reform that Congress adopt a long-term, policy-based legislative approach to the taxation of lifetime and testamentary transfers devoid of sunsets, phase-ins or changes in the transfer tax system (save inflation adjustments) predicated on the mere passage of time.

II. Unification of the Federal Estate and Gift Tax Exclusion Amounts.

From the standpoint of neutrality and efficiency, with respect to the applicable exclusion amount, it is preferable for the federal transfer tax regime to operate in a uniform manner to gratuitous transfers made during life and by reason of death absent overriding policy considerations. Indeed, until EGTRRA, the federal estate and gift tax exclusions had been unified for almost twenty-five years. EGTRRA prescribed staggered increases in the applicable exclusion amount for estate tax purposes, which reached $3.5 million in 2009. Although the legislation provided for an initial increase in the applicable exclusion amount under the gift tax to $1 million, the gift tax exclusion remained capped at this amount. Accordingly, the “unified credit” for gift and estate tax purposes remained unified only through 2003, after which the levels of the two credits started to diverge. The apparent justification for the disparate credit levels prescribed by EGTRRA was the need for a more circumscribed gift tax to protect the income tax base during a period of estate tax repeal. This justification, however, was never supported beyond mere speculation.

As a result of the discrepancy between the estate tax and gift tax exclusion amounts, individuals who sought to transfer wealth during life were subject to considerably worse tax treatment than those who desired to retain their assets until death. For instance, based on 2009 figures, an individual who made $3.5 million in taxable gifts would have paid $1.1 million in gift tax; those same transfers would have been fully shielded from estate taxation if made at death. No sound reason exists to severely penalize individuals who wish to give away assets during
life. Anecdotal evidence from practice indicates that the considerably less generous credit under the gift tax prevented parents from making lifetime transfers to children as a result of the effective tax penalty on the value of cumulative transfers falling between the two credit levels. Rather than imposing a penalty on gratuitous transfers made during life, we believe that, from the public policy perspectives of encouraging generosity among family members and promoting the free transferability of capital, lifetime transfers are to be encouraged. As a practical matter, lifetime gifts shift property to individuals who are more likely to put the property to productive economic use. The re-unification of the gift and estate tax unified credits achieved by the 2010 legislation therefore represents a salutary return to a significant and important prior policy.

**Options for Consideration:** We offer as an option for tax reform that the reunification of the applicable credits for gift and estate tax be maintained in future legislation.

### III. Portability of the Exemptions

Prior to TRA 2010, it was common for married taxpayers to include special trusts in their testamentary documents and to divide their assets in order to ensure that the estate of the spouse who died first would be able to utilize fully his or her estate tax unified credit. One welcome reform implemented by TRA 2010 was to authorize the executor of a deceased spouse’s estate to “transfer” the deceased spouse’s unused estate tax exclusion amount to the surviving spouse, effectively making the estate tax unified credit “portable” between spouses (referred to as “Portability”). As may be expected with any new law, there are some issues to be addressed to make its operation clearer, simpler and more efficient. We have highlighted certain issues and options we believe Congress may wish to consider with respect to changes to the Portability provisions. The options that we offer for your consideration are intended to present different and perhaps mutually exclusive approaches to changes to the Portability provisions.

**A. Portability for GST Tax Purposes.**

**Present Law:** Portability applies only to the unified credit; it does not apply to the exemption for generation-skipping transfer (“GST”) tax purposes.

**Reasons for Change:** In planning today, quite often an individual’s Applicable Exclusion Amount (for estate and gift tax purposes) is used in tandem with the individual’s GST exemption. By not applying the portability concept to a decedent’s unused GST exemption, current GST tax law does not conform to the estate and gift tax laws, and causes confusion and complexity. Thus, a logical expansion of Portability would be to allow Portability of an individual’s unused GST exemption.

**Options for Consideration:** Congress could allow the unused GST exemption of the first spouse to die to be available as an additional GST exemption amount to the surviving spouse. If Portability is expanded for GST tax purposes, careful thought should be given to its implementation. Issues to consider include, but are not limited to, the computation of the portable GST exemption (the “Portable Exemption”), the relationship that must exist between the Portable Exemption and the automatic GST exemption allocation rules, whether hierarchal provisions must be implemented when a surviving spouse utilizes any GST exemption, and how

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1 See also, infra, paragraph B.5 of section VIII of these options.
the Portable Exemption is to be enacted (i.e., elective on a estate tax return or applied automatically).

B. **Indexing for Cost of Living Adjustments ("COLA").**

*Present Law:* Under the Code, many threshold amounts, such as the gift tax annual exclusion, are indexed with COLA adjustments. The Basic Exclusion Amount, defined in §2010(c)(3)\(^2\) has a COLA clause built into the new provision. In contrast, the Deceased Spousal Unused Exclusion Amount ("DSUEA"), defined under §2010(c)(4), does not have such an adjustment.

*Reasons for Change:* A COLA provision for the DSUEA would mitigate any loss of benefit due to inflation, be consistent with the adjustment to the Basic Exclusion Amount, and remove one of the remaining reasons for taxpayers to engage in credit shelter trust planning.

*Options for Consideration:* To implement such a change, Congress could simply modify §2010(c)(3)(B), by inserting the words “and any dollar amount determined under paragraph (4)(B)” immediately between the words “subparagraph (A)” and “shall.” If Congress implements a COLA clause to adjust the DSUEA, it may also consider a mechanism to account for the use of DSUEA so that only the unused portion of the DSUEA is adjusted.

C. **Adopting a “Combined” Approach on a Second Deceased Spouse’s Death.**

*Present Law:* As part of the definition of DSUEA, §2010(c)(4)(B)(i) utilizes “the Basic Exclusion Amount of the last such deceased spouse of the surviving spouse.” We refer to this as the “Last Deceased Spouse Approach.”

*Reasons for Change:* By adopting the Last Deceased Spouse Approach, the surviving spouse can possibly lose DSUEA if the surviving spouse remarries and the new spouse dies.

*Portability Example 1:*

Facts: H1 and W are married. H1 dies and leaves $3 million of DSUEA to W. W then marries H2. H2 predeceases W. H2’s DSUEA is $1 million.

Result: As a result of H2’s death, the $3 million of DSUEA that W received from H1 disappears, and, in its place, W has $1 million of DSUEA received from H2 because, pursuant to §2010(c)(4)(B)(i), H2 is the “last such deceased spouse of the surviving spouse.”

It may be argued that the Last Deceased Spouse Approach effectively penalizes the surviving spouse (W, in Portability Example 1) as a result of remarriage and the early death of the new spouse (H2, in Portability Example 1). Taken to extreme, this aspect of the current law could arguably discourage marriage in certain circumstances.

\(^2\) Unless otherwise indicated, all section references herein refer to the Internal Revenue Code of 1986, as amended.
Prior Portability proposals in both the House of Representatives\textsuperscript{3} and the Senate\textsuperscript{4} did not utilize the Last Deceased Spouse Approach in the DSUEA determination. Rather, all such proposals would have utilized the sum of the DSUEA’s from each predeceased spouse of the surviving spouse (referred to herein as the “Combined Deceased Spouse Approach”).

We acknowledge and understand the criticism of the Combined Deceased Spouse Approach in that it may be argued that the Combined Deceased Spouse Approach could cause an individual to marry multiple spouses for their DSUEA (\textit{i.e.}, the so-called “black widow” circumstance). To mitigate the perceived ill-effects of this “black-widow” behavior, all prior proposals (as well as current law) also limited or capped the amount of an individual’s DSUEA to the lesser of: (i) the DSUEA from all prior spouses, or (ii) the then Basic Exclusion Amount (referred to herein as the “DSUEA Cap”). If the Combined Deceased Spouse Approach is adopted, it could have the same cap as exists under current law (\textit{i.e.}, $5 million).

\textit{Options for Consideration:}

1. **Combined Deceased Approach.** Congress could choose to adopt the Combined Deceased Spouse Approach and maintain the DSUEA Cap (as currently in effect under §2010(c)(4)(A)). In other words, this approach could be adopted by employing the provision that was included in the various bills proposed before TRA 2010 was passed.

2. **Retain the Last Deceased Spouse Approach.** Congress could choose to retain the Last Deceased Spouse Approach. While retaining this approach does not eliminate the perceived inequity described above (\textit{e.g.}, if a surviving spouse with DSUEA from a predeceased spouse remarries and the new spouse dies with a lesser DSUEA), Congress could amend the law to simplify the statute by deleting the "lesser of the Basic Exclusion Amount" limitation, because that limitation is not needed to avoid the "black widow” abuse if only the last deceased spouse’s unused exclusion is included in determining the DSUEA. To effect this change, §2010(c)(4) would be re-drafted as follows:

\begin{quote}
“(4) For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term ‘deceased spousal unused exclusion amount’ means the excess of –

(A) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over

(B) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.”
\end{quote}

\textsuperscript{3} H.R. 5638, 109th Congress 2d Session (July 2006); H.R. 5970, 109th Congress 2d Session (July 2006); H.R. 3170, 110\textsuperscript{th} Congress 1st Session (July 2007); H.R. 6499, 110\textsuperscript{th} Congress 2d Session (July 2008); H.R. 498, 111\textsuperscript{th} Congress 1st Session (January 2009); and H.R. 2320, 111\textsuperscript{th} Congress 1st Session (May 2009).

\textsuperscript{4} S. 722, 111\textsuperscript{th} Congress 1st Session (March 2009); S. 2784, 111\textsuperscript{th} Congress 1st Session (November 2009); and S. 3773, 111\textsuperscript{th} Congress 2d Session (September 2010).
D. “Portability Recapture.”

**Present Law:**

As explained in section VI of these Options, in the estate tax context, “recapture” is a result of the inclusion of “adjusted taxable gifts” in the estate tax computation to arrive at an estate tax imposed at the appropriate marginal rate. This is accomplished by a two-part computation involving a “tentative tax” on the sum of the taxable estate and all “adjusted taxable gifts,” the purpose of which is to prevent a taxpayer from gaining two bracket runs by making both gifts during lifetime and transfers upon death.\(^5\)

The assumption at the core of this analysis is that the estate tax Applicable Exclusion Amount is either (a) the same amount as or (b) exceeds the amount of the gift tax Applicable Exclusion Amount. In a “unified” approach, the gift and estate tax applicable exclusions are technically the same exclusion. Until the passage of TRA 2010, the gift tax Applicable Exclusion Amount at the time of gifting never exceeded the estate tax Applicable Exclusion Amount. Applying those assumptions, the “tentative tax” worked to assess estate taxes at the marginal, combined rate, but would never effectively impose transfer taxes for prior gifts in excess of any gift taxes paid at the time of the gift. Thus, the inclusion of “adjusted taxable gifts” in the computation did not create an additional transfer tax (or “recapture”), but rather resulted in the appropriate tax rate being applied to the taxable estate.

The effect of the temporal nature of TRA 2010 and the possible reversion to pre-EGTRRA rules in 2013 create a scenario whereby it is entirely possible that the gift tax Applicable Exclusion Amount could possibly exceed the estate tax Applicable Exclusion Amount. As a result, recapture is a possibility.\(^6\) The new Portability provisions raise additional potential circumstances where an unanticipated “recapture” of tax may occur. The concept of such later taxation has been informally referred to as the estate and gift tax “recapture” or “clawback” and, when the “recapture” is caused by DSUEA, it may be referred to as the “Portability Recapture.” The Last Deceased Spouse Approach of current law and the possibility of a reduced Basic Exclusion Amount, both could lead to a recapture of transfer tax that was likely not anticipated.

**Reasons for Change:** The current Portability provisions may create unanticipated estate and gift tax consequences depending on factors outside the taxpayer’s control.

**Inadvertent Estate Tax - Issue #1:** An individual who makes lifetime gifts to utilize DSUEA may be subject to estate taxes upon death if such individual remarries and

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\(^5\) In its analysis of the purpose for the “tentative tax,” the Tax Court in *Estate of Frederick R. Smith v. Commissioner*, 94 T.C. 872 (1990) noted that “by [the unification of the estate and gift taxes], Congress meant to “reduce the disparity of treatment between lifetime and death-time transfers.” Smith at 876. Judge Wells’ dissent carries this further by stating that “[t]he purpose of adding post-1976 gifts to the taxable estate and then subtracting the gift tax payable on those gifts is to “push the taxable estate up to its ‘proper’ place on the unified cumulative rate schedule.” Smith at 882-3, citing Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶133.3.2 (1972).

\(^6\) See discussion, *supra*, in section VI of these Options.
survives a subsequent spouse who has less DSUEA than the amount so used during such individual’s lifetime.

*Inadvertent Estate Tax - Issue #2:* An individual who makes lifetime gifts to utilize DSUEA may be subject to estate taxes if the maximum Basic Exclusion Amount is reduced after such utilization but before such individual’s death.

*Inadvertent Gift Tax:* An individual who makes a lifetime gift, in an attempt to utilize DSUEA, may owe gift taxes on such gift if his or her current spouse dies after the individual completes the gift but before the end of the calendar year of the gift (referred to herein as the “Calendar Year Spousal Death Effect”).

*Options for Consideration:* The Portability Recapture may be addressed as follows:

**Estate Tax Issue #1:**

*Option #1:* A “greater of” DSUEA approach could be adopted. For example, in Portability Example 1, whereby an individual (W) receives DSUEA (of $3 million) from her deceased spouse (H1), remarries (H2), who then dies and who passes lesser DSUEA (of $1 million), the individual (W) is effectively penalized by remarriage. Further, the potential of this negative tax result could cause W to choose not to remarry. In contrast, if a “greater of” approach is adopted, even if the individual (W) utilizes the entire DSUEA that he or she received from the first spouse (H1), she (W) is not penalized by the death of a subsequent spouse (H2), because she can utilize the greater of the two DSUEA’s (from H1 and H2). This option negates the “Portability Recapture,” because the DSUEA will never be reduced in a subsequent marriage/death scenario.

*Option #2:* The Combined Deceased Spouse Approach detailed in paragraph C of this section above could be adopted. Under this approach, an individual is not penalized with the loss of a predeceased spouse’s DSUEA, because the DSUEA available for the individual’s use is the combined DSUEA’s of all prior deceased spouses, subject to the DSUEA Cap. Thus, applying Portability Example 1, W would have a combined DSUEA of $4 million ($3 million from H1 and $1 million from H2). Further, if in Portability Example 1, H2’s DSUEA is $5 million, W’s DSUEA would not be $8 million (which is the sum of H1’s DSUEA of $3 million and H2’s DSUEA of $5 million); rather, the DSUEA Cap limits W’s DSUEA to the then Basic Exclusion Amount of $5 million.

**Estate Tax Issue #2 - Options for Consideration:** Adopting a “permanent” DSUEA concept could solve the inadvertent estate tax that could arise if the Basic Exclusion Amount is decreased. Once a taxpayer receives DSUEA from a deceased spouse, such DSUEA remains fixed and permanent and is not reduced by a subsequent reduction in the Basic Exclusion Amount. The DSUEA Cap from §2010(c)(4)(A) would be imposed at the maximum Basic Exclusion Amount in effect at any time when the surviving spouse receives any DSUEA, but the Cap would be applied only as to DSUEA the spouse receives at that time. A surviving spouse can receive additional DSUEA at the death of a subsequent spouse as long as the aggregate DSUEA from all deceased spouses does not exceed the Basic Exclusion Amount at the death of the subsequent spouse.
For example, under Portability Example 1, H1 dies and leaves $3 million of DSUEA to W, at the time that the Basic Exclusion Amount is $5 million. W marries H2, who predeceased W with DSEUA of $5 million at a time the Basic Exclusion Amount is $6 million. The aggregate DSUEA that W can have from all predeceased spouses is $6 million (the Basic Exclusion Amount at H2’s death). Therefore, W can receive an additional $3 million of DSUEA from H2 (i.e., $6 million Cap minus $3 million from H1), bringing her aggregate DSUEA to $6 million. If, instead, H2 dies at a time that the Basic Exclusion Amount was $1 million, W would retain the $3 million of DSUEA from H1, but would not add any additional DSUEA from H2.

**Gift Tax Issue:**

Option #1: If the Last Deceased Spouse Approach continues to apply, with regard to the Spousal Calendar Year Death Effect, Congress may consider determining the Applicable Exclusion Amount as of the time of the gift, not as of the end of the year of the gift. This avoids inadvertently penalizing the donor if a subsequent spouse dies after the donor makes a gift but prior to the end of the calendar year of the gift.

Option #2: If the Combined Deceased Spouse Approach is adopted, the Spousal Calendar Year Death Effect is eliminated because the DSUEA inherited from the prior spouse will always be available.

E. Contradiction Between Statute and Joint Committee Reports – The Issue of “Privity.”

Present Law: Statutorily, a surviving spouse cannot use a predeceased spouse’s DSUEA that the predeceased spouse received from his or her prior spouse. Pursuant to §2010(c)(4), a “deceased spousal unused exclusion amount” is defined as the lesser of the deceased spouse’s Basic Exclusion Amount or the excess of the Basic Exclusion Amount of the last such deceased spouse of such surviving spouse, over the amount with respect to which the tentative tax is determined on the estate of such deceased spouse.

Upon the issuance of the Joint Committee’s Report on TRA 2010, a discrepancy occurred with respect to a specific Portability example, namely, Example 3 (“JCT Example 3”). The solution to JCT Example 3 appeared to be inconsistent with the plain language of §2010(c)(4) by allowing the deceased spouse’s Applicable (and not Basic) Exclusion Amount to enter into the DSUEA calculation.7

The Joint Committee has acknowledged this discrepancy in its Errata release on March 23, 2011 (the “Errata”), indicating that the Congressional intent may have been for the approach used by the Joint Committee.8

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7 Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in The 111th Congress*, JCS-2-11, 555 (March 16, 2011); see also Joint Committee Staff, *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, 52 (December 10, 2010).

Reasons for Change: The Errata is evidence that the provision may require legislative change. We believe that the extent of the necessary change requires consideration of the concept of “privity” and how it pertains to Portability.

As stated above, all prior legislative proposals introducing Portability advocated the Combined Deceased Spouse Approach. The final proposal, which became TRA 2010, included the concept of the Last Deceased Spouse Approach. Arguably, both approaches espouse the importance of “privity.” In other words, the person who is using the DSUEA of a predeceased spouse (whether all prior spouses or the last deceased spouse) is required to have “privity” to such deceased spouse in order to utilize such deceased spouse’s DSUEA. “Privity,” in this context, may be defined as a relationship between two individuals that entitles them to share tax benefits (for example, utilization of the unlimited gift and estate tax marital deduction).

For example, using Portability Example 1, H1 and W have privity, H2 and W have privity, but H1 and H2 do not have privity. Consequently, if H2 survives W, under the current statute it does not appear that H2 should be able to use any of H1’s DSUEA that passed to W.

Ultimately, whether changes to §2010(c)(4)(B)(ii) are warranted depends on how strictly Congress chooses to adhere to the privity concept. To date, there have been three (3) different concepts of DSUEA determination as they relate to privity:

Immediate Privity: Immediate Privity is adopted in the current law. We refer to it above as the “Last Deceased Spouse Approach,” where the DSUEA is determined by the most recently deceased spouse. For example, under Portability Example 1, upon W’s death, she can use only H2’s DSUEA (limited by the DSUEA Cap).

Hybrid Privity: Hybrid Privity was utilized in the prior legislative proposals referred to above where the surviving spouse may utilize the DSUEA from all prior deceased spouses, but capped at the Basic Exclusion Amount. We refer to this above as the Combined Deceased Spouse Approach. For example, under Portability Example 1, upon W’s death, she would be able to use both H1 and H2’s DSUEA (limited by the DSUEA Cap).

No Privity: No Privity appears to be implicit in the Joint Committee’s Errata statement. In JCT Example 3, when it is suggested that §2010(c)(4)(B) should have been drafted so that W’s “Applicable Exclusion Amount” and not W’s “Basic Exclusion Amount” is utilized, the actual effect is allowing H2 to use H1’s DSUEA. Recall in JCT Example 3 that the order of deaths is H1, W, and H2, respectively. Thus, since H1 and H2 have no relationship (other than that they were married at separate times to W), the Joint Committee’s suggestion allows for the use of one’s DSUEA without having privity. For example, under Portability Example 1, if the order of deaths is changed so that H1 dies first, followed by W, W’s DSUEA passing to H2 includes both W’s and H1’s DSUEA.
**Options for Consideration:** Based on the above analysis, one of three approaches could be adopted to implement Congressional intent regarding the privity issue.

**Alternative #1 – Immediate Privity:** If Immediate Privity (or the Last Deceased Spouse Approach) is adopted, no change to §2010(c)(4)(B)(ii) is necessary. Under Immediate Privity, the DSUEA will always be less than or equal to the DSUEA received under the any other approach. Although Immediate Privity appears to be the least favorable for the taxpayer as compared to the other approaches (and appears to contradict the Joint Committee’s intent), it has the advantage of simplifying the record keeping and conceptual determination of the DSUEA because only the last deceased spouse’s unused Basic Exclusion Amount is taken into consideration (although, as discussed in paragraph G of this section, this approach raises “hierarchy of use” issues). If Immediate Privity is retained, the Joint Committee should consider the option of amending JCT Example 3 to conform to the statutory language.

**Alternative #2 – Hybrid Privity:** If Hybrid Privity (or Combined Deceased Spouse Approach) is adopted, it has the potential to provide a greater amount of DSUEA to a surviving spouse (compared to the Immediate Privity approach). Hybrid Privity simply adds the DSUEA from all prior spouses, so it will naturally always be equal to or greater than Immediate Privity. As stated above, while this would appear to be susceptible to a “black widow” concern, a DSUEA Cap would help alleviate this concern.

**Alternative #3 – No Privity:** If the No Privity approach is adopted, either the Last Deceased Spouse Approach or the Combined Deceased Spouse Approach must also be adopted. In other words, there are two No Privity options.

- **No Privity - Last Deceased Spouse:** The No Privity – Last Deceased Spouse approach is used in JCT Example 3. In such example, H2, was able to use both W’s and H1’s DSUEA (limited to the DSUEA Cap.)

- **No Privity – Combined Deceased Spouses:** The No Privity – Combined Deceased Spouse would be a twist on JCT Example 3. In this instance, the aggregate DSUEAs from all deceased spouses would be included as long as the additional DSUEA received from any particular deceased spouse did not cause the aggregate DSUEA to exceed the Basic Exclusion Amount at that time. Under this approach, not only is an individual able to utilize the DSUEA from any predeceased spouse, but such DSUEA also includes the DSUEA from any spouse of a predeceased spouse. While this would appear to be susceptible to a “black widow” concern, a DSUEA cap would help alleviate this concern.

**F. Filing Requirement.**

**Present Law:** Under current law, a surviving spouse receives the DSUEA only if the fiduciaries of his or her last deceased spouse elect Portability on the last deceased spouse’s federal estate tax return (the “Form 706”).

**Reasons for Change:** The requirement of an affirmative election raises a variety of issues with potentially detrimental results:
• Estates that would not otherwise be required to file a Form 706 will now be required to file such a form to transfer the DSUEA to the surviving spouse. In many cases the preparation of a Form 706 merely to elect Portability will be a waste of time, effort and expense. Clearly, if the surviving spouse dies with a taxable estate and adjusted taxable gifts of less than $5 million, the expense of preparing the Form 706 on the first spouse’s death will have been wasted. In addition, if the surviving spouse remarries and the new spouse predeceases such surviving spouse, the preparation of a Form 706 on the first spouse’s death will have been a waste of time, effort and expense. (See Portability Example 1.) It seems likely that in many cases, taxpayers will choose not to bear the cost of preparing an unnecessary return. Some of those taxpayers will be penalized at the surviving spouse’s death with a higher estate tax burden, which could have been avoided. It also seems likely that, to be safe, many taxpayers will choose to prepare returns which will ultimately provide no benefit at all. Not only does such a system complicate the tax system and encourage a waste of taxpayer resources, it will also impose a burden on the Service to administer a system that encourages the filing of unnecessary returns.

• Portability’s temporary status (currently expiring in 2012) prevents taxpayers from relying on it. In addition to heightening the uncertainty of any future benefit from filing a Form 706 to make a Portability election, the temporary status of the law compels taxpayers to engage in the same estate planning (e.g., with credit shelter trusts and a reallocation of assets between spouses) as if Portability had not been enacted. Finally, if Portability is not extended, all of the time and effort expended in preparing Forms 706 for the sole purpose of electing Portability will also have been wasted.

• There is potential for substantial professional liability for the failure to timely file a Form 706, which places a burden on the tax preparer, especially if, based solely on the asset valuations, a Form 706 would not otherwise be due.

• Taxpayers may not be aware that a Form 706 must be filed in order to take advantage of Portability, and therefore may inadvertently fail to make a timely election.

• In second marriage situations, when the “poorer” spouse dies first, the surviving “wealthy” spouse may not know that there is a DSUEA to transfer and, even if he or she does know, absent a nuptial agreement, he or she will not be able to compel the executor of the estate of the first spouse to die to file the return and make the election.

Pursuant to statistics compiled by the Internal Revenue Service (the “Service”), fewer than 39,000 Forms 706 were filed in 2009. It is suggested that with the increase of the Basic Exclusion Amount to $5 million for 2011 and 2012, fewer Forms 706 would be required to be filed for decedents dying in 2011.

With the introduction of Portability and the mandatory election requirement, we believe it is probable that the number of taxpayers who file a Form 706 will increase substantially. We

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acknowledge that without the filing requirement it would be extremely difficult administratively for the Service to verify the exclusion amount used by the decedent and subsequently the amount of DSUEA passing to the surviving spouse. Nevertheless, the filing requirement would appear to place an additional burden on the Service to review and approve a substantial number of additional returns in a timely manner. This is especially difficult in an era of budget cuts and deficits where there is no accompanying revenue increase to pay for the work and costs associated therewith. In addition to the costs and burden to the Service, as outlined above, a major disadvantage to the filing requirement is the cost of compliance for many estates in preparing and filing a Form 706 that would otherwise be unnecessary. The preparation of a Form 706 will substantially increase the costs to an estate that, absent Portability, would not be required to file a Form 706. Unlike the income tax environment, where many taxpayers prepare their own forms (generally with the use of income tax preparation software), in the estate tax environment, tax return preparation is generally the task of professionals. In addition to the cost of preparing the form, the additional costs of appraisals (i.e., for closely-held assets or other “hard to value” assets) also adds to the burden.

**Options for Consideration:** A significant number of taxpayers have a net worth significantly below the current Form 706 filing threshold of $5 million and many married couples are likely to have a combined net worth under $5 million. Requiring these taxpayers to file a Form 706 merely to elect Portability forces them to choose whether to expend significant effort and assets in order to make an election that may well be a waste of effort and assets or potentially suffer the penalty of a lost exclusion amount for the failure to make a timely election. Cognizant of the Service’s desire for contemporaneous valuation information in order to verify the DSUEA, a simple solution to this problem is elusive. We even acknowledge that the possibility that the costs and administrative difficulties with filing requirements and enforceability may prove to outweigh the benefits derived from Portability prompting future consideration that Portability be repealed until a practical system can be implemented. We submit the following options for consideration as possible alternatives to address the issues and note some of the potential imperfections of each option.

1. **Maintain Current Filing Requirement With Automatic Election.** As set forth above under “Reasons for Change,” we believe that the current rule requiring the filing of a Form 706 and an affirmative election will prove problematic for the Service to adequately administer and monitor and it places some estates in the difficult position of having to guess at future circumstances to determine whether the election will be worth the present effort and assets spent to prepare and file an estate tax return that is otherwise not required to be prepared. If Congress chooses to maintain the status quo, Congress might consider amending the law to make the election automatic upon the filing of a federal estate tax return, rather than requiring an affirmative election. There is precedent for such an automatic election, as this has been done under sections 2056(b)(7) and 2652(a)(3) in order to make “QTIP” and “reverse-QTIP” elections, respectively.

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10 If the decedent lived in a state with a state estate tax or owns property in such a state, some or all of the cost may be required in any event to prepare the state estate tax return.
2. **Return Required for Election, But On A Simplified Form.** For those estates not otherwise required to file a Form 706 (i.e., because the value of the gross estate and adjusted taxable gifts is less than the filing threshold), Congress might consider permitting the Portability election to be made on a simplified version of the Form 706 (which we will call “Form 706EZ”). The clear advantage of a Form 706EZ is that it would reduce the effort and expense that would be required for the preparation and filing of a Form 706. Devising such a Form 706EZ that will ensure a certain minimum of valuation information is reported and supported while also significantly reducing the costs to a taxpayer who otherwise would not be required to file a Form 706 may prove difficult. If the minimum information required on the simplified form is substantially the same as the information required on the Form 706, the purpose (and advantage) of a simplified form would be defeated.

3. **Reduce the Filing Threshold for the Form 706 If Portability Is Desired.** Instead of mandating that all taxpayers must file a Form 706 to elect Portability, Congress could consider imposing a lower filing threshold for estates electing Portability. For example, if the value of the gross estate and adjusted taxable gifts is less than the $5 million filing threshold, but more than $3.5 million, the estate could be required to file a Form 706 if a Portability election is desired. If the gross estate and adjusted taxable gifts is more than $3.5 million and no Form 706 is filed, the DSUEA would be presumed to be zero. For those estates that do not meet the filing threshold, the Portability election could be automatic but the DSUEA at the first spouse’s death (if eventually needed) would obviously have to be proved by the taxpayer at the surviving spouse's death. This would reduce the number of returns received by the Service and thus reduce its administrative burden. It also would appear likely that those taxpayers who may benefit from a Portability election would fall within the class of individuals required to file a Form 706. For those estates under the $3.5 million with a surviving spouse who later dies with a need for his or her predeceased spouse’s DSUEA, the problems of proving the value of the first spouse’s taxable estate will need to be addressed and may prove insurmountable.

4. **Eliminate the Filing Requirement and Make Portability Automatic.** Clearly, making Portability automatic would dramatically increase the advantage of the provision to taxpayers and eliminate the burdens of preparing and filing a Form 706 when the filing is not otherwise necessary. It also would reduce the administrative burden on the Service that we foresee if the filing requirement were maintained. A major problem with the automatic application of Portability is that the determination of the predeceased spouse’s DSUEA may not occur until the death of the surviving spouse, which could be decades later. At that time, the information necessary to properly appraise the fair market value of the predeceased spouse’s taxable estate and DSUEA may be lost. A possible approach to address this problem would be to require adjusted standards for proof of valuation, possibly including contemporaneous appraisals for certain types of hard-to-value assets owned by the predeceased spouse.

G. **Hierarchy of Use.**

**Present Law:** Current law does not provide for a mandatory hierarchy with respect to the surviving spouse’s use of his or her Applicable Exclusion Amount when the surviving spouse makes gifts.
Reasons for Change: While JCT Example 3 suggests that the DSUEA is used first, this is not statutorily mandated. Especially because current law adopts the Last Deceased Spouse Approach, the determination of which exclusion is used first has repercussions if a taxpayer with DSUEA makes taxable gifts during his or her lifetime, then dies survived by another spouse, and his or her fiduciaries wish to elect Portability.

If the donor’s Basic Exclusion Amount is used first, this reduces the amount of DSUEA available for the surviving spouse. If the donor’s inherited DSUEA is used first, this preserves the Basic Exclusion Amount available for the passage of the donor’s own DSUEA to the surviving spouse.

Options for Consideration: Congress might consider adopting a formal hierarchy for the use of a taxpayer’s Applicable Exclusion Amount either by providing that the DSUEA be utilized first when the surviving spouse makes gifts, which appears to be consistent with JCT Example 3, or by providing that the Basic Exclusion Amount be used first. Regardless of which method Congress favors, the law should be amended to provide clarity.

We note that the hierarchy is relevant only as to Immediate Privity (or the Last Deceased Spouse Approach under current law). If either a Hybrid Approach (Combined Approach) or a No Privity approach is adopted, the hierarchy of use issue is not present.


Present Law: Under present law, determining a deceased individual’s DSUEA under §2010(c)(4) appears to be straightforward: deduct from the decedent’s Basic Exclusion Amount (at the time of his or her death) an amount with respect to which the “tentative tax” is determined under §2001(b)(1) of that decedent’s estate. Under §2001(b)(1), the amount with respect to which the “tentative tax” is determined is the sum of the decedent’s taxable estate and adjusted taxable gifts.

Reasons for Change: An issue arises when a taxpayer (1) makes a taxable gift that exceeds the then Applicable Exclusion Amount, (2) pays gift taxes on such excess amount, and (3) dies when the gift tax exclusion amount has increased since the time of the original gift. This is best illustrated in the following example:

Portability Example 2: In 2010, when the gift tax Applicable Exclusion Amount was $1 million, H1, never having made any prior taxable gifts, makes a taxable gift of $2.75 million and pays the gift taxes due. In 2011, H1 dies survived by his wife, W. H1 has a gross estate of $3.25 million, which he leaves in trust to W, leaving him with a taxable estate of $0.

At the time of H1’s death, H1’s apparent unused exclusion amount is $4 million, determined by H1’s Basic Exclusion Amount in 2011 of $5 million, reduced by the $1 million Applicable Exclusion Amount (as defined in 2010) utilized by the 2010 taxable gift of $2.75 million.
Applying a strict reading of §2010(c)(4), H1’s DSUEA available for passage to W is not $4 million. Rather, H1’s “amount with respect to which the tentative tax is determined under §2001(b)(1)” (the “Tentative Tax Amount”) is $2.75 million \( (i.e., \) the taxable estate of $0 and the amount of the “adjusted taxable gifts” of $2.75 million).

Applying the formula in §2010(c)(4), H1’s DSUEA is $2.25 million, determined by H1’s Basic Exclusion Amount of $5 million less the Tentative Tax Amount of $2.75 million.

Technically, the DSUEA should be $4 million, but, pursuant to a “glitch” in §2010(c)(4), the Tentative Tax Amount does not take into account that gift taxes were paid on prior gifts in excess of the then applicable exclusion amount.

The glitch first appeared in the determination of the estate and gift taxes with the increase of the applicable exclusion amount under EGTRRA, when taxpayers who paid gift taxes on pre-EGTRRA gifts were subject to a reduction of additional gift tax exclusion amount granted under EGTRRA.

As part of TRA 2010, Congress recognized this anomaly and modified the law \( (e.g., \) §2001(g) and §2505) to correct the glitch in the context of determining the estate and gift taxes. The glitch remains for Portability purposes, however, in the computation of the DSUEA.

**Options for Consideration:** This glitch can be easily fixed by inserting at the end §2010(c)(4)(B)(ii) (before the period): “, except that the amount of adjusted taxable gifts on which a federal gift tax was payable shall not be included.”

This correction limits the amount factored into the “tentative tax” to only those gifts within the applicable exclusion amount. Thus, the calculation effectively affords a credit for gift taxes paid.

**I. Permanency.**

**Present Law:** Under TRA 2010, Portability is scheduled to sunset as of January 1, 2013.

**Reasons for Change:** The impermanence of Portability requires taxpayers to engage in estate planning as if Portability had not been enacted.

**Options for Consideration:** As a tax reform option to both clarify the law and achieve an equitable resolution of these issues, regardless of the potential sunset of other changes in the federal estate, gift and GST tax laws under EGTRRA and TRA 2010, Portability could be made permanent.

**IV. Section 6166.**

Section 6166 permits an estate owning a significant interest in a closely held business to defer the payment of the federal estate tax attributable to that interest for up to five years, followed by payment of the applicable estate tax in equal installments over the next ten years.
The purpose of §6166 is to avoid an impairment and possible forced sale of the family business that might otherwise occur if the federal estate tax were required to be paid within nine months from the date of the decedent’s death. Since its enactment in 1958, §6166 has been subject to a number of intermittent efforts to correct its limitations and to broaden its availability. Despite these efforts, the statute is in need of restructuring, simplification and modernization. The remainder of this section focuses on suggested reforms for three aspects of §6166.\textsuperscript{11}

A. Modernization and Consistency.

\textit{Present Law:} When §6166 was originally enacted, most closely held businesses were organized as either corporations or as partnerships. Accordingly, the qualification rules of §6166 were designed with these specific legal structures in mind. Since the enactment of the installment payment provisions, however, modern business structures such as limited liability companies and limited liability partnerships have become commonplace and, often, the preferred legal form for closely held operations.

\textit{Reasons for Change:} Despite the proliferation of these new business entities, §6166 continues to distinguish between businesses operated as corporations and businesses operated as partnerships. Unfortunately, the mere legal form of the business entity can dramatically affect whether an estate qualifies for §6166 relief.

\textit{Options for Consideration:} Congress might consider modifying the statute to reflect a more modernized view of business planning and to apply consistent qualification criteria regardless of the legal form or tax treatment of the business entity. These changes would include (i) a uniform definition of “closely held business” and (ii) a functional standard for aggregating ownership interests in multiple or tiered entities.

B. Election on Supplemental or Late Returns.

\textit{Present Law:} In order to be effective, a §6166 election must be made by the executor on a timely filed estate tax return. Except in the case of certain deficiencies,\textsuperscript{12} the statute does not permit an election to be made on a late or supplemental return.

The valuation of interests in closely held businesses is often a contentious issue during the estate tax audit, because application of the willing buyer/willing seller test is subjective in nature. As a result, it is not uncommon for an estate tax audit to result in an adjustment to the value of a closely held business interest. An increase in the value of the business interests could cause the value of those interests to exceed 35% of the adjusted gross estate, thereby satisfying one of the requirements for qualification under §6166. The values originally reported on the estate tax return, however, may have been insufficient to satisfy the 35% threshold, preventing the executor from making a timely election.

\textsuperscript{11} For a detailed discussion of these issues and other aspects of §6166, see Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko and Michael Patiky Miller, \textit{Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Real Property, Probate and Trust Journal}, page 73-121 (Spring 2006).

\textsuperscript{12} See §6166(h).
**Reasons for Change:** Although §6166 permits an executor to file a protective election, the statute does not permit a late election. We cannot find any policy reason justifying the prohibition on making an election on a late or supplemental return. The allowance of such an election would not present a potential for abuse or negatively impact compliance. Instead, it would further the Congressional intent of protecting closely held businesses from liquidity pressures associated with the federal estate tax and avoid conditioning that liquidity relief on the mere timing of the election. Further, allowing such an election would eliminate the need for the making of a protection election, thus reducing the preparer’s effort and paperwork in connection with a protective election that may ultimately be unnecessary.

**Options for Consideration:** Congress might consider amending §6166 to expressly permit an election on a late or supplemental return or during the audit process.

C. **Security**.

**Present Law:** Section 6165 authorizes the Service to require a surety bond in order to secure the payment of estate tax for which a §6166 extension has been obtained. The surety bond may not be more than twice the extension amount. In lieu of providing a bond, the Service may require a lien under §6324A, thereby relieving the personal representative of any personal liability for the deferred tax.

**Reasons for Change:** The Service’s position on whether to require either a bond or a lien has vacillated over the years. One concern of the Service is that the general estate tax lien under §6324 expires ten years after the decedent’s death. Consequently, if an estate is paying the estate tax over 14 years and 9 months under §6166, there will be no security for the payment of the deferred tax after the tenth year absent some type of collateral other than the general estate tax lien. Because of a recommendation by the U.S. Treasury Inspector General that was based on the number of unsecured outstanding estate tax balances and the number of overdue and uncollectable estate taxes, the Service adopted a bright line bond requirement in 2002; the estate had to either provide a surety bond or agree to §6324A lien.

The Tax Court, in *Estate of Roski v. Commissioner*, 128 T.C. 113 (2007), held that the Service abused its discretion by requiring that all estates electing to pay the estate tax in installments under §6166 must provide a surety bond (or alternatively a special lien). The court found that it was Congress’s intent for the Service to determine, on a case-by-case basis, whether the government’s interest is at risk prior to requiring security from an estate electing to pay the estate tax in installments under §6166.

In response, the Service issued Notice 2007-90 to provide interim guidance and to describe a change in policy regarding §6166, that, in light of the Tax Court decision, the Service will now determine on a case-by-case basis whether security will be required when a qualifying estate elects to pay all or a part of the estate tax in installments. The notice states that the Treasury and the Service intend to issue regulations establishing standards and guidelines in determining when a bond or lien will be required. In the meantime, the notice lists the following factors that the Service will consider in determining whether deferred installment payments of estate tax under §6166 pose a sufficient credit risk to the government to justify the requirement of either a bond or special lien: (1) duration and stability of the business; (2) ability to pay the
installments of tax and interest timely; and (3) the taxpayers’ history of complying with the tax laws. Other factors may be considered and no single factor will be determinative.

The Service, in Chief Counsel Memorandum 200747019, addressed a number of issues when the Service is considering whether to accept stock in a closely held corporation as collateral for the special estate tax lien under §6324A.\textsuperscript{13} First and foremost, the Service stated that if three requirements under §6324A are met, the §6324A special lien arises and the collateral must be accepted by the Service. The Service cannot reject the closely held stock as collateral because it would be burdensome to determine the value of the stock, because the Service would prefer other collateral, or because that the stock might decline in value. The three requirements are (1) the stock must be expected to survive the deferral period; (2) the stock must be identified in the written agreement described in §6324A(b)(1)(B); and (3) the value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest.

In order to protect its lien, the memorandum points out that the Service may require an estate to provide annual reports or certified financial statements each year, and if the estate refuses to provide the information, the Service may demand additional collateral or may accelerate the deferred tax if estate refuses to provide the additional collateral. Furthermore, the Service may demand additional collateral if it determines that the closely held stock is not sufficient collateral because it has declined in value. Again, if the estate refuses to furnish the additional collateral, the Service may accelerate the payment of the deferred tax.

\textit{Options for Consideration:} While the 2007 developments summarized above have added a degree of clarity regarding application of the special lien and bond requirements associated with §6166, Congress might consider amending the law to expressly enable the executor to provide alternative means of assuring payment, including commercially reasonable covenants and subordination agreements. Doing so would provide additional flexibility in structuring an arrangement that balances the need to secure payment of the federal estate tax with the economic realities of operating the closely held business.

\textbf{V. Valuation of Interests in Closely Held Entities.}

\textit{Present Law:}

Each of the three taxes that comprise the federal wealth transfer tax system is imposed on the value of transferred property. Property valuation therefore plays a critical role in determining the extent of the transfer tax base. The applicable standard for determining the value of transferred property is found in the Treasury regulations. The regulations provide a nearly identical standard for determining fair market value under the estate tax and gift tax. The estate tax regulation provides as follows:

\textsuperscript{13} The Service issued a similar memorandum with respect to ownership interests in limited liability companies in Internal Memorandum 200803016. See also Program Managers Technical Advice (PMTA) 2009-046, a memorandum issued by the Office of Chief Counsel for the Service, dated February 25, 2009.
The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.\textsuperscript{14}

The gift tax regulation provides as follows:

The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.\textsuperscript{15}

Hence, value is determined on an objective basis for transfer tax purposes, and any subjective premium or discount the transferor may place on the objective value of the property is irrelevant.

Consistent with determining value pursuant to the regulatory standard, courts routinely recognize the propriety of discounts in valuing non-controlling interests in closely held business entities (\textit{i.e.}, lack of marketability and lack of voting control) and undivided fractional interests in real property. While reasonable people may disagree over the amount of these discounts, they are not fictional; rather, they reflect the very real challenges that an owner of property would face in attempting to dispose of such an interest in a market exchange with disinterested third parties.

\textit{Reasons for Change:}

The wide acceptance of valuation discounts in the context of a closely held business has motivated taxpayers to create and fund entities with business-like structures in order to reduce the value of the property for transfer tax purposes. For instance, taxpayers who own liquid assets may capitalize a newly-created closely held entity with cash or marketable securities and then make gratuitous transfers of beneficial interests in the entity to their children or other family members. Where a closely held entity is created for no meaningful nontax purpose, but rather to reduce the transfer tax value of property to be transferred to family members, and where the family members who receive the interests will not actually suffer the practical detriment associated with ownership of non-controlling interest in a closely held entity, application of valuation discounts to determine the value of the transferred interest is inappropriate. The application of valuation discounts in this context not only erodes the federal transfer tax base, it effectively penalizes those taxpayers who choose not to “game the system” in this manner or who simply lack the counsel necessary to implement such a strategy.

In the past, the Service attempted to combat the use of closely held entities for purposes of exploiting valuation discounts by contending that the likelihood of family members selling their interests as part of a controlling group constituted a relevant fact to be considered under the willing-buyer, willing-seller standard.\textsuperscript{16} This argument was rejected by the courts\textsuperscript{17} and the Service ultimately abandoned this position.\textsuperscript{18} More recently, with only limited success, the

\textsuperscript{14}Treas. Reg. §20.2031-1(b).
\textsuperscript{15}Treas. Reg. §25.2512-1.
\textsuperscript{17}See Estate of Bright v. Commissioner, 658 F.2d 999 (5th Cir. 1981).
\textsuperscript{18}See Rev. Rul. 93-12, 1993-1, C.B. 202 (transfer of separate 20 percent interests in closely held corporation entitled to be valued through application of minority-interest discount; ownership of entity among family members expressly irrelevant for valuation purposes).
Service has attacked aggressive discounting techniques through the invocation of the estate tax recapture provisions in §2036 based on an individual’s retention of or control over the beneficial enjoyment of property transferred to an entity. In short, the current law appears inadequate to deter taxpayers from creating closely held entities merely to transfer property to family members at a reduced value for transfer tax purposes. Indeed, the apparent ease with which the transfer tax value of property can be reduced through the use of closely held entities has led to litigated claims of legal malpractice for not recommending their formation. Moreover, the incentive for the Service to challenge values in this context may be significantly reduced by the use of “defined value” clauses, which courts have recently upheld.\textsuperscript{19}

Although it is clear there is a need for legislative reform with respect to valuation discounts in the context of some closely held family entities, devising a practical and fair solution is not a simple task. Valuation discounts are not abusive \textit{per se}. Rather, they estimate real decreases in value that an owner would actually realize if attempting to sell a non-controlling interest in a closely held entity to an unrelated third party. The difficulty in crafting reform therefore lies in determining when deviations from the objective standard for determining fair market value are most appropriate, and considering the circumstances, if any, under which a blanket disallowance of discounts may be warranted.

We believe it is useful to distinguish between closely held entities that are active businesses and those that are not. Other than not-for-profit businesses, active businesses are created to make a profit. The availability of valuation discounts to reduce the transfer tax value of interests in the business is not likely to be a motivation for starting a business. While it is relatively easy to create a family limited partnership funded with marketable securities, it is significantly more difficult to create a sustainable active business. As the same opportunity for abuse does not exist with respect to active businesses, legislative reform in this context is not needed.\textsuperscript{20} Moreover, the application of a rule limiting valuation discounts in the context of a family-owned active business would in some cases overvalue such an interest, while a non-family-owned business would not suffer the same overvaluation. Accordingly, we suggest that the alternative options set forth below be limited to the valuation of interests in closely held entities that are not active businesses.

One way to define an “active business” for this purpose is to adopt the existing definition in §6166, which provides for deferral of estate taxes attributable to a closely held business. To deter the contribution of cash, marketable securities or other property to an active business in order to take advantage of the discounts applicable to interests in the active business, it would also be necessary to extend whatever measure is adopted to non-business assets that are held in an active business.\textsuperscript{21} Admittedly, the definition of “non-business assets” could prove to be

\textsuperscript{19}See, e.g., Estate of Petter v. Commissioner, T.C. Memo. 2009-280, 98 T.C.M. (CCH) 534, \textit{aff’d}, 653 F.3d 1012 (9\textsuperscript{th} Cir. August 4, 2011).

\textsuperscript{20}Although there are certainly litigated controversies over the fair market value of non-controlling interests in active businesses, the same is true with any type of property interest that is not publicly traded. If Congress sought to limit controversies regarding the application of valuation discounts in the context of an active business, one alternative might be to establish presumptive valuation guidelines and safe harbors to reduce valuation uncertainty and the controversy that the uncertainty produces. \textit{See} §18 of the 2004 Report.

\textsuperscript{21}Section 6166 addresses this issue as well. \textit{See} §6166(b)(9). Section 6166 and alternatives regarding its reform is discussed \textit{supra} in section IV of these options.
difficult and may invite artificial transactions in search of a different classification. One possible method of defining non-business assets would be by reference to the standards for determining the “reasonable capital needs of the business” under §531, so that liquid assets that are needed for the reasonable capital needs of the business are considered business assets.

*Options for Consideration:*

We offer the options set forth below for consideration, limited to interests in closely held entities that are not active businesses and to the non-business assets of active businesses, as potential methods of addressing the need for legislation set forth above. The 2004 Report of the Task Force on Federal Wealth Transfer Taxes sets forth a number of reform proposals aimed at addressing fairness and efficiency concerns relating to the role of valuation discounts in the present federal transfer tax regime. This section identifies the most promising options that Congress might consider to curtail the intentional exploitation of valuation discounts in the context of closely held entities that are not active businesses for federal transfer tax purposes. These options are not mutually exclusive, and the order of appearance is not intended to reflect the preference of one approach over another.

**A. Denial of Discounts Where Transferred Interest is Part of a Controlling Interest.** Under this approach, if a transferred interest in an entity is part of a controlling interest owned before the transfer by the transferor or after the transfer by the transferee (determined through the application of aggregation rules), then the value of the interest (or in the context of an active business, the value attributable to the portion of the transferred interest consisting of non-business assets) is determined without taking into account any minority discount.

Alternatively, Congress could adopt a transfer tax rule that values interests in a closely held entity at a proportional share of the net asset value of the entity at the time of a transfer. (Note that the application of such rule might be complicated in situations involving different classes of interests, such as preferred and non-preferred interests, or voting and non-voting interests.) In the context of active businesses, to the extent the business has non-business assets (as discussed above), that portion of the interest transferred represented by non-business assets would be valued at a proportional share of the net asset value of the entity at the time of transfer.

This approach would discourage taxpayers from manufacturing valuation discounts by placing marketable assets in a closely held entity or contributing them to an active business that does not use the assets in the operation of the business. Such a rule may be overbroad as applied to transactions with third parties, so other limitations may be warranted.

**B. Aggregation of Family-Owned Interests.** Congress could consider requiring that the value of an interest in closely held entity for transfer tax purposes be equal to that interest’s pro rata share of all interests in the property that the transferor and certain other persons hold. There are two primary approaches to aggregation available. The broader aggregation approach would require aggregation of a transferor’s interest in an asset with interests in that same asset held by members of the transferor’s family. This approach would disallow minority discounts for all transfers except arms’ length transfers to nonfamily members, unless all interests held by the

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transferor and family members would qualify for the discounts. This approach does not consider family disharmony, particularly after the original donor is no longer able to influence the family (for example, due to disability or death).

The more narrow aggregation approach would require aggregation of a transferor’s interests in a closely held entity with interests in that same entity held by persons to whom the transferor is making or previously has made transfers, other than arms’ length transfers to nonfamily members. Under this narrower approach, at the time of such a transfer, the value of a partial interest in property for transfer tax purposes would equal that partial interest’s pro rata share of all interests in that property that: (i) the transferor owned at such time and (ii) other persons owned at such time, to the extent that the transferor had transferred those interests to those other persons, except for interests transferred to nonfamily members in arms’ length transfers. To prevent circumvention of this rule, it may be necessary also to include interests that family members acquired in exchange for capital contributions.

If an aggregation approach were adopted, it would be necessary to change the gift tax law to protect individuals from gift tax liability when they purchase fractional interests in a closely held entity from family members for a purchase price equal to the pro-rata share of the total value of the entity. It seems likely that both approaches would discourage taxpayers from creating entities solely to obtain valuation discounts.

A clear disadvantage of any family aggregation approach is its premise that members of a family will act in concert in connection with their closely held entity interests and, as a result, will not experience the practical detriment associated with ownership of a non-controlling interest. Harmonious relations among family members may be common, but they are not guaranteed - particularly among second or third generation transferees of family entities. In such a context, a family aggregation approach will overvalue interests in some family-owned entities that were created for nontax purposes. The significance of this disadvantage would appear to be greater in the broad aggregation approach.

These alternatives can be illustrated by the following examples:

Example 1: A gift to a family member, a sale to a family member, and a bequest by a 100 percent owner. G owns all of the stock of XYZ Corporation, which is not an active business. In year 1, G gives a 26 percent interest in XYZ to G’s child, B. In year 2, G sells a 26 percent interest in XYZ to another child, C. In year 3, G dies. At the time of G’s death, G owns 48 percent of XYZ and each child owns 26 percent of XYZ. At all times, the value of XYZ is $1 million. The 26 percent interest that G gave to B has a value for gift tax purposes of $260,000 (26 percent x $1 million). The pro rata valuation rule prevents a valuation discount because G and B together control XYZ. The 26 percent interest that G sold to C also has a value for gift tax purposes of $260,000. Again, the pro rata valuation rule prevents a valuation discount because G, B(a donee), and C (a family member to whom G sold XYZ stock) together control XYZ. The 48 percent interest in XYZ owned by G at the time of G’s death has a value for estate tax purposes of $480,000 (48 percent x $1 million). Once more, the pro rata valuation rule prevents a valuation discount because G, B, and C together control XYZ. G’s estate would receive a marital or
charitable deduction of $480,000, if $G$ were to bequeath the 48 percent interest in $XYZ$ to $G$’s spouse or to a charity.

**Example 2: A bequest by a donee of a fractional interest.** Donee $B$ from example 1 dies owning 26 percent of $XYZ$ Corporation, which is not an active business. At the time of $B$’s death the value of $XYZ$ is $1$ million, $G$ owns 48 percent of $XYZ$, and $C$ owns 26 percent of $XYZ$. The value for estate tax purposes of $B$’s 26 percent interest in $XYZ$ is not necessarily equal to 26 percent of the value of $XYZ$. The pro rata valuation rule does not apply because $B$ never had a controlling interest in $XYZ$.

**C. Revision/Simplification of Chapter 14 Special Valuation Rules.** If Congress were to adopt one or more of the alternatives described above, the special valuation rules contained in §§2703 and 2704 might be unnecessary in most cases. The elimination or substantially narrowing of these provisions would achieve considerable simplification, while also eliminating many of the traps for the unwary these provisions currently pose.

If the special valuation rules of chapter 14 continue to serve as the chief vehicle for addressing valuation discounts, Congress might modify §2704 to provide that the tax law will disregard restrictions on liquidation or withdrawal, whether imposed by state law or by partnership or limited liability company agreements, unless the restrictions are comparable to those agreed to by persons dealing at arms’ length. Disregarding restrictions on liquidation or withdrawal would effectively eliminate a lack of marketability discount.

**D. Adoption of More Stringent and Uniform Standards for Appraisals Used to Justify Discounts.** In the context of the charitable income tax deduction, Congress has conditioned allowance of the deduction on the taxpayer obtaining a “qualified appraisal” of property exceeding certain values. It is generally believed that the heightened substantiation requirements of a qualified appraisal have proven successful in stemming valuation abuse associated with the charitable deduction. Congress could consider imposing a similar qualified appraisal regime for federal transfer tax purposes. In particular, Congress could condition the allowance of any discount from proportionate value (i.e., fractional-interest, minority interest, lack of marketability) on the taxpayer obtaining an appraisal satisfying conditions that Treasury would articulate by regulation.

**VI. “Clawback” or “Recapture” of Transfer Tax on Gifts Protected by Gift Tax Unified Credit.**

**Present Law:** Section 2001(b) sets forth the methodology for computing the federal estate tax attributable to a decedent’s estate. First, one computes a tentative tax on the sum of (i)

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23 In addition, without the need for further statutory amendment to §2701, Treasury could permit more than the one valuation approach it describes in its regulations. The “subtraction method,” imposed by Treas. Reg. §25.2701-3(b), assumes that there is only one valuation method that appraisers can apply to a closely held corporation and that appraisers could not apply the statutory mandate to treat nonqualified payment rights as valueless under other valuation models. For example, under a cash flow determination of the value of an equity interest, appraisers could regard a nonqualified payment right as valueless and refuse to subtract the nonqualified payment obligation in determining the net cash flow of the entity. The subtraction method does not accommodate, or appear to even acknowledge, this technique.

24 See §170(f)(11).
the value of the decedent’s taxable estate and (ii) the amount of post-1976 gifts (“adjusted taxable gifts”). Second, one subtracts a hypothetical gift tax equal to the amount of gift tax that would had been payable on the adjusted taxable gifts had the rate schedule in effect as of the decedent’s death been in effect as of the date the gifts were made (the “Chapter 12 Offset Amount”). Section 2010 then provides for the application of the applicable credit amount to compute the final estate tax liability.

Purpose: The addition of a decedent’s adjusted taxable gifts to the value of the taxable estate is intended to gross up the estate tax base for purposes of applying the historically progressive rate schedule. In other words, the purpose is to tax the estate at the highest tax bracket, considering that the decedent has made prior taxable gifts.

Chapter 12 Offset Amount: In computing the Chapter 12 Offset Amount, the hypothetical gift tax is reduced by the applicable credit amount, which is a product of the applicable exclusion amount and the applicable tax rates. In that regard, §2001(g), which is scheduled to sunset at the end of 2012, provides that the tax rates in effect as of the date of the decedent’s death are to be utilized in computing the Chapter 12 Offset Amount. Unfortunately, the statute does not identify whether the applicable exclusion amount at the date of the gift or at the date of death should be used in calculating the credit amount for purposes of determining the Chapter 12 Offset Amount.

Reasons for Change: The instructions for Form 706, Line 7 worksheet indicate that the Chapter 12 Offset is to be computed using the applicable exclusion amount in effect as of the date the gift was made. Those instructions were promulgated prior to the enactment of TRA 2010 and presumably did not contemplate the possibility that the applicable exclusion amount at death might be lower than the applicable exclusion amount at the time the adjusted taxable gifts were made. It is not clear how the Chapter 12 Offset Amount is to be computed if the applicable exclusion amount (and therefore, the applicable credit amount) at the date of the decedent’s death is lower than the applicable exclusion amount available at the time the adjusted taxable gifts were made.25 Specifically, should the Chapter 12 Offset Amount be computed using the applicable exclusion amount in effect on the date of the gift or the applicable exclusion amount in effect on the date of the decedent’s death? The answer to this question can have a dramatic effect on a decedent’s federal estate tax liability at death and the current uncertainty is a source of frustration to taxpayers who wish to plan their affairs currently. The examples below illustrate the difference between the two possible results.

Date of Death Amount: If the applicable exclusion amount in effect as of the date of death is utilized, the adjusted taxable gifts will gross up the value of the taxable estate, but will not be subject to tax in the decedent’s estate.

Example: Decedent makes a gift of $5 million in 2011 when the applicable exclusion amount is $5 million and the top federal gift tax rate is 35% and dies in 2013 with a taxable estate of $10 million when the applicable exclusion amount is $1 million and the top federal estate tax rate is 55%.

25 For example, under current law the exclusion amount is $5 million for the year 2011 but it will be $1 million for decedents dying after December 31, 2012
1. Tentative tax on $15 million ($10 million estate + $5 million post-1976 gifts) | $7,890,000

2. Less gift tax on gift tax on $5 million gift (using date of death rate (55%) minus unified credit (using date of death applicable exclusion ($1 million) and date of death rate (55%)) | ($2,390,800 - $345,800) = (2,045,000)

3. Less unified credit (using date of death applicable exclusion ($1 million) and date of death rate (55%)) | ($345,800)

| Estate Tax | $5,500,000 |

*Date of Gift Amount:* If the applicable exclusion amount in effect as of the date of gift is utilized, the adjusted taxable gifts will not only gross up the value of the taxable estate, but a portion of those gifts will also be subject to tax in the decedent’s estate.

*Example:* Decedent makes a gift of $5 million in 2011 when the applicable exclusion amount is $5 million and the top federal gift tax rate is 35% and dies in 2013 with a taxable estate of $10 million when the applicable exclusion amount is $1 million and the top federal estate tax rate is 55%.
3. Less unified credit (using date of death applicable exclusion ($1 million) and date of death rate (55%)) ($345,800)

| Estate Tax | $7,545,000 |

**Options for Consideration:** Congress might consider amending §2001 to clarify that adjusted taxable gifts are not subject to estate tax in the decedent’s estate if the applicable exclusion amount at the date of the decedent’s death is lower than the applicable exclusion amount at the date the gifts were made. One method to accomplish this would be to provide that, in making the hypothetical gift tax payable calculation, "the amount determined under Section 2505(a)(1) [i.e., the gift tax unified credit] for each calendar year shall not exceed the estate's applicable exclusion amount under Section 2010(c) [i.e., the tax on the estate tax applicable exclusion amount]." Alternatively, if Congress intends for the estate tax to recapture the transfer tax on adjusted taxable gifts made when the applicable exclusion amount is higher than the applicable exclusion amount at death, Congress might consider amending §2001 to make that result clear.

VII. **Annual Exclusion.**

**Present Law:** Section 2503(b) permits each taxpayer to transfer assets with a value up to $13,000 (indexed for inflation in multiples of $1,000) to each of any number of donees each year without incurring any gift tax, and without utilizing any of the taxpayer’s lifetime gift tax exclusion. Congress enacted the gift tax annual exclusion so that taxpayers could avoid having to keep records for numerous small gifts.\(^2\)

Section 2503 limits the annual exclusion from the gift tax to gifts of “present interests” in property. Treasury Regulation §25.2503-3(b) defines a present interest to be “[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property….” The purposes underlying the present interest requirement were to avoid the valuation of remote or contingent future interests and also to make it easier to identify donees in certain circumstances.\(^2\)

**Reasons for Change:** The present interest requirement for annual exclusion gifts, particularly for gifts made in trust, creates complexity and uncertainty. Only two types of trust interests can qualify for the §2503(b) annual exclusion from gift tax: (i) the annual payment of income from a trust for a term of years or a person’s life and (ii) a withdrawal power.\(^2\)

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\(^2\) *Id.*

\(^2\) Section 2503(c) makes an exception to the present interest requirement for gifts made in trust for minors. The donor can make a gift in trust, giving a trustee the discretion to distribute or accumulate the income from the property as long as the trustee distributes the property and any accumulated income when the minor attains age 21. If the minor dies before attaining age 21, §2503(c)(2)(B) requires the trust to provide that the trustee pay the property and any accumulated income to the minor’s estate or as the minor directs under a general power of appointment.
Crummey v. Commissioner and other later cases, a trust beneficiary’s right to withdraw all or a portion of the donor’s contribution to the trust, even if only for a limited period of time, qualifies as a present interest. Donors use Crummey withdrawal powers extensively when they want the income and corpus to remain in trust, rather than being distributed to the trust beneficiaries. Donors also use Crummey withdrawal powers as a method of funding premium payments on life insurance policies owned by a trust. A transfer of funds to a life insurance trust ordinarily does not qualify as a gift of a present interest and, therefore, does not qualify for the annual exclusion unless a Crumney withdrawal power is used.

Technical aspects of Crummey powers make reliance on professional advice a near requisite. The Service's position is that the donee powerholder must receive adequate notice of, and be given a reasonable opportunity to exercise the withdrawal power. Other added complexities pertaining to Crummey powers concern the application of the “five or five” power rules under §§2041(b)(2) and 2514(e), which make an exception to the rule that the release of a general power is a transfer for purposes of estate and gift taxes. Sections 2041(b)(2) and 2514(e) provide that a lapse of a general power of appointment with respect to an amount that does not exceed the greater of $5,000 or 5 percent of the aggregate value of the property subject to the power at the time of the lapse shall not be considered a release and, therefore, shall not be subject to the estate and gift tax rules pertaining to powers of appointment. To the extent the Crummey power exceeds $5,000 or 5 percent of the property subject to the power, the lapse of the power leads to estate and gift tax consequences for the donee. Additional income tax complications arise because §678 treats a donee with a withdrawal power over a portion of a trust as the owner of that portion of the trust for income tax purposes.

The gift tax annual exclusion plays a related role under the GST tax law that adds to the complexities of its operation. Outright gifts to grandchildren and other generation-skipping transfers that qualify for the gift tax annual exclusion are not subject to the GST tax. Donors cannot enjoy the GST tax annual exclusion for gifts made in trust, however, unless the transfers meet the requirements of §2642(c). Section 2642(c) provides for a very specific type of trust in order to ensure that the gifted interest eventually will be subject to estate or gift tax, depending on whether the donee ultimately transfers the gifted property at death or during life. Thus, the

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29 Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), acq. in result.
30 Treas. Reg. §25.2503-3(c) (Ex. 2).
31 Rev. Rul. 81-7, 1981-1 C.B. 474, which held that a Crummey power is illusory if the power holder has neither knowledge of nor a reasonable opportunity to exercise that power.
32 For this reason, many withdrawal powers for gifts in excess of $5,000 are structured as “hanging” powers that will lapse over several years at a rate not to exceed the $5,000 or 5 percent rule. Hanging powers add complication to the administration of life insurance trusts, as they usually must be tracked for several (or possibly many) years after the last contribution is made to the trust.
33 §2642(c)(1).
34 §2642(c)(2) provides:

Any transfer to a trust for the benefit of an individual [will not qualify as an exclusion from the direct skip rules] unless:

(A) during the life of such individual, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such individual, and
(B) if the trust does not terminate before the individual dies, the assets of such trust will be includable in the gross estate of such individual.
annual exclusion for gifts made in trust under the GST tax is more restrictive than the annual exclusion under the gift tax. These different requirements create confusion for taxpayers and financial advisors, because a transfer that qualifies for the gift tax annual exclusion can result in a taxable transfer under the GST tax.³⁵

The present interest requirement also causes problems for donors who seek to make outright gifts of illiquid assets, such as partnership or limited liability company interests. Recent cases have held that, where the donee receives unpredictable cash flow distributions from the gifted interests and/or must seek management’s consent to transfer the gifted interests, the donee has not received a present interest in property.³⁶

If the purpose of the present interest requirement merely is to identify the donee, outright gifts of illiquid assets should qualify for the annual exclusion from gift tax. For gifts made in trust, the Crummey power adequately identifies the donee.

Options for Consideration. In order to cure the complexity and uncertainty posed by the present interest requirement, Congress may wish to consider the alternatives set forth below. These alternatives assume that a wealth transfer tax system is in place. The first group of alternatives presents possible revisions to the present interest requirement. Alternative B raises the possible elimination of the present interest requirement. Alternative C considers setting dollar limitations on the annual exclusion, and alternatives D and E propose an expansion of the exclusion for educational and medical expenses.

A. Possible Revisions to Present Interest Requirement.

1. Retain the Present Interest Requirement and Establish Rules for a Qualifying Withdrawal Power. Congress could retain the present interest requirement and codify the rules for a Crummey withdrawal power, or a “qualifying withdrawal power.” By establishing what constitutes a qualifying withdrawal power, Congress would eliminate the uncertainties and complexities that arise because taxpayers have to rely on a smattering of cases, revenue rulings, technical advice memoranda, and private letter rulings.

   If Congress were to codify the rules for a qualifying withdrawal power, Congress also could conform §§2041(b)(2) and 2514(e) and provide that a lapse of a qualifying power of withdrawal to the extent of the greater of the annual exclusion amount or five percent of the value of the trust assets does not constitute a release for either estate or gift tax purposes. Congress further could eliminate the complexities of the withdrawal power by either clearly including or excluding a lapsed qualifying withdrawal power from the operation of §678, which treats a power holder as the owner of all or a portion of a trust for income tax purposes.

   2. Retain the Present Interest Requirement and Allow the Annual Exclusion for Gifts Made in Trust That Meet the Requirements of §2642(c). Congress could retain the present interest requirement, but allow an annual exclusion only for gifts made in trust that meet the §2642(c) requirements, which ensure that donees are treated, for estate and gift tax purposes.

³⁵ For further discussion of the annual exclusion and the GST tax, see section IX of these options.

³⁶ See Hackl v. Commissioner, 335 F.3d 664 (7th Cir. 2003), aff’d 118 T.C. 279 (2002); Price v. Commissioner, T.C. Memo. 2010-2 (January 4, 2010); Fisher v. United States, 105 AFTR 2d. 2010-1347 (S.D. Ind. March 11, 2010).
as owners of the property placed in trust. This alternative would disallow the gift tax annual exclusion for transfers of property into a trust that now qualify only because they are subject to a *Crummey* power. Thus, it would remove donors’ ability to use the gift tax annual exclusion to fund trusts that benefit multiple beneficiaries and that give trustees the ability to “sprinkle” the trust funds among any one or more of the beneficiaries, in equal or unequal amounts, much as parents naturally provide for their children. Nevertheless, a §2642(c) trust does enable the donor to protect a donee from creditors, divorce and spendthrift for the duration of the donee’s life.

3. Retain the Present Interest Requirement and Deny the Annual Exclusion for Gifts Made in Trust. Congress could retain the present interest requirement, but deny annual exclusions for any gifts made in trust, except for those that qualify under §2503(c), having to do with gifts to persons under age 21. This alternative would disallow the gift tax annual exclusion for a transfer of property into a trust that qualifies because of a *Crummey* power, and it would also disqualify gifts made to trusts that give the donee a quantifiable income interest. Congress may want to conform the GST tax rules and exclude from the GST tax only outright gifts or gifts that qualify under §2503(c). Section 2503(c) could be modified to permit distribution at an older age – perhaps 25 or 30.

Arguing against such an approach, many donors in today’s uncertain world prefer to make gifts to their children and other loved ones in trust, to protect the property from creditors, divorcing spouses, and spendthrift beneficiaries. A clear disadvantage of denying annual exclusion treatment to gifts made in trust, is that it denies annual exclusion treatment to a method of gift-giving that is used by many taxpayers. The remaining alternatives offer solutions that do not categorically deny the annual exclusion to gifts made in trust.

B. Possible Elimination of the Present Interest Requirement. Congress could eliminate the present interest requirement and allow transfers to a donee made either outright or in trust to qualify for the annual exclusion, regardless of the type of asset transferred to the donee. If the rationale for the present interest requirement is that the requirement helps to identify the beneficiary, it is not clear why gifts of present interests satisfy that objective, while gifts of future interests do not. Elimination of the present interest requirement would remove many of the annual exclusion’s existing technical complexities and compliance costs, and would reduce litigation over whether gifts of closely-held business interests qualify for the exclusion. To curtail the potential for abuse in naming a large class of beneficiaries of a discretionary trust in order to use multiple annual exclusion amounts, one of the following limitations could be considered:

1. The donee’s interest in the trust must be susceptible to valuation. Beneficial interests that can be defeated by the exercise of fiduciary or beneficial powers, or are subject to conditions that are not susceptible to actuarial valuation, would not qualify for the annual exclusion. With this limitation, the donor would be limited to trusts that grant the beneficiary an ascertainable income interest or §2642(c) trusts and again would not be able to use the annual exclusion to fund trusts that benefit multiple beneficiaries and that give trustees the ability to “sprinkle” the trust funds among any one or more of the beneficiaries.

2. The donee must have a vested current or remainder interest in the trust. Another option is to permit the annual exclusion for gifts made in trust where each beneficiary
who has a vested current or remainder interest in the trust that is greater than a de minimis
interest can be counted as a donee for annual exclusion purposes. This limitation would better
reflect donors’ intent by enabling them to use the annual exclusion to fund trusts that benefit
multiple beneficiaries and that give trustees the ability to “sprinkle” the trust funds among any
one or more of the beneficiaries. The Service would have to employ a facts and circumstances
test to determine if a donor failed to comply with the de minimis interest requirement, but this is
no different from the Service’s current position that the recipient of a Crummey withdrawal
power have an interest in the trust greater than the withdrawal right.37

3. The donee must have a qualifying withdrawal power over the assets
calculated to the trust. This limitation would track the alternative described in paragraph A.3 of
this section VII, with the difference being that outright gifts of property interests would qualify
for the annual exclusion regardless of their degree of liquidity.

C. Impose Additional or Different Types of Dollar Limitations. If Congress believes
the extent of tax-free annual giving to be a problem, Congress could eliminate the per donee
annual exclusion and, instead, permit a donor to make aggregate gifts up to some designated
amount each year. This rule would permit one donee to receive the entire amount allowed or a
number of donees to receive gifts up to the aggregate amount allowed. Under this approach, who
received the property or what type of interest that person received would not matter, which would
mean that Congress could eliminate the present interest requirement.

This alternative may penalize large families, and has the added disadvantage of
requiring taxpayers to keep records of the small gifts that Congress intended the annual exclusion
to ameliorate.

D. Expand the Availability of §2503(e) for Educational Expenses. The total cost of
education, including fees, books, supplies, equipment, room and board, has increased since the
enactment of §2503(e), which exempts from gift tax amounts paid as tuition to an educational
organization. Frequently, the expenses in excess of tuition will exceed the annual exclusion
amount. Congress may want to consider expanding §2503(e) to cover those expenses in excess
of tuition that are allowed under §529(e)(3), such as books, room and board, if such expenses are
paid directly to the provider.

E. Include as a “Qualified Transfer” under §2503(e) a Transfer in Trust where Trust
Distributions Are Limited to the Beneficiaries’ Health and Education. Older taxpayers often
have the means, but not the life expectancy to provide for the health and education expenses of
their descendants. Their preference would be to fund a trust that could be used to pay the
education and health expenses of these family members as those expenses arise, in the event the
expenses do not arise until after the donor is deceased. Congress may want to include as a
“qualified transfer” under §2503(e) transfers in trust where the trust instrument limits
distributions to pay for the beneficiaries’ health and education expenses, so long as such
payments are made directly to the provider.


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37 Action on Decision 1996-010; TAM 9628004; TAM 9731004.
A. The Estate Tax Override.

Present Law: Treasury Regulation §26.2612(b)(1)(i) provides that a transfer, which otherwise qualifies as a taxable termination under the GST tax law, is not a taxable termination if it is subject to the estate tax (or gift tax). The GST tax may result in a higher tax than would have resulted had the assets been subject to the estate tax, primarily because the GST tax is imposed at the highest estate tax rate. Transferors, therefore, adopt estate plans to avoid the GST tax, if their beneficiaries would be subject to a lower tax by having the transferred property taxed under the estate tax law. For instance, a transferor may give discretion to a trustee to distribute income or corpus to a non-skip beneficiary. If the trustee distributes income or corpus to the non-skip beneficiary, that beneficiary can then make taxable gifts to donees who otherwise would be skip persons if the trustee had distributed the income or corpus to them directly. Alternatively, a transferor may give a trust beneficiary a general power of appointment to avoid a taxable termination at his or her death. In fact, a fairly standard drafting technique is to arrange for a “springing” or “conditional” general power of appointment to a beneficiary or to give an independent trustee the power to grant a beneficiary a general power of appointment solely for the purpose of avoiding a GST tax at the time of the beneficiary’s death in the event the tax resulting from estate tax inclusion would be less than the GST tax.

Reasons for Change: Transferors must engage in sophisticated planning techniques to prevent their beneficiaries from having to pay more under the GST tax than they would if the interests they received were subject to the estate tax.

Options for Consideration: Provide Taxpayers the Right to Elect the GST Tax or the Estate Tax. Congress could give taxpayers the right to elect to be subject to either the GST tax or the estate tax if the GST tax would otherwise apply as a result of a taxable termination.

For example, a non-skip beneficiary’s executor could elect to treat the trust assets as part of the non-skip beneficiary’s gross estate and have them subject to the estate tax, rather than have the trust assets subject to the GST tax because the non-skip beneficiary’s death is considered a taxable termination. An election would simplify estate planning and would prevent adverse tax consequences for those taxpayers who do not have the advantage of sophisticated estate planning. If one purpose of the GST tax is to protect the estate tax, there seems to be no policy reason not to allow taxpayers to elect estate tax, instead of GST tax, treatment.

The election also has the benefit of ameliorating a GST tax that can result in a higher tax on interests held in trust than on interests held outright. Trust interests are no more valuable to a beneficiary than outright ownership. For reasons of administrative simplicity, however, the GST tax law frequently taxes transfers of interests held in trust more harshly than the estate tax law taxes successive outright transfers. The election essentially acknowledges the limitations of the GST tax law to achieve its own purposes.

One disadvantage of this alternative is that Congress would have to develop criteria for the identification of the individual who would be eligible to elect to be treated as the transferor

38 §2641.
39 §2612(a).
under the estate tax law. In addition, the current unified wealth transfer tax system would seem to require statutory provisions that take an election into account when determining the tax on that individual’s subsequent lifetime or deathtime transfers and subsequent elections for estate or gift tax, rather than GST tax, treatment.

B. The Coordination of the GST Tax with the Estate and Gift Taxes.

The General Explanation of the Tax Reform Act 1986 (hereinafter 1986 Bluebook) states that the purpose of the federal transfer taxes is not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations.\(^{40}\)

The 1986 Bluebook further states that the goal of the GST tax is to simplify administration “while insuring that transfers having a similar substantial effect will be subject to tax in a similar manner.”\(^{41}\) The legislative history of the GST tax is devoid of any discussion that Congress intends to tax transfers of interests held in trust more harshly than outright transfers.

In some cases, the lack of coordination between the GST tax and the estate and gift taxes may be a deliberate response to potential abuses. In other cases, the inconsistencies appear inadvertent or are the result of an intentional choice to value simplicity over uniformity. For example, the imposition of the highest estate tax rate in determining the GST tax eliminates the need to engage in a complicated inquiry into what the tax would have been had the property been subject to the estate tax.\(^{42}\) In still other cases, the inconsistencies appear to arise due to


}\(^{41}\) Id.

}\(^{42}\) The Tax Reform Act of 1976 first enacted the GST tax. Pub. L. No. 94-455, 90 Stat. 1520. Congress designed that tax to approximate the estate or gift tax that would have been imposed if property had been given to the oldest beneficiaries in a trust who were assigned to a generation younger than that of the grantor (referred to as the “deemed transferor”) and then transferred by them to beneficiaries who were assigned to even younger generations. The marginal estate or gift tax bracket of the deemed transferor was then determined to compute the GST tax. See §2602 (1976 version of the GST tax). As the 1986 BLUEBOOK indicates, Congress wanted to simplify the GST tax law adopted in 1976.

The Congress believed, as it stated when the generation-skipping transfer tax originally was enacted in 1976, that the purpose of the three transfer taxes (gift, estate, and generation-skipping) was not only to raise revenue, but also to do so in a manner that has as nearly as possible a uniform effect. This policy is best served when transfer tax consequences do not vary widely depending on whether property is transferred outright to immediately succeeding generations or is transferred in ways that skip generations. The Congress determined that the present generation-skipping transfer tax was unduly complicated. Therefore, the Congress determined that this tax should be replaced with a simplified tax, determined at a flat rate. The Act accomplishes Congress’ goal of simplified administration while ensuring that transfers having a similar substantial effect will be subject to tax in a similar manner.

1986 BLUEBOOK, supra n.39.
fundamental differences between the GST tax law and the estate and gift tax laws. Finally, several of the inconsistencies result from certain elections that the GST tax law allows the taxpayer, such as the elective allocation of GST exemption and the reverse QTIP election. These elections are intended to give the taxpayer flexibility to minimize the GST tax. Nonetheless, these elections are available only for GST tax purposes. Moreover, the increases in planning options add opportunities for tax savings at the same time that they add significant compliance costs. In sum, even if the inconsistencies are explainable on simplification or structural grounds, they nevertheless can lead to unfair results and frequently complicate the administration of the tax.

1. The Annual Exclusion.

Present Law: A transfer of property to a skip person, to the extent it qualifies for the gift tax annual exclusion under §2503(b), can be a nontaxable transfer for GST tax purposes. It is nontaxable, however, only if it is a direct skip made either outright or to a trust for the benefit of only one skip person during that skip person’s life, and, if the trust does not terminate before that skip person dies, the assets of the trust will be includable in the gross estate of that skip person. An outright transfer that qualifies for the annual exclusion under the gift tax law is exempt from taxation under the GST tax law. The problem is that the requirements for exclusion of transfers of interests held in trust under the GST tax law are more limited than the requirements for enjoying the annual exclusion under the gift tax law. The differences between the two sets of qualification rules create confusion and planning traps.

The GST tax and the gift tax laws treat transfers made in trust that are subject to withdrawal rights differently. If a transferor transfers property to a trust and gives the trust beneficiary a properly drafted right to withdraw the property transferred, the gift tax law treats the transfer to the trust as if the transferor had given the property directly to the power holder and allows the transfer to qualify for the gift tax annual exclusion. In contrast, the GST tax law treats a transfer made to a trust that is subject to a right of withdrawal as a transfer to the trust and not as a transfer to the beneficiary with the withdrawal right. The fact that a gift made to a trust that qualifies for the gift tax annual exclusion does not automatically qualify for an exclusion from the GST tax causes significant confusion and complexity.

43 §2642(c). Section 2642(c)(1) assures nontaxability by treating the qualifying direct skips as having an inclusion ratio of zero without using any part of the transferor’s GST exemption.
44 While the transfer is treated the same as if made directly to the power holder for gift tax annual exclusion purposes, it is not so treated for all estate and gift tax purposes. For example, a lapse of the withdrawal right constitutes a lapse of a general power of appointment over a trust and thus is not treated as a contribution of property by the power holder to the extent the lapse falls within the “five or five” exception of §§2541(e) and 2041(b)(2). For further discussion of the gift tax annual exclusion and withdrawal powers, see supra section VII of these options.
45 Such a transfer is a direct skip only if the trust itself is a skip person. §2612(c).
46 The rule that limits the annual exclusion for GST tax purposes is effective for transfers made to trusts after March 31, 1988. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §11703(C)(1), (2), 104 Stat. 1388 (1990), amending §2642(c)(2). For transfers made before that date, if the transfer to the trust qualified for the gift tax annual exclusion, it would not be subject to the GST tax. For transfers made after that date, if the trust is not a qualified trust as described in §2642(c)(2), the GST exemption must be allocated, either by affirmative allocation or pursuant to the automatic allocation rules, to avoid the GST tax.
Reasons for Change: The gift tax annual exclusion is coordinated with the GST tax for some, but not all, transfers, creating unfairness, confusion, and complexity.

Options for Consideration:

a. Exclude from the GST Tax All Transfers That Qualify for the Gift Tax Annual Exclusion. Congress could exclude from the GST tax all transfers that qualify for the gift tax annual exclusion, regardless of whether they are outright transfers or transfers made to trusts and regardless of whether they are direct skips. Congress could implement this rule by repealing §2642(c)(2) which would result in such transfers having an inclusion ratio of zero without requiring the transferors to allocate their GST exemptions to the transfers. The advantage of this approach is that it coordinates the GST tax rule with the gift tax rule by relying on the more familiar rules of the gift tax. Most importantly, it avoids the confusion of having a transfer excluded from gift taxation, yet remain subject to GST taxation.

b. Allow the Annual Exclusion for Gifts Made in Trust Only if the Transfers Meet the Requirements of §2642(c). Congress could allow an annual exclusion for gifts made in trust, but only if the transfers meet the §2642(c) requirements. This approach also would coordinate the gift tax and GST tax rules and eliminate the potential for confusion.

c. Modify the Gift Tax Annual Exclusion and Enact Comparable Rules to Assure Nontaxation Under the GST Tax Law. Congress could adopt new requirements for the gift tax annual exclusion and coordinate the GST tax law accordingly to assure nontaxation under the GST tax law of transfers that qualify for the gift tax annual exclusion.

2. State Death Taxes.

Present Law: Federal estate tax law, as it existed before 2005, allowed a state death tax credit for death taxes paid to states up to an amount set forth under §2011(b). EGTRRA repealed the state death tax credit after 2004. In 2005, the state death tax credit was replaced with a deduction for state death taxes paid, which is provided in §2058. The GST tax law, as it existed before 2005, allowed a credit for state GST taxes under §2604 if a generation-skipping transfer, other than a direct skip, occurred at the same time as, and as a result of, the death of an individual. In that event, §2604 allowed a credit to reduce the federal GST tax equal to the lesser of the GST tax paid to a state or five percent of the federal GST tax. EGTRRA repealed this provision after 2004. The GST tax law does not provide for a deduction for state GST taxes comparable to the deduction for state death taxes it provides under §2058. If a direct skip occurs upon the death of an individual and a state imposes a GST tax on the transfer, the GST tax law does not provide a deduction for state GST taxes resulting from the direct skip. Prior to its

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47 As a corollary, the inclusion ratio of a trust that receives a transfer that qualifies for the gift tax annual exclusion could be computed (or recomputed, as the case may be) as if the GST exemption were allocated to the transfer to the trust in the amount of the transfer that qualifies for the annual exclusion, even though no such exemption, in fact, is allocated.

48 For further discussion of this alternative, see supra section VII of these options.

49 For further discussion of the gift tax annual exclusion and a consideration of possible modifications to it, see supra section VII of these options.

50 §2604(c).
repeal, §2604 did not permit a credit to reduce the federal GST tax for the state GST tax paid on direct skips.

**Reasons for Change:** The failure to provide a credit or a deduction for state GST taxes makes successive transfers of interests held in trust subject to the federal GST tax more expensive than successive outright transfers. The failure to provide a credit or a deduction for state GST taxes resulting from a direct skip treats a direct skip more harshly than other types of generation-skipping transfers and more harshly than if the skip person had received the property as a result of a series of intergenerational outright transfers.

**Options for Consideration:**

a. **Amend the GST Tax Law to Provide for a Deduction for State GST Taxes.** Congress could provide a deduction for state GST taxes, comparable to the deduction under §2058 for state death taxes. Congress could allow the deduction for direct skips occurring upon the death of an individual, as well as taxable terminations and taxable distributions. The advantage of providing a deduction comparable to the one found in §2058 is that it furthers Congress’s goal of creating a unified wealth transfer tax system.

b. **Amend the GST Tax Law to Provide for a Credit for State GST Taxes on a Direct Skip.** Congress could restore and expand §2604 to permit a credit for state GST taxes assessed against a generation-skipping transfer, including a direct skip occurring upon the death of an individual. The advantage of this change is that it eliminates a distinction between direct skips and other types of generation-skipping transfers, and it furthers Congress’s goal of creating a unified wealth transfer tax system.

3. **Assignments of Remainder Interests.**

**Present Law:** The GST tax consequences of a transfer or assignment of a remainder interest are unclear. They appear to depend on whether or to what extent the transfer causes a change in the identity of the transferor of the remainder interest after the assignment. The identity of the transferor is important because the transferor determines the generation assignment of the recipients of the transferred property and, therefore, the eventual GST tax consequences. For reasons discussed below, the analysis of transfers of remainder interests becomes even more uncertain in the case of a sale for adequate and full consideration.

Section 2652(a)(1) provides the general rule that the donor is the transferor “in the case of any property subject to [gift tax],” and the decedent is the transferor “in the case of [estate tax].” There is no direct authority on the extent to which remainder beneficiaries who gratuitously transfer all or a portion of their remainder interests held in trust in a manner that makes the transfers subject to estate or gift tax become transferors of those trusts. Similarly, there is no

51 There may be other ways to analyze the GST tax consequences of an assignment, such as focusing on whether the transferee changes for GST tax purposes. However, example 4 of Treas. Reg. §26.2652-1(a)(5), which concerns a transfer of a term interest held in trust and is the only direct guidance on the GST tax consequences of assignments of interests held in trust, focuses exclusively on the transferor. Additional authority supporting a focus on the transferor and not the transferee is the U.S. Supreme Court’s decision in Blair v. Commissioner, 300 U.S. 5, 12 (1937), which held that, for income tax purposes, the assignee of a trust interest is treated as the trust beneficiary.
direct authority on the extent to which remainder beneficiaries who sell all or a portion of their remainder interests held in trust for adequate and full consideration, and therefore are not subject to estate or gift tax, become transferors of those trusts.

There appears to be three possible ways that an assignment of a remainder interest held in trust can affect the identity of the transferor. One is that the transfer does not affect the identity of the transferor at all—that is, the transferor of the underlying property remains the same. A second possibility is that the individual assigning the remainder interest becomes the transferor of the portion of the underlying property equal to the portion of the remainder interest transferred. Yet a third possibility is that the individual assigning the remainder interest becomes the transferor of a portion of the value of the underlying property based on the relative value of the remainder interest to the full value of the underlying trust property. Under this approach, the individual becomes the transferor of a fraction of the trust, the numerator of which is the actuarial value of the remainder interest and the denominator of which is the full value of the trust property. The distinctions among these three approaches can be best understood by an example.

Example: A transfer of a remainder interest held in trust by the settlor’s child to the settlor’s grandchild. W transfers $100 to a trust to pay a stated dollar amount to her husband, H, for H’s life, and on H’s death to pay all remaining trust property, i.e., the remainder interest, to her son, C, or to C’s estate if C dies before H. If C makes a lifetime gift of his remainder interest held in the trust or, if at C’s death before H, C bequeaths his remainder interest by will to his child, G, C then would have made a taxable transfer for estate or gift tax purposes. Under the estate and gift tax rules, the value of a remainder interest is equal to its actuarial value, unless a specific exception to the use of the actuarial tables applies. If at the time C transfers to G his entire remainder interest by lifetime gift or by will the actuarial value of the remainder is, for example, $15, and none of the exceptions to the use of the actuarial tables apply, C or C’s estate will be subject to estate or gift tax on that $15.

On H’s death, after the lifetime gift or bequest from C to G, the GST tax consequences are uncertain because the trust property passes to G, who is a skip person with respect to W but not with respect to C. The tax results would appear to depend on the extent to which the transferor changes from W to C. With regard to the three choices described above: (i) W would remain the transferor of the entire trust, (ii) C would become the transferor of the entire trust, or (iii) W would

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52 See Treas. Reg. §§20.7520-3 and 25.7520-3 for the exceptions to the use of the actuarial tables. The gift tax zero-valuation rule of §2702 (valuing the term interest at zero and then calculating the value of the remainder interest by subtracting the zero-value term interest from the total value of the trust) is one such exception, and it is cross-referenced in Treas. Reg. §25.7520-3(a)(9). The zero-valuation rule of §2702 does not apply under certain circumstances, including when the trust in which the interest is transferred meets the definition of a “qualified personal residence trust,” when the term interest in the trust is in the form of a qualified annuity or unitrust interest, or when the transferees of the transferred trust interest are nonfamily members.

The preamble to the proposed §§2701 and 2702 regulations (P.S. 92-90, 1991-1 C.B. 998) (as confirmed by the preamble to the final regulations (T.D. 8395, 1992-1 C.B. 316)) provides that §§2701 and 2702 do not apply to the GST tax. For further discussion of the applicability of §§2701 and 2702 to the GST tax, see infra paragraph B.4 of this section VIII.
remain the transferor of 85 percent of the trust \((\$100 - \$15) ÷ \$100\) with \(C\) becoming the transferor of the remaining 15 percent \((100\% - 85\%\)\), based on the relative value of the remainder interest at the time of the transfer.

For different reasons, the GST tax consequences also are uncertain if, instead of \(C\) making a gratuitous transfer, he sells the remainder interest to \(G\) for \$15 when its actuarial value is \$15. \(G\) would have paid adequate and full consideration, and the sale would not be subject to gift tax. As a result of the sale, \(C\) would have received the full benefit of the remainder interest held in trust that gratuitously was transferred to \(C\) by \(W\). For that reason, it may be inappropriate for the trust potentially to be subject to the GST tax at \(H\)’s death, because \(G\) is not a beneficiary with respect to \(W\), the initial transferor. Instead, \(C\), as the recipient of the \$15 from \(G\), would seem to have remained \(W\)’s beneficiary.\(^{53}\) Put differently, for GST tax purposes, \(C\) could be considered to have received a trust distribution of \(C\)’s entire trust interest.\(^{54}\) In the case of a sale, there may be yet a fourth choice—a purchased remainder interest could simply not be subject to the GST tax at all.

The Fifth Circuit Court of Appeals decision in Wheeler v. United States provides support for the proposition that \(C\) becomes the transferor of the entire trust regardless of whether \(C\) transferred the remainder interest by lifetime gift, will, or sale for adequate and full consideration.\(^{55}\) Wheeler holds that the decedent’s sale to his sons in 1984 of a remainder interest in his ranch for its actuarial value “as calculated by the appropriate factor set forth in the Treasury Regulations constitutes an adequate and full consideration under section 2036(a).” The court holds that the sale was sufficient to avoid inclusion of the ranch in the decedent’s gross estate for estate tax purposes under §2036. The court explains that the present receipt of the actuarial value of a remainder interest in property is the economic equivalent of the future receipt of the property itself.\(^{56}\) The court stated:

The sale of a remainder interest for its actuarial value does not deplete the seller’s estate. “The actuarial value of the remainder interest equals the amount

\(^{53}\) For income tax purposes, however, it appears that the purchaser is taxed as a trust beneficiary. See Priv. Ltr. Rul. 95-12-002 (Mar. 24, 1995), in which the Service concluded that the purchaser of a remainder interest is a beneficiary for purposes of §§661 and 662.

\(^{54}\) It follows from this analysis that if \(C\) had been a skip person with respect to the original transferor, the sale could be treated as a taxable distribution, giving rise to a GST tax at that time. Thus, if the facts concerning the remainder had been reversed so that \(G\) or \(G\)’s estate was the named remainder beneficiary and \(C\) had purchased \(G\)’s interest at its full actuarial value, then \(G\) should be considered to have received a taxable distribution equal to the proceeds of the sale.

\(^{55}\) 116 F.3d 749 (5th Cir. 1997). Estate of D’Ambrosio v. Commissioner, 101 F.3d 309 (3d Cir. 1996), cert. denied, 520 U.S. 1230 (1997), and Estate of Magnin v. Commissioner, 184 F.3d 1074 (9th Cir. 1999) both reached the same result as Wheeler on the same issue. All three courts criticized Gradow v. United States, 11 Cl. Ct. 808 (1987), aff’d, 897 F.2d 516 (Fed. Cir. 1990), which had reached the opposite conclusion on the same issue.

\(^{56}\) 116 F.3d at 767. The 1984 transfer took place seven years before the decedent’s death. The decedent retained a life estate in the ranch. Section 2702 did not apply because the sale took place before §2702’s effective date; §2702 is inapplicable to transfers made on or before October 8, 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, §11602(c), 104 Stat. 1388 (1990). Nevertheless, it appears that the court’s reasoning remains applicable to cases subject to §2702.
that will grow to a principal sum equal to the value of the property that passes to the remainderman at termination of the retained interest. To reach this conclusion, the tables assume that both the consideration received for the remainder interest and the underlying property are invested at the table rate of interest, compounded annually.” [Martha W. Jordan, Sales of Remainder Interests: Reconciling Gradow v. United States and Section 2702, 14 VATAX REV. 671, 692–93 (1995), citing Keith E. Morrison, The Widow’s Election: The Issue of Consideration, 44 Tex. L. Rev. 223, 237–38 (1965)]. In other words, the actuarial tables are premised on the recognition that, at the end of the actuarial period, there is no discernible difference between (1) an estate holder retaining the full fee interest in the estate and (2) an estate holder retaining income from the life estate and selling the remainder interest for its actuarial value—in either case, the estate is not depleted. This is so because both interests, the life estate and the remainder interest, are capable of valuation. Recognizing this truism, the accumulated value of a decedent’s estate is precisely the same whether she retains the fee interest or receives the actuarial value of the remainder interest outright by a sale prior to her actual death.57

Although Wheeler involved a sale, the same reasoning would indicate that, if discrepancies in the transfer tax rates are ignored, a present payment of an estate tax or gift tax based on the actuarial value of a remainder interest is the equivalent of a future payment of GST tax based on the full value of the property—that is to say, the GST tax that would have applied when the remainder beneficiary would have come into possession of the property upon the termination of the prior possessory interest. Therefore, it would be consistent with the reasoning of Wheeler to change the transferor of the entire trust in the above example from W to C, regardless of whether the remainder interest is subject to an estate tax, subject to a gift tax, or sold for an amount equal to its value determined for estate or gift tax purposes.

In Private Letter Ruling 2001-07-015, the Service, however, reaches a different conclusion.58 It adopts the third possibility, i.e., that the transferor of the remainder interest becomes the transferor of only a fraction of the underlying property, based on the ratio of the actuarial value of the remainder interest to the full value of the underlying property. This private ruling involved the transferor’s child assigning a vested remainder interest in a charitable lead annuity trust to the child’s children (the grandchildren of the original transferor). The Service ruled that the child of the original transferor would become the transferor over only the portion of the trust represented by the actuarial value of the remainder interest at the time of the assignment. The transferor would not change with respect to the remaining portion of the trust.

There is yet a third source of authority for the treatment of assignments of remainder interests. It is example 4 of Treasury Regulation §26.2652-1(a)(5), involving the transfer of an income interest, which is quoted below:

T transfers $100,000 to a trust providing that all of the net income is to be paid to T’s child, C, for C’s lifetime. At C’s death, the trust property is to be paid to T’s

57 116 F.3d at 762.
grandchild. C transfers the income interest to X, an unrelated party, in a transfer that is a completed transfer for Federal gift tax purposes. Because C’s transfer is a transfer of a term interest in the trust that does not affect the rights of other parties with respect to the trust property, T remains the transferor with respect to the trust.

The application of the example to a transfer of a remainder interest (as opposed to an income interest) is susceptible to several interpretations and leaves a number of unanswered questions. A possible negative implication of the last sentence of the example is that, if the interest transferred is not a term interest, or if it does “affect the rights of other parties with respect to the trust property,” T would not remain the transferor with respect to the entire trust. Of course, the example does not explain to what extent, if any, the transferor would change under these circumstances. Nor does it provide any guidance as to when a transfer of a trust interest would be considered to “affect the rights of other parties with respect to the trust property.”

The statement that there is no change in the transferor of the property remaining in the trust also leaves unaddressed the GST tax consequences of the gift of the income interest. Presumably, there is a change in the transferor with respect to that interest. For example, if X, the person to whom C assigned the income interest, is in the same generation as C’s child and thus the generation of T’s grandchild, the transfer of the income interest by C to X should not be a direct skip from C, and the distributions of income to X should not be taxable distributions. It is possible that such a transfer by C could be treated as a taxable termination and then, under the move-down rule of §2653, the transferor would be assigned to C’s generation, even though C does not become the transferor of any portion of the trust. Subsequent distributions to X would not be taxable distributions once a taxable termination occurs and the transferor is reassigned to C’s generation. If X were in the same generation as C’s grandchildren, then, presumably, C’s transfer of the income interest would have constituted a direct skip; however, if the transfer were a sale, under §2624(d), the direct skip would be reduced by the consideration paid by the transferee.

**Reasons for Change:** The GST tax consequences of a transfer of a remainder interest are unclear, and the GST tax rules regarding the transfer of a remainder interest may not conform to the estate tax and gift tax laws.

**Options for Consideration:** Possible Clarification of the GST Tax Law to Conform to the Estate and Gift Tax Laws by Treating the Actuarial Value of a Remainder Interest as the Full Value of the Underlying Property Encumbered by the Term Interest. Congress could provide by statute that, for the purpose of the GST tax, the transfer of a remainder interest changes the transferor of the underlying property to the extent of the portion of the remainder interest transferred, whether the transfer is subject to the estate or gift tax or would be subject to the estate or gift tax but for the receipt of adequate and full consideration. Even without a statutory change, Treasury could achieve this result through regulations. It could adopt this rule for transfers subject to the estate or gift tax. It also could provide that, if a transfer is not subject to the estate or gift tax because the transferor received full consideration (as determined under §7520, if applicable), then the GST tax would cease to apply to the devolution of the remainder interest (or the portion of the remainder interest transferred for full consideration). In addition, Treasury could revise the regulations to treat beneficiaries who sell a portion or all of their
remainder interests held in trust as having received a distribution equal to the consideration received.

4. §§2701 and 2702.

Present Law: Sections 2701 and 2702 provide special methods for the purpose of valuing a transfer for gift tax purposes. If §§2701 and 2702 apply, the value on which the gift tax must be paid can be greater than the fair market value of the interests in the property that the donor transfers. Both §§2701 and 2702 apply “solely for purposes of determining whether a transfer [of certain property interests to or for the benefit of certain donees] is a gift (and the value of such transfer).”

Section 2612(c) provides that a transfer to a skip person subject to gift tax is a direct skip. Section 2623 provides that the taxable amount of a direct skip upon which the GST tax is to be paid is “the value of the property received by the transferee.” If a donor allocates the GST exemption on a timely filed gift tax return or the GST exemption is deemed allocated to a lifetime transfer by reason of the automatic allocation rules, the GST tax rate applicable to any resulting generation-skipping transfer is determined according to an inclusion ratio. Under §2642(b)(1)(A), the inclusion ratio is determined with reference to the “value of the property . . . as finally determined for purposes of chapter 12 [the gift tax].” If §§2701 and 2702 apply only for gift tax purposes, it appears that the value on which the law determines a donor’s gift tax liability may not be the value on which the law determines, for GST tax purposes, either the taxable amount or the inclusion ratio, which in turn, under §2641, determines the GST tax rate.

Neither the Code nor the regulations address whether the value determined under §2701 or §2702 applies for GST tax purposes. The GST tax regulations do not address this question, notwithstanding that Treasury adopted them after the regulations under §§2701 and 2702. Whenever, for GST tax purposes, the value of property is based on the value at the time of the gift, a lack of symmetry between the value used for gift tax purposes and the value used for GST tax purposes will cause complexity and confusion. If a special value that is greater than fair market value is warranted for gift tax purposes, it is hard to see how that special value also would not be appropriate for GST tax purposes.

Reasons for Change: The Code and regulations are unclear as to whether the special valuation rules of §§2701 and 2702 apply to determine GST tax liability.

Options for Consideration: Possible Change to Clarify That §§2701 and 2702 Apply to Determine the GST Tax Liability on a Direct Skip. Congress or Treasury could clarify that §§2701 and 2702 apply to establish the value of property for the purpose of determining the GST tax on a direct skip, but not to other types of generation skipping transfers. This means that the special valuation rules would apply for the purpose of determining the taxable amount under §2623 and the inclusion ratio on a direct skip under §2642(b)(1)(A). If §§2701 and 2702 were to apply to other types of transfers, taxpayers could avoid their application by making a late
allocation of their GST exemptions, which simply would result in greater complexity in the operation of the GST tax law.

5. **Portability of GST Exemption.**

*Present Law:* Although §303 of TRA 2010 provides for portability of the unified credit between spouses, it does not provide for portability of the GST exemption.

*Reasons for Change:* The GST tax law, in not allowing portability of unused GST exemption, does not conform to the estate tax and gift tax laws and causes confusion and complexity. Many married couples engage in sophisticated planning techniques and frequent reallocation of assets to assure that each spouse can take full advantage of the GST exemption (as well as the unified credit).

*Options for Consideration:* Possible Legislative Change to Allow Portability of Unused GST Exemption Between Spouses. Congress could allow the unused GST exemption of the first spouse to die to be available as an additional GST exemption amount to the surviving spouse.

C. **Generation Assignments of Persons Unrelated to the Transferor.**

*Present Law:* Section 2651(d) assigns unrelated persons to generations based on age for the purpose of applying the GST tax. Section 2651(d)(1) assigns a person who is not more than 12 ½ years younger than the transferor to the transferor’s generation. Section 2651(d)(2) assigns a person who is more than 12 ½ years but not more than 37 ½ years younger than the transferor to the same generation as the transferor’s child. Section 2651(d)(3) assigns a person who is more than 37 ½ years but not more than 62 ½ years younger than the transferor to the same generation as the transferor’s grandchild, and so forth. Put differently, the generation assignment rules treat each generation as 25 years long, but place the transferor in the middle of the transferor’s generation.

This means that the GST tax currently applies to transfers to nonrelatives, if the transferee is more than 37 ½ years younger than the transferor. In reality, a person who is slightly more than 37 ½ years younger than another person is not likely to be two generations younger than that other person. If a typical generation is 25 years long, then it would seem that the generation assignment rules would consider only persons more than 50 years younger than the transferor to be skip persons. The concern about the generation assignment rules arises only if the GST tax continues to apply to transfers to unrelated persons.

*Reasons for Change:* If the typical generation is 25 years long, the generation assignment rules assign nonrelatives to more remote generations than they should be assigned.

*Options for Consideration:* Possible Change to the Generation Assignment Rules for Unrelated Persons. Congress could consider amending §2651(d) and assign all unrelated persons not more than 25 years younger than the transferor to the transferor’s generation, all unrelated persons more than 25 years but less than 50 years younger than the transferor to the same generation as the transferor’s child, and all unrelated persons more than 50 years but not more

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62 See also *supra* section III of these options.
than 75 years younger than the transferor to the same generation as the transferor’s grandchild, and so forth. The effect of this change would be to place the transferor at the beginning of the transferor’s generation, rather than in the middle. This more liberal generation assignment rule is unlikely to lead to abuse, because transferors presumably would not make transfers to unrelated persons to avoid an estate or gift tax at the generation of those transferees’ parents.

D. GST Tax Planning Completed While EGTRRA in Effect.

Present Law. EGTRRA introduced a host of provisions aimed at simplifying taxpayer compliance with the GST tax and reducing traps for the unwary. Many of these provisions are related to the allocation of the GST exemption, which is discussed separately under paragraph E below. Apart from the exemption-allocation items, EGTRRA introduced two significant modifications to the GST tax regime: (1) substantial increases in the GST exemption (which were continued as part of TRA 2010) and (2) the ability to sever a trust through a qualified severance.

EGTRRA provided for staggered increases in the GST exemption, reaching $3.5 million for 2009 prior to the repeal of the GST tax in 2010. TRA 2010 retroactively reinstated the GST tax for 2010 but preserved the benefit of repeal for 2010 by assigning an applicable rate of zero to all generation-skipping transfers occurring that year. Following 2010, the applicable rate returned to its regular definition under §2641(a) (that is, the maximum estate tax rate multiplied by the inclusion ratio), but Congress increased the GST exemption to $5 million for 2011 and 2012.

In light of the significant increases in the GST exemption introduced by EGTRRA and augmented by TRA 2010, taxpayers could take advantage of these increased levels by making generation-skipping transfers or establishing GST trusts to which GST exemption was fully allocated. For instance, a taxpayer in 2009 could have transferred $3.5 million to a trust for the benefit of her children and grandchildren, allocating $3.5 million of GST exemption to the trust (assuming no prior use of the GST exemption) and thereby rendering the trust forever exempt from GST tax. In 2011, the same transferor could have transferred an additional $1.5 million to the same trust, allocating another $1.5 million of GST exemption that was made available under TRA 2010. Alternatively, a taxpayer in 2010 could have made a direct-skip transfer of an unlimited amount to a trust for the exclusive benefit of her grandchildren (so that the trust constituted a skip person), and any future distributions to those grandchildren would be exempt from GST tax as a result of the generation reassignment of the transferor under §2653(a). In this manner, taxpayers reasonably undertook planning designed to capture the benefits of the increased GST exemption and the one-year effective suspension of the GST tax by creating trusts that appeared immune from GST tax under the law as then in effect.

In addition to the increased GST exemption levels, EGTRRA introduced the concept of a qualified severance into the GST tax regime. A qualified severance constitutes division of a single trust (having an inclusion ratio between zero and one) into two trusts, one having an inclusion ratio of zero (and therefore fully exempt from GST tax) and the other having an inclusion ratio of one (and therefore fully subject to GST tax on any generation-skipping transfers from the trust). Obtaining a qualified severance of a single trust permits taxpayers to make effective use of the GST exemption by causing distributions to or for the benefit of a non-
skip person to be made from the non-GST-exempt trust, thereby preserving the GST-exempt trust for the benefit of skip persons. Additionally, severing a single trust into exempt and non-exempt portions permits the trustee to pursue differing investment strategies tailored to the needs of skip persons and non-skip persons, respectively. In short, the qualified severance technique affords taxpayers the ability to undertake post-transfer GST tax planning that was not undertaken by the transferor, either due to failure to consider the effect of the GST tax or the transferor’s belief that her estate would not exceed the prevailing GST exemption.

**Reasons for Change:** There is significant uncertainty regarding the status of GST planning completed while EGTRRA was in effect. EGTRRA’s sunset rule, as amended by the TRA 2010, states that the GST tax laws apply to transfers after 2012 as if EGTRRA “had never been enacted.” The breadth of this language creates considerable concern that the simplification and relief measures introduced by EGTRRA and extended by TRA 2010—on which taxpayers reasonably relied—could be ignored altogether following 2012. As a result, the long-term effect and validity of certain GST planning implemented between 2001 and 2013 is unclear.

**Options for Consideration:** Possible Clarification of the Effect of the EGTRRA Sunset Provision on GST Planning Completed Between 2001 and 2013. Congress could consider clarifying, by statute, the effect and validity after 2012 of GST planning implemented pursuant to EGTRRA between 2001 and 2013. Specifically, Congress could clarify that prior allocations of GST exemption in excess of the 2013 GST exemption will be respected. In addition, Congress could clarify that qualified severances under §2642(a)(3) will still be respected after 2012, even if that provision is not maintained.

**E. Procedures for Allocating and Administering the GST Exemption.**

**Present Law:** GST tax planning is centered on the allocation of the transferor’s GST exemption. A timely allocation of GST exemption to a trust that will yield generation-skipping transfers in the future operates to shield appreciation in the trust assets from future GST taxation. To permit a greater number of taxpayers—particularly those who did not have the benefit of professional advice—to enjoy the benefits of a timely allocation of GST exemption to trusts, Congress enacted §2632(c) as part of EGTRRA to allocate automatically the transferor’s GST exemption to transfers in trust in a timely manner. Broadly speaking, these automatic allocation provisions of §2632(c) are designed to allocate exemption to those trusts that possess a sufficient likelihood of yielding a generation-skipping transfer in the future. If a transferor does not wish to have her GST exemption automatically allocated in this manner, the transferor may elect out of the automatic allocation under §2632(c), on a transfer-by-transfer basis.

Another significant taxpayer benefit provided by Congress through EGTRRA, relating to allocation of the GST exemption, is the potential for a retroactive allocation of GST exemption pursuant to §2632(d). Suppose a transferor created a standard trust for the benefit of the transferor’s child that called for the trust assets to be distributed to the child upon the attainment of a specified age (say, 35). If the child were to die prior to attaining that age, the trust calls for the assets to be distributed to the child’s then living issue. Upon funding the trust, it would not be advisable to allocate GST exemption to the trust due to the likelihood of a terminating distribution in favor of a non-skip person. If the child were to predecease the transferor, however, the termination of the trust in favor of the child’s issue would constitute a taxable
termination subject to GST tax in full. To avoid this unfortunate result, §2642(d) permits the transferor to make an allocation of GST exemption to the trust following the death of the non-skip person (the child) and, importantly, the allocation is treated as having been made on a timely gift tax return in the year the trust was funded. As a result, the allocation of GST exemption will operate to shield any investment growth in the trust from the year of funding.

As a final matter, Congress provided taxpayers with an avenue to seek relief from late allocations of GST exemption under §2642(g) (commonly referred to as “9100 relief”). The provision authorizes the Service to grant discretionary relief after taking into account all relevant circumstances relating to the otherwise late allocation.

Reasons for Change: The changes that Congress made concerning the allocation of the GST exemption under EGTRRA will sunset after 2012, unless they are made permanent. These are welcome changes that simplify GST tax planning and protect against unintentional and costly mistakes by taxpayers.

Options for Consideration: Consider Making Permanent the GST Simplification Provisions of EGTRRA. Congress could retain the EGTRRA changes to the procedures for allocating and administering the GST exemption, specifically the provisions regarding (i) deemed allocations of GST exemption, (ii) elections in and out of automatic allocations, (iii) retroactive allocation of GST exemption in the case of a death of a non-skip person, and (iv) “9100 relief.”

IX. Inter Vivos QTIP Elections.

Present Law: Section 2523(f) allows a gift tax marital deduction for property transferred to a QTIP (an acronym for “qualified terminable interest property”) trust, but only to the extent the donor spouse so elects on a gift tax return. Taxpayers have had difficulty properly making the election on gift tax returns and the Service has routinely granted relief if the relief is applied for within six months of a timely filed return. The Service has determined that, due to the statutory language of the gift tax QTIP provision, it does not have the authority to grant relief for failure to properly elect QTIP treatment on a gift tax return beyond the six month period. This is inconsistent with the QTIP election for estate tax purposes, regarding which the Service has clear regulatory authority under the Treasury Regulations to grant relief at any time after the making of the election, without limitation imposed by the statutory language of the estate tax QTIP provision.

We believe that a legislative change to allow the Service to grant relief for failure to make a QTIP election on a gift tax return beyond the six month period following the timely filing of the return may be desirable and believe that Congress could consider two alternatives for such legislation.

Reasons for Change: A marital deduction is allowed for transfers to QTIP trusts for both estate tax purposes (under §2056) and for gift tax purposes (under §2523), provided an election is made on a timely filed return. In the estate tax area, §2056 does not expressly contain the
requirement that the election be made on a timely filed return.\textsuperscript{63} Instead, that is a requirement of the Treasury Regulations (Treas. Reg. §20.2056-7(b)(4)) and, therefore, the Service is also given discretion under the Regulations to grant relief to taxpayers to make late elections, known as “Section 9100 Relief” (Treas. Reg. §301.9100-2).

By contrast, in the gift tax area, §2523(f)(4)(A) expressly requires that the election for a QTIP marital deduction be made “on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer.” The Service has taken the position in numerous private letter rulings that this statutory language restricts it from granting Section 9100 Relief because that relief is available only for extensions of time fixed by regulations or other published guidance.

The problem presented by this inconsistency is a real one. Taxpayers have difficulty making the election on returns either because of oversight or because they mistakenly believe that the election is made by merely claiming the marital deduction. Section 9100 Relief is available in these circumstances for estate tax QTIP elections and for GST tax “reverse QTIP” elections, but not for the gift tax QTIP election. There is no rational basis for this difference and it would be good tax policy and true tax simplification to amend §2523(f) to bring the gift tax back in line with the other transfer taxes in this regard. The interests of the federal government would not be prejudiced by this change. Allowing the Service to grant relief would merely put taxpayers in the same position, not a better one, than they would have been had they made a timely election.

\textit{Options for Consideration}: In light of the above, we set forth two alternative legislative proposals for consideration.

1. The first proposal is to restructure the language in §2523(f)(4) to make it consistent with the language under §2056(b)(7)(B)(v) that provides for the making of the QTIP election on an estate tax return. Such restructuring would eliminate the separate heading of §2523(f)(4)(A) for “Time and Manner” of making the election and the separate heading under §2523(f)(4)(B) for “Election Irrevocable” in favor of the language of §2056(b)(7)(B)(v) that combines the authority to make the election with the statement that the election is irrevocable. This restructuring would eliminate the current language in §2523(f)(4)(A) that contains the statutory time restriction for making the election. The time restriction would then become regulatory under Treas. Reg. §25.2523(f)-1(b)(4), and the Service would then have the ability to grant Section 9100 Relief in the gift tax area, just as in the estate and GST tax areas.

Under this proposal, §2523(f)(4) would read:

\begin{quote}
“(4) \textit{Election. -- An election under this subsection with respect to any property shall be made on the return of tax imposed by section 2501. Such an election, once made, shall be irrevocable.”}
\end{quote}

\textsuperscript{63} Section 2056(b)(7)(B)(v) provides, “Election. – An election under this paragraph with respect to any property shall be made by the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable.”
2. The second legislative alternative would be to include in §2523(f) the express authority for the Service to grant extensions of time to make the QTIP election for gift tax purposes

Under this proposal, a new §2523(f)(7) would be added to read:

“(7) Relief From Late Elections. The Secretary shall prescribe by regulation such circumstances and procedures under which extensions of time will be granted to make an election in paragraph (4) of this subsection. Such regulations shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of this paragraph. For purposes of determining whether to grant relief under this paragraph, the time for making the election shall be treated as if not expressly prescribed by statute.”

We believe the first legislative proposal (under paragraph 1. above) is preferable because (i) it is consistent with the statutory and regulatory scheme for making the QTIP election for estate tax purposes and (ii) does not require the issuance of additional regulations.

X. Marital Deduction and Charitable Giving

A. Marital Deduction for Spouse’s Interest in CRT

Present Law: Section 2056(b)(8) provides an estate tax marital deduction for the donee spouse’s interest in a qualified charitable remainder trust. The parallel gift tax section, §2523(g), provides a marital deduction for gift tax purposes as well. Both of these provisions provide that in the case of a spousal interest in a qualified charitable remainder trust, the disallowance of a marital deduction for terminable interest property shall not apply. As a result, the marital deduction for a spouse’s interest in a qualified charitable remainder trust is “automatic,” meaning that one need not make an election for marital deduction treatment. There is a trap, however. Both of these sections provide a marital deduction for a spouse’s interest in a qualified charitable remainder trust only if, after the transfer, “the donee spouse is the only non-charitable beneficiary other than the donor.” Consequently, where there is a non-charitable beneficiary other than the donee spouse, no gift or estate tax marital deduction is allowable for the spouse’s interest, even though the actuarial value of all of the interests can be easily determined. These sections deny, therefore, a marital deduction to the donor to a charitable remainder trust for the joint lifetime of the donor and the donor’s spouse, followed by the donor’s elderly parent.

The Service confirmed this reading in Private Letter Rulings 8742001 and 8730004 and in the subsequent final regulations.

“In the case of a charitable remainder trust where the decedent’s spouse is not the only non-charitable interest beneficiary (for example, where the non-charitable interest is payable to the decedent's spouse for life and then to another

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64 An income tax charitable deduction will still be available for the charitable remainder and the trust will be a qualifying charitable remainder trust, but no marital deduction will be allowed.
individual for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2056(b)(7) and not under section 2056(b)(8).”  Reg. §20.2056(b)-8.

Reasons for Change: It is difficult to discern a policy justification for denial of the marital deduction in this situation for the portion of the trust passing to the surviving spouse. A strong argument can be made that a donor wishing to create a charitable remainder trust for her spouse and then for her aged parent if living should be allowed a marital deduction for the spouse’s interest, a charitable deduction for the remainder and be subject to estate tax on the parent’s survivorship interest. The present statutes are largely a trap for the unwary, because the same estate tax treatment can be achieved by the less satisfactory drafting solution of a QTIP trust for the surviving spouse followed by a charitable remainder trust for the third beneficiary -- a cumbersome solution.

Options for Consideration: We suggest that Congress consider amending §2056(b)(8)(A) as follows:

(A) In general. If the surviving spouse of the decedent is a beneficiary of a qualified charitable remainder trust, paragraph (1) shall not apply to any interest in such trust which passes or has passed from the decedent to such surviving spouse.

If such an amendment is made, a parallel amendment should be made to §2523(g)(3) for gift tax purposes.


Present Law: The marital deduction rules for a spouse’s interest in a split interest charitable gift which is not a qualified charitable remainder trust are unnecessarily complex. A bequest of a remainder interest in a personal residence to charity, reserving a prior life estate for the donor’s spouse, qualifies for the estate tax marital deduction, but only by virtue of the QTIP rules and only if the personal representative remembers to treat it as such on Schedule M of the federal estate tax return. The spouse will not receive income from the property, but the regulations under §2056(b)(7) confirm that a marital deduction is available for the surviving spouse’s legal life estate in the personal residence. See Reg. §20.2056(b)-6(g)—Example (1):

“Life estate in residence.  D owned a personal residence valued at $250,000 for estate tax purposes.  Under D’s will, the exclusive and unrestricted right to use the residence (including the right to continue to occupy the property as a personal residence or to rent the property and receive the income) passes to S for life.  At S’s death, the property passes to D’s children.  Under applicable local law, S must consent to any sale of the property.  If the executor elects to treat all of the personal residence as qualified terminable interest property, the deductible interest

65 The actuarial value of the parent’s survivorship interest is easily calculated by computing first the two-life value of the unitrust or annuity trust interest and then subtracting the one-life value of the spouse’s interest. Provision would need to be made in the instrument for payment of tax on the parent’s interest from other assets, as is already required in two-life inter vivos charitable remainder trusts.
is $250,000, the value of the residence for estate tax purposes.”

The marital deduction should be automatic in this case, as it is for the spouse’s interest in a charitable remainder trust. It is difficult to imagine a case when an executor would not want the marital deduction in this situation.

More typically, a married couple will own a residence jointly and transfer the residence to charity reserving a prior life estate for the couple. In order to achieve the desired result that the interest transferred is not considered a taxable gift or bequest that fails to qualify for the marital deduction, the requirements are Byzantine – and appear unnecessary. If the property is jointly held by a married couple, the couple may deed the property to charity reserving for themselves a legal life estate. Each spouse is making a gift to the other spouse of his or her survivorship interest, but no lifetime QTIP election under §2523 can be made for that interest because of the requirement that no person other than the spouse may have an interest in the property during the lifetime of the spouse. Here, the donor spouse has an intervening interest and thus the marital deduction for the donee spouse’s interest is not available. Where the property is titled in the name of one spouse only, the same problems arise.

Reasons for Change: In order to avoid adverse tax consequences from a transfer of a residence to charity reserving a prior life estate in a married couple, it appears that the taxpayer must engage in careful planning. Thus, where the donor spouse owns the entire residence, the deed transferring the property to charity with the life estate in both spouses must permit the donor spouse to revoke the successor beneficiary spouse’s interest by will in order to prevent a completed gift to the spouse for gift tax purposes. This is necessary because no gift tax marital deduction is available for the spouse’s interest because of the intervening interest of the donor spouse. Where the property is held jointly, the deed must provide that each spouse reserves the right by will to revoke the surviving spouse’s survivorship interest in the first spouse’s contribution. When the first spouse dies, his or her interest will be includable in his or her estate and only by virtue of QTIP eligibility will an estate tax marital deduction be available for the surviving spouse’s interest. Even these actions may not be enough, however. In order to qualify as qualified terminable interest property for which a marital deduction is available, the surviving spouse must have what under state law is equivalent to a legal life estate. A right to occupy the residence is not enough to qualify. In the regulation quoted above, the spouse also had the right to rent the property. The extent of rights in a legal life estate is a question of state law. In Private Letter Ruling 9033004, the Service noted that use must include both the right to occupy the property as a personal residence and the right to convey the life estate to others. Accordingly, the deed must make clear that what is being retained is a full legal life estate, including the right to occupy the property, lease the property and convey the life interest. Merely reserving the right to use and occupy the property may be insufficient in many states to obtain a marital deduction.

All of this complexity creates a trap for the unwary without any discernible policy rationale. The marital deduction could be made automatic in this case, as it is with the charitable remainder trust, and available even if both spouses have an interest in the property.

66 §2523(b).
Options for Consideration: Congress could consider amending §2056(b)(8) so that the marital deduction rules for gifts of remainder interests in a personal residence or farm parallel the rules applicable to spousal interests in a qualified charitable remainder trust which provide an automatic marital deduction for the spouse’s survivorship interest. A similar change could be made to provide for an automatic marital deduction for a spouse’s survivorship interest in a pooled income fund.