Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2769

Date:16-Dec-19

Subject: Mike Jones and DeeAnn Thompson – Final Regulations Governing Deceased Spousal Unused Exclusion Amount and the Basic Exclusion Amount

"Shifting future growth out of an estate has always been an effective course to take. The specter of the 2026 tax cliff warrants greater planning urgency. Also, in order to avoid application of transfer taxes to valuation increases, clients should consider making gifts sooner rather than later. For example, $1 million growing at an after-tax rate of return of just 3% from January 1, 2020 to December 31, 2025 (5 years) will increase in value by $159,247. Getting that growth out of an estate saves 40% of that amount, or $63,710."

Mike Jones and **DeeAnn Thompson** provide members with their analysis of newly-issued final treasury regulations governing the estate and gift tax Deceased Spousal Unused Exclusion Amount and the basic exclusion amount.

Michael J. Jones, CPA is a partner in Monterey, California's Thompson Jones LLP. His tax consulting practice focuses on tax-efficient wealth transfer strategy, maximizing the value of inherited retirement benefits, trust and probate tax matters (both administration and controversy resolution), and family business transitions. Mike is the author of four books, including Inheriting an IRA and Inheriting an IRA Professional Edition. He has written over 160 articles published in Trusts & Estates, Leimberg Information Services, Inc., Ed Slott's IRA Newsletter and elsewhere. He serves as chair of Trusts & Estates magazine's Retirement Benefits Committee and the CPE Forum of the Central Coast. He has lectured across the U.S. for Jerry A. Kasner Estate Planning Symposium; Southern California Tax & Estate Planning Forum, Hawaii Tax Institute, AICPA Advanced Estate Planning Conference, AICPA Conference on Tax Strategies for the High-Income Individual, UCLA-CEB Estate Planning Institute, New York University Institute on Federal Taxation, CEB Estate Planning and Administration Annual Updates panels, and others. He has been quoted in Natalie Choate's Life and Death Planning for Retirement Benefits, Keith Schiller's Estate Planning At The Movies® — Art of the Estate Tax Return, New York Times, Forbes Magazine, The Wall Street Journal, and Bloomberg Financial Report. Mike is also a musician, avid prone paddleboarder, and surfer.

DeeAnn L. Thompson, CPA focuses her practice on estate planning. In her forty-plus years of experience as a CPA, she has developed her skills to tackle complex problems in detail and produce user-friendly analysis. In her thirteen years with two family wealth management offices, her primary responsibilities involved client relations and coordination of all aspects of financial, estate, and tax planning; risk management; trust administration; and financial education. DeeAnn is a member of the board of directors for Harmony At Home and serves on the Investment Advisory Committee for the Hospice Giving Foundation in Monterey. She relishes a good mystery novel and enjoys knitting and cooking.

Here is their commentary:

EXECUTIVE SUMMARY:

A "unified credit" against federal estate or gift taxes is available under Internal Revenue Code Sections 2010 and 2505, respectively. The amount of the unified credit is equal to the tax on the donor's or decedent's own applicable exclusion amount, referred to as the "basic exclusion amount" (BEA). Ignoring inflation adjustments, the BEA was $5 million before 2018. Beginning with 2019, the BEA became $10 million, but will return to $5 million after 2025. The estate tax credit cannot exceed the estate tax. In addition, the unused amount of a deceased spouse's exclusion ("DSUE") amount may be ported to the decedent's surviving spouse by making an election.

Final Treasury Regulations governing BEA have been issued. There will be no so-called clawback of presently-enhanced BEA used to shelter gifts from gift tax when the donor dies after 2025. In other words, a gift sheltered by BEA will continue to be sheltered, regardless of whether the donor dies after 2025. The preamble observes that Congress granted Treasury regulatory authority to insure that there will be no imposition of estate tax on inter vivos gifts that were sheltered from gift tax by the increased BEA in effect at the time when gifts are made.

The new rules include DSUE provisions. The key part of this ruling limits the applicable exclusion amount for a surviving spouse who dies after 2025 to $10 million, comprised of the surviving spouse's $5 million BEA and the deceased spouse's DSUE. The regulations also provide an ordering rule: DSUE ported to the surviving spouse must first be fully absorbed by the surviving spouse's lifetime gifts before the surviving spouse's lifetime gifts may be sheltered by the surviving spouse's own BEA. Thus, this ordering rule tends to place BEA in excess of $5 million at risk.

FACTS:

DSUE

A surviving spouse who makes gifts, or the estate of the surviving spouse, is entitled to apply, in addition to the surviving spouse's own basic exclusion amount ("BEA"), the deceased spouse's unused exclusion amount ported to the surviving spouse ("DSUE") amount, so that the sum of both spouses' basic exclusions may potentially be used in entirety, regardless of which spouse survives.

Ordering rules added at Treasury Regulations section 20.2010-1(c)(1)(ii)(A) provide that DSUE will apply to a surviving spouse's own gifts before gifts can utilize the surviving spouse's own BEA. For a surviving spouse who remarries and dies after 2026 but before the new spouse does, that rule will tend to preserve the surviving spouse's own BEA. That's helpful because DSUE remaining upon the death of the surviving spouse can't be ported to benefit the spouse of a subsequent marriage.

The Internal Revenue Code doesn't specify the period of time within which an estate may make a DSUE election – setting the due date was delegated to Treasury. Under previously issued regulations, a DSUE election was to have been made on a timely filed estate tax return, including extensions.

In cases where an estate tax return is <u>required to be filed,</u> the newly-finalized DSUE regulations observe and recognize that extensions of time to elect DSUE may not be granted. That's because the election's due date is set by statute, and not by regulation. But, the final regulations recognize that extensions of time may be granted, where the estate tax return *isn't* required be filed. The basis for requesting relief for regulatory elections, including the DSUE election, is provided in Treasury Regulations section 301.9100-3. The preamble includes a reminder that relief may instead be available under Notice 2012-21 and Revenue Procedure 2014-18.

The preamble notes that an effective portability election is made where a complete and properly prepared estate tax return is filed, and the amount of tax reported is zero – in other words, in that case, an automatic election occurs. Of course, the better practice is to make an affirmative election, report the amount of DSUE on the decedent's estate tax return, and alert the surviving spouse to the election.

The preamble acknowledges that it isn't necessary to file a protective claim for refund to preserve the right to make a DSUE election. Note that, if a supplemental estate tax return is later filed increasing or decreasing the deceased spouse's taxable estate, the amount of DSUE must be adjusted accordingly.

Qualified Domestic Trusts

The presence of Qualified Domestic Trusts suspended application of DSUE under the proposed regulations until the surviving spouse died, since the taxable estate and resulting estate tax couldn't be finally determined as long as QDOT taxes might be incurred. The final regulations introduce an additional rule: automatic suspension of time to make a DSUE election terminates when both of two events have occurred: the surviving spouse becomes a U.S. citizen; and no further QDOT tax can be assessed as a result of lifetime QDOT distributions to the surviving spouse.

After Sunset

The final regulations make it clear that, after 2025, when the 2018 Act sunsets, DSUE originating in prior years won't be limited to the amount of the post-2025 basic exclusion amount. The surviving spouse's $5 million BEA, plus all DSUE will be available to the surviving spouse's estate. Accordingly, DSUE originating during the basic exclusion amount enhancement period isn't affected by post 2025 Basic Exclusion Amount of surviving spouse.

Your authors have previously suggested that the amount of DSUE ported to the estate of a surviving spouse would be limited after 2025 to the Basic Exclusion Amount of the surviving spouse, in Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2708 (3/14/19). Not so, under the final regulation -- a pleasant surprise.

Examples Provided in the Regulation

The regulation provides the following examples illustrating operation of the regulation. Examples 1 and 2 illustrate the effect of lifetime gifts on the credit against the estate tax for gift taxes.

Example 1. Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, … the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts.

Example 2. Assume that the facts are the same as in Example 1 of paragraph (c)(2)(i) of this section except that A made cumulative post-1976 taxable gifts of $4 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

Examples 3 and 4 illustrate how DSUE affects the exclusion amount available to the surviving spouse, considering the reduction to the BEA after 2025.

Example 3. Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to §20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gifts attributable to the basic exclusion amount (zero) is less than the credit based on the basic exclusion amount allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

Example 4. Assume the facts are the same as in Example 3 … except that, after C's death and before 2026, B makes taxable gifts of $14 million in a year when the basic exclusion amount is $12 million. B is [treated as having applied] the DSUE amount to the gifts before applying B's basic exclusion amount. The amount allowable as a credit in computing the gift tax payable on B's post-1976 gifts for that year ($5,545,800) is the tax on $14 million, consisting of $11.4 million in DSUE amount and $2.6 million in basic exclusion amount. This basic exclusion amount is 18.6 percent of the $14 million exclusion amount allocable to those gifts, with the result that $1,031,519 (0.186 x $5,545,800) of the amount allowable as a credit for that year in computing gift tax payable is based solely on the basic exclusion amount. The amount allowable as a credit based solely on the basic exclusion amount for purposes of computing B's estate tax

($2,665,800) is the tax on the $6.8 million basic exclusion amount on B's date of death. Because the portion of the credit allowable in computing the gift tax payable on B's post-1976 gifts based solely on the basic exclusion amount ($1,031,519) is less than the credit based solely on the basic exclusion amount ($2,665,800) allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

COMMENT:

A significant uptick in lifetime gifts through 2025 might occur as a result of the regulations, in order to lock in use of the enhanced BEA, as well as DSUE. The final regulations are a reminder that, as the law now reads, the enhanced BEA is a use it or lose it proposition. And, there's no way to predict what a future Congress might do.

Shifting future growth out of an estate has always been an effective course to take. The specter of the 2026 tax cliff warrants greater planning urgency. Also, in order to avoid application of transfer taxes to valuation increases, clients should consider making gifts sooner rather than later. For example, $1 million growing at an after-tax rate of return of just 3% from January 1, 2020 to December 31 2025 (5 years) will increase in value by $159,247. Getting that growth out of an estate saves 40% of that amount, or $63,710.

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

Mike Jones

DeeAnn Thompson

CITE AS:

CITES:

Internal Revenue Code Section 2010; Unified Credit Against Estate Tax; Treasury Decision 9884 (11/22/19).