Just Passing Through on a Bridge Too Far: Deduction for Qualified Business Income and $10 Million Estate Tax Exclusion Expire in 2026

Robert Denham

Sunrise, Sunset

"We were 8 years in effect," one might say (in a more recent pop culture reference) regarding the individual provisions of the so-called Tax Cuts and Jobs Act (Pub L 115-97, 131 Stat 2054), almost all of which are scheduled to expire for tax years beginning after December 31, 2025.

From another perspective, the "permanent" estate tax provisions enacted with great fanfare in 2013 lasted all of exactly 5 years. Here's how we put the point (in another pop culture reference) in Denham, *A Midwinter Night's Dream: It's the End of the World as We Know It for Estate Planners (And I Feel More or Less Okay)*, 34 CEB Est Plan R 113 (Feb. 2013):

> Estate planners awoke on January 2 wondering, "What was that about?" Maybe the Mayans were onto something after all. A few days after that ancient apocalypse and 24 hours after its modern equivalent in the form of the fiscal cliff, Congress did the unexpected and almost unthinkable. After 12 years of uncertainty, gridlock, and kicking the can down the road, it suddenly repealed all operative sunset dates and enacted permanent legislation that fixes the essential elements of the tax law needed for rational estate planning with no ifs, ands, or buts. Estate tax repeal? Gone. Clawback? Gone. Tax rates and exclusion amounts that rise and fall and rise again? Gone.

For now, at least, estate tax repeal is gone. Tax rates also remain fixed, until someone changes them. But exclusion amounts that rise and fall are back with a vengeance. Estate planners now have no idea what the exclusion amount will be on a client's death, certainly not on a surviving spouse's death for married clients. However, the risk of clawback appears to have been eliminated by IRC §2001(g)(2). More on this below under "Estate Tax Implications."

But first, the expiring provisions include a never-before-dreamed-of exclusion or deduction for a portion of income received by some taxpayers from many or most (but not all) passthrough entities. The deduction was enacted in connection with a permanent corporate tax cut and modified in conference at the 11th hour. And thereby hangs a tale.

Why a Duck?

How an exclusion for passthrough income came to be styled as a deduction (with apologies to the Marx Brothers and the viaduct routine from their 1929 movie version of The Cocoanuts) tells us a lot about the legislative process. Why an exclusion or deduction for passthrough business income was felt necessary in the first place and how it came to be enlarged in the final version of the legislation tell us more.

The centerpiece of the legislation is a permanent reduction in the corporate tax rate from a maximum 35 percent to a flat rate of 21 percent. The rate reduction is combined with a shift from a worldwide tax regime for U.S. resident corporations in which taxation is deferred indefinitely on foreign earnings to a quasi-territorial system in which corporations are generally taxed only on their domestic earnings but foreign earnings are subject to a minimum tax to prevent what is euphemistically known as base erosion. (Lesser rates apply to certain kinds of intellectual property income.) The primary stated purpose of these corporate tax provisions is to provide increased incentives for location and expansion of economic activity within the United States in light of geographical limitations on taxation and reduced tax rates in other developed countries. The legislation also modestly limits the deduction for interest on corporate debt, made less valuable by the rate reduction, in a further bid to deter excessive leverage.

The Obama Administration had proposed a 28 percent rate combined with a similar minimum tax on foreign earnings, and former House Ways and Means Committee Chair Dave Camp (R-Mich) had proposed a 25 percent rate as part of his own much more sweeping revenue-neutral tax reform package. For its part, the Trump Administration at first insisted on a 15 percent rate but acceded to the 20 percent rate contained in HR 1, 115th Cong, 1st Sess (2017). The reduced corporate tax rate, later modified to 21 percent in conference, was adopted by current Chair Kevin Brady (R-Tex) and House Speaker Paul Ryan (R-Wis) after a months-long flirtation with an intriguing but ultimately unsound proposal to replace the corporate income tax with a so-called border-adjusted, destination-based cash flow tax, as discussed in *The Dog That Didn't Bark: Significant Elisions in the Trump Tax Proposal,* 38 CEB Est Plan R 165 (June 2017).

The resulting reduction in revenue is partly offset by a one-time tax on offshore earnings (much of which are actually held in New York banks) similar to that proposed by the Obama Administration and larger than many had expected. Nevertheless, the legislation results in a deficit increase of approximately $1.5 trillion over 10 years using the so-called static scoring mandated in the budget reconciliation process, which allowed the measure to be enacted with a simple majority vote in the Senate, and an estimated net revenue loss of approximately $1 trillion allowing for growth effects, according to the Joint Committee on Taxation (JCT). The JCT estimate is based on a projected increase of 0.8 percent *total* in gross domestic product (GDP) after 10 years, consistent with academic models. Administration economists had predicted an increase of 0.8 percent *per year* resulting from an unprecedented boom in foreign investment that would have more than completely offset the increased deficit.

Note: If there were really an incipient boom in foreign investment, the dollar should be rising. Instead, it is at a 3-year low against other major currencies.

These official estimates take into account budgetary savings of $300 billion from elimination of premium subsidies for 13 million Americans expected to drop their health insurance because the legislation repeals the individual mandate in IRC §5000A. The ongoing savings in future decades (in part) also allow the corporate tax rate reduction to be made permanent using the reconciliation process. Some might question whether such phantom savings should be considered, but the calculation evidently was accepted by the Congressional Budget Office (CBO) and the Senate parliamentarian. These official estimates also assume that the individual tax provisions will lapse as provided in 2026, although the leadership in both houses have insisted that the provisions will be extended. If these assumptions are not made, the legislation has a revenue cost in excess of $2 trillion over 10 years. Even the $1 trillion official estimate is in addition to a projected cumulative deficit of $9 trillion, as we observed in Denham, *Identity Crisis: Kalecki's Law and the Future of Estate Planning in a Low-Return World,* 39 CEB Est Plan R 5 (Aug. 2017), bringing the total to $10 trillion.

To put this in perspective, the Simpson-Bowles Commission (remember them?) had concluded that the federal government ultimately needed revenue equal to 21 percent of GDP to meet its reduced expenditures after their recommended entitlement reforms. The recent tax legislation effectively reduces federal revenue from 18 percent to 17 percent of GDP. Looking beyond 10 years, the benefit of individual rate reductions (if extended) is gradually eroded by the use of the chained CPI in amended IRC §1(f)(3). To that extent, the legislation is less fiscally irresponsible than it might appear at first sight. The chained CPI generally produces smaller inflation adjustments for bracket amounts, restoring some of the lost revenue as income is shifted into higher tax brackets and further amplifying increases for some taxpayers in mostly blue states resulting from the $10,000 limitation on deductions for state and local taxes in IRC §164. In other words, the tax cuts are front-loaded for maximum effect in the next election cycle.

Investment incentives are also front-loaded with the enactment of a temporary 100 percent expensing provision in 2018–2022 (phased out over 2023–2027) for qualified property in IRC §168. The corporate rate reduction is redundant to the extent that the expensing provision would be equally effective regardless of the tax rate, because it makes the effective tax rate on new investment zero (or negative) for any tax rate. Looked at another way, the temporary expensing provision is otiose to the extent that the reduced corporate tax rate is expected to drive economic growth. Adair Turner puts it this way in an afterword to the 2017 paperback edition of his book on the financial crisis entitled Between Debt and the Devil (2015) regarding the economic consequences of a Trump presidency, conceding the need for further fiscal stimulus (p 256):

> The precise form of his fiscal stimulus will likely be inefficient and regressive—skewed more toward pointless tax cuts for the rich than useful infrastructure spending—but it will still have some positive effect, and the Republican Congress will allow President Trump a fiscal relaxation which it would have denied President Obama.

However, economic theory suggests that the rate reduction will not increase investment or economic activity to the extent that corporate income consists of monopoly profits or economic rents from what economists would call market power and so cannot be increased proportionally (if at all) by expanding production. Apple, anyone? From that perspective, the corporate tax cut may be seen as a kind of reverse leverage in which large amounts of foregone revenue induce a small amount of new investment.

With these reservations, the corporate tax provisions with all their unavoidable complexities appear reasonably designed to achieve their stated economic objectives, except for overreaching in the degree of rate reduction, as Mindy Herzfeld concedes in her more favorable account of the legislation. See Herzfeld, *Why I'm a Fan of the Tax Cuts and Jobs Act,* Tax Notes Int'l 1140 (Dec. 18, 2017). Here, the legislation goes a bridge too far (in yet another pop culture reference to an Allied attempt to capture the Arnhem bridge in World War II as depicted in the eponymous 1977 film). Not only did the selection of 20 percent (rather than 28 percent or even 25 percent) as a maximum corporate tax rate result in an unsupportable revenue loss, but it also prompted a wrong-headed effort to extend a parallel rate reduction to passthrough entities not taxed as corporations.

Herzfeld and others have questioned the logic of equalizing benefits to corporations and passthrough entities, noting that the latter have enjoyed more favorable treatment in recent decades as a result of reductions in individual tax rates, reversing historical patterns. Anyone who wishes can check the box for a limited liability company (LLC) or even a partnership and elect to be taxed as a C corporation, if that treatment becomes more favorable in their current economic circumstances. Sole proprietors who have not already done so for liability protection may form an LLC or incorporate if necessary to obtain more favorable tax treatment, as solo attorneys must because they cannot use an LLC. Even with sharply reduced rates, a C corporation retains the disadvantage of double taxation on dividends (or capital gains) when earnings are distributed, albeit at preferential tax rates.

Nevertheless, the proponents evidently felt some sort of equalizing provision for passthrough business entities was necessary, particularly in the original House version of the legislation. The House version would have kept the 39.6 percent individual rate for incomes above $1 million per year, with an additional 6 percent recapture rate (in a curious echo of Steve Bannon's alternative proposal, which had included a 45 percent maximum rate). The House version would have taxed a portion of passthrough business income at the 20 percent corporate rate, with a safe harbor for 30 percent of income subject to an alternative calculation based on the amount of invested capital. The reduced rate would not have applied to personal service income, and the income of a personal service corporation would have been taxed at a higher 25 percent rate.

The Senate took a different tack, incorporating elements of the little-used domestic production activities deduction in IRC §199 (repealed as redundant) into a new IRC §199A. Section 199A provides for an individual income tax deduction for a portion of passthrough business income, subject to a 50 percent wages paid limitation borrowed from IRC §199 and an exception for specified personal service income, both of which are phased in over the next $50,000 of income for single taxpayers with income in excess of $157,500 (over the next $100,000 of income for married taxpayers filing jointly with income over $315,000). Reasonable compensation for services rendered and guaranteed partnership payments are excluded from deductible qualified business income. The deduction expires in 2026. IRC §199A(i).

For example, a law partner (or sole practitioner with a professional corporation) who derives $300,000 from a law practice with reasonable compensation of $200,000 apparently could deduct $20,000 (*i.e.*, 20 percent of $100,000) from the lawyer's taxable income. The original Senate version had provided for a 17.3 percent deduction, but the percentage was increased to 23 percent as the insistence of Sen. Ron Johnson (R-Wis), whose vote was obtained in urgent negotiations before final passage in exchange for various concessions, along with those of Sen. Susan Collins (R-Me), Jeff Flake (R-Ariz), and Marco Rubio (R-Fla). Senator Bob Corker (R-Tenn) also changed his vote from no to yes (coincidentally or not) after changes to the passthrough provision favorable to real estate interests.

The ultimate adoption of the 20 percent deduction in the Conference Report was associated with a further reduction of the top tax rate from 38.5 percent to 37 percent. The rate reduction preserves the value of the deduction, because the resulting effective tax rate of 29.6 percent (80 percent of 37 percent) nearly equals the 29.645 percent effective rate (77 percent of 38.5 percent) under the Senate bill, and it has the added fillip of reducing the tax burden on other high-income taxpayers. So is the proverbial sausage made. Practitioners operating in passthrough entities are cautioned that the legislation was not intended to reduce the tax rate applicable to income from their own professional services, except for architects and engineers, whose professions were specifically excluded from the exception to the definition of qualified trade or business in IRC §1202(e)(3)(A), incorporated by reference in IRC §199A(d).

The wage limitation in IRC §199A(b)(2) obviates the qualified business income deduction for most passthrough entities created for estate planning purposes, which often have few or no employees other than their owners. However, donees of annual exclusion gifts of entity interests below the income threshold may get a break on their proportional share of dividends, rents, and royalty payments that have no relation to any operating business. Passive rental income of less affluent owners from cash or cropshare leases of agricultural land also may qualify for the deduction. The qualified business income deduction also applies to dividends from real estate investment trusts (REITs) held in a brokerage account or in a trust. REITs are required by law to distribute all of their net income and so may be considered passthrough entities in their own right. The logic of the corporate tax cut and the associated qualified business income deduction implies that income from passive ownership of capital assets is favored over wage labor or active ownership of a business. Wages paid have little relation to the quantity of invested capital in a business, suggesting that the wage limitation is intended more generally to curb excessive benefits to high-income taxpayers.

For trusts and estates owning interests in passthrough entities not necessarily created for estate planning purposes, the wage limitation is applied at the beneficiary level. Section 199A(f)(1)(B) provides:

> (B) APPLICATION TO TRUSTS AND ESTATES—Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

Section 199(d)(1)(B)(i) provides that the W-2 wages of the trust or estate "shall be apportioned between the beneficiaries and the fiduciary (and among the beneficiaries) according to regulations to be prescribed by the Secretary." In other words, a beneficiary with income greater than $50,000 (for a single taxpayers) or $100,000 (for married taxpayers filing jointly) in excess of the threshold amount ($157,500 for single taxpayers, $315,000 for married taxpayers filing jointly) will be able to deduct only the lesser of 20 percent of the beneficiary's share of passthrough income or 50 percent of the beneficiary's share of wages paid by the entity. The trust or estate apparently has its own $157,500 threshold amount under IRC §199A(e)(2), although it is difficult to imagine how or why any trust or estate would ever have that much undistributed income.

The alternative 2.5 percent qualified property limitation in IRC §199(d)(1)(B)(ii) should be at least as restrictive for most passive passthrough entities created for estate planning purposes. To recount: The deductible amount is the *lesser* of 20 percent of passthrough income or the *greater* of 50 percent of wages paid or 2.5 percent of qualified business property. Even an active business may not often have specified depreciable qualified business property more than 20 times greater than wages paid and less than eight times greater than qualified business income, as needed for the alternative limitation to make a difference.

For example, imagine a business entity with $10 million of qualified business property, $1,500,000 of qualified business income, and $400,000 of wages paid. (We can't.) The owners of such an entity could deduct $250,000 (2.5 percent of $10 million) rather than $200,000 (50 percent of $400,000) of a possible $300,000 (20 percent of $1,500,000) of passthrough income, assuming the limitations apply because all entity owners are above the individual income threshold. Get it? Whew!

Talk About Simplification

In the end, 61 of 84 items accounting for 98 percent of all so-called tax expenditures or loopholes adding up to $8.3 trillion over the period 2016–2020 were untouched, according to an analysis by Ryan Alexander, President of Taxpayers for Common Sense, published in Letters to the Editor, *Tax Reform Package Misses the Obvious,* Tax Notes 152 (Jan. 1, 2018). A quick count from the Table of Contents in the Conference Report identifies at least two dozen such provisions eliminated in the House bill that survive in the final legislation.

Among tax expenditures reduced or eliminated, the most notable is the state tax deduction limitation mentioned above. The limitation also rendered redundant the 3 percent Pease phaseout of itemized deductions in IRC §68, which largely recaptured the benefit of the state income tax deduction. Oddly enough, in the last-minute rush to add back revenue, the final legislation did not manage to repeal the individual alternative minimum tax (AMT), although the state income tax deduction is also the most important preference item for most taxpayers disallowed under IRC §58. (The conference was necessitated by a legislative afterthought to repeal the corporate AMT, which would have effectively eliminated the benefit of the research and development credit.) Remarkably, the legislation retains the much-reviled net investment income tax in IRC §1411. We had always thought that any Republican-sponsored comprehensive tax reform would have eliminated both items.

Also lost on the way to Arnhem bridge was "simplification" of individual income tax rates as promised in the heading for Subtitle A of Title I—Individual Tax Reform. The original House version of the legislation had reduced the seven individual ordinary income rates (10-15-25-28-33-35-39.6) to a mere four rates (12-25-35-39.6) plus a 6 percent bubble. The final version retains seven different ordinary income rates *and* the five applicable capital gain rates, all of which are now different from the ordinary income rates and apply at different bracket amounts from the ordinary income rates.

Presented schematically, IRC §1 now provides the following individual income tax rates: 0-10-12-15-20-22-24-25-28-32-35-37. The resulting profusion of tax rates (neglecting the special 25 and 28 percent capital gain rates for, *e.g.*, collectables) and bracket amounts is illustrated in the following tables:

Married Filing Jointly					
2017			2018		
Gross income	Ordinary income	Capital gains	Ordinary income	Capital gains	Gross income

	10%	0%	10%	0%	
$18,650	15%		12%		$19,050
				15%	$77,200
$75,900	25%	15%	22%		$77,400
$153,100	28%		24%		$165,000
$233,350	33%		32%		$315,000
$416,700	35%		35%		$400,000
				20%	$479,000
$470,700	39.6%	20%			
			37%		$600,000

So much for simplification. To be fair, the different bracket amounts for the 22 percent ordinary income rate and the 15 percent capital gain rate will be conformed in 2019, although the 20 percent capital gain rate will continue to diverge from the 35 and 37 percent ordinary income rates.

Single Taxpayers					
2017			2018		
Gross income	Ordinary income	Capital gains	Ordinary income	Capital gains	Gross income
	10%	0%	10%	0%	
$9,325	15%		12%		$9,525
				15%	$38,600
$37,950	25%	15%	22%		$38,700
$91,900	28%		24%		$82,500
$191,600	33%		32%		$157,500
$416,700	35%		35%		$200,000

				20%	$425,800
$418,400	39.6%	20%			
			37%		$500,000

Oddities abound. Note that the 35 percent ordinary income rate now kicks in at a much lower bracket amount ($200,000) for single taxpayers and heads of household, prompting complaints of unfairness from professional women in high-wage and high-cost-of-living areas such as San Francisco, particularly those with two or more children also adversely affected by elimination of the personal exemption in IRC §151.

Trust and estate tax rates are somewhat simplified from five rates (15–25–28–33–39.6) to four rates (10–24–35–37), although preferential rates (0–15–20–25–28) still apply to capital gains and qualified dividends:

Trusts and Estates					
2017			2018		
Gross income	Ordinary income	Capital gains	Ordinary income	Capital gains	Gross income
	15%	0%	10%	0%	
$2,550	25%		24%		$2,550
				15%	$2,700
$6,000	28%				
$9,150	33%		35%		$9,150
$12,500	39.6%	20%			
				20%	$12,700

Here, too, the bracket amounts for the top ordinary income and capital gain rates will be conformed in 2019. In an interesting twist, the trust and estate tax rates (rather than the parent's tax rate) will now be used under the "kiddie tax" in IRC §1(g) for unearned income of children under age 19, or age 24 in the case of full-time students, who formerly qualified as dependent children before the personal exemption was eliminated. Thus, qualified dividends will be taxed at 15 percent when the child's unearned income exceeds $2700 and 20 percent when it exceeds $12,700.

Before, the parent's tax rate applied to the child's unearned income in excess of an amount ($2100 in 2017) equal to twice the (now obsolete) standard deduction for children claimed as dependents. The change may result (for better or worse) in a higher tax rate on income from property contributed by wealthy grandparents or other friends and relatives to children of relatively impecunious parents, and was apparently intentional. Congress could have simply written the $2100 amount into the statute, as it did with the special $4150 deduction (in 2018) for qualified disability trusts in IRC §642(b)(2)(C), formerly based on the personal exemption amount.

Estate Tax Implications

We have tried to be fair to the legislation and its authors, despite some reservations. However, the temporary increase in the applicable exclusion amount (AEA) is a serious disservice to estate planners and their clients.

Under IRC §2010(c), as amended, the AEA is $10 million plus cost-of-living adjustments ($11,200,000 in 2018) for gifts made and decedents dying in 2018–2025, but the AEA reverts to $5 million plus cost-of-living adjustments in 2026 and thereafter. (Note: The chained CPI in IRC §1(f)(3) is incorporated by reference in IRC §2010(c)(3)(B). Hence, the exact amount is uncertain but has been estimated at $11,180,000.) Estate planners cannot blithely assume that the increased AEA will, in fact, be extended beyond 2025 despite assurances to that effect. As a result, estate planners now have no idea what the AEA will be on the date of death even for their single clients, let alone on the death of the surviving spouse for their married clients.

With a little less overreaching on the corporate tax rate, the $10 million AEA could have been made permanent. But it still seems an odd policy choice. The original House version of the legislation had provided for outright repeal of the estate tax and the GST tax in 2023. One might have expected that most Republicans would favor a reduced tax rate (say 35 percent, as in effect in 2009) over an increased exclusion amount. A few million dollars more or less mean little or nothing to the dynastic family donors who dominate Republican party politics. Perhaps the senators themselves are more modest millionaires.

Note that the current zone of uncertainty is considerably larger than it was when the temporary $5 million exclusion (made permanent in 2012) was enacted in 2010. Although bills were introduced in Congress to limit the exclusion to $2 million, as in effect in 2006-2008, the Obama Administration had proposed to roll back the exclusion only to $3.5 million, as in effect in 2009 before the single year of repeal in 2010. The range of probable outcomes was thus limited to $1.5 million out of $5 million or 30 percent and to a much smaller absolute amount. Even so, estate planners were advised to take the uncertainty into account by building flexibility into their documents, as had been the mantra during the years leading up to repeal, by using a QTIPable bypass trust so that trust assets could be included (or not) in the survivor's estate.

The QTIPable bypass trust (or credit trust) remains the touchstone of estate planning for married clients with combined estates of $10 million for whom there might be a need or desire to cause inclusion (or not) in the survivor's estate.

For married clients with combined estates of less than $10 million, it remains true that the decedent's trust usually created on the first death probably need not qualify for the marital deduction to avoid estate tax on the second death.

For married clients with combined estates in excess of $20 million, it remains true that inclusion of any part of the decedent's trust in the survivor's estate may trigger estate tax and probably should be avoided.

However, the legislation creates new problems for married clients with combined estates between $10 million and $20 million. For these clients, a possible Plan A is to create a traditional three-trust estate plan with a marital deduction qualifying trust funded by a formula that will result in no trust being created on the first death if the $10 million exclusion is extended or the first death occurs before 2026.

The credit trust that receives the remaining decedent's share also may be designed to qualify for the marital deduction by giving the survivor a qualifying life income interest under IRC §2056(b)(7) for which a QTIP election may be made that will cause inclusion in the survivor's estate to obtain a second step-up in basis on the survivor's death under IRC §1014. Alternatively, a single trust may be used for which a partial QTIP election is made. Conversely, the QTIP election will not be made for the credit trust on a first death after 2025 if the AEA reverts to $5 million.

Unless the $10 million AEA is made permanent, care must be exercised in making the QTIP election on a first death before 2026. A possible strategy is make the QTIP election for as much of the decedent's trust as would ensure that the amount included in the survivor's estate does not exceed the deceased spouse's unused exclusion (DSUE) amount plus $5 million. If the marital estate is unlikely ever to exceed $15 million, the QTIP election may be made for the entire credit trust because the $10 million DSUE amount may be combined with the survivor's $5 million AEA to shelter up to $15 million on the second death. For larger amounts, the QTIP election cannot be made safely for any portion of the decedent's trust if the surviving spouse has determined to pay no estate tax on the second death.

A variation of this strategy is to make lifetime gifts in excess of $5 million before 2026, relying on the freezing provision in IRC §2001(g)(2). Act §11061 provides in its entirety:

SEC. 11061. INCREASE IN ESTATE AND GIFT TAX EXEMPTION.

(a) IN GENERAL.—Section 2010(c)(3) is amended by adding at the end the following new subparagraph:

''(C) INCREASE IN BASIC EXCLUSION AMOUNT.—In the case of estates of decedents dying or gifts made after December 31, 2017, and before January 1, 2026, subparagraph (A) shall be applied by substituting '$10,000,000' for '$5,000,000'.''.

(b) CONFORMING AMENDMENT.—Subsection (g) of section 2001 is amended to read as follows:

''(g) MODIFICATIONS TO TAX PAYABLE.—

''(1) MODIFICATIONS TO GIFT TAX PAYABLE TO REFLECT DIFFERENT TAX RATES.—For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute—

''(A) the tax imposed by chapter 12 with respect to such gifts, and

''(B) the credit allowed against such tax under section 2505, including in computing—

''(i) the applicable credit amount under section 2505(a)(1), and

''(ii) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).

''(2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—

''(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and

''(B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.''.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying and gifts made after December 31, 2017.

In other words, IRC §2001(g)(2) apparently provides that a lifetime gift in excess of $5 million will not result in the imposition of estate tax with respect to the excess amount on death at a time when the AEA has reverted to $5 million (or any amount less than the amount of the gift). In a stereotypical May-December couple, for example, the older spouse with essentially all the marital assets could make a $10 million lifetime gift to children from a former marriage, leaving everything else to a marital deduction qualifying trust for the younger spouse. In this way, at least $15 million in marital assets can be sheltered even if both spouses die after 2025.

Spouses with $16 million (or $18 million) in community property could transmute the property to $11 million (or $13 million) in separate property for one spouse and $5 million for the other spouse. The resulting $3 million (or $4 million) gift is sheltered by the unlimited marital deduction in IRC §2523. The wealthier spouse then makes a lifetime gift of $6 million (or $8 million) to the couple's children. Regardless of which spouse dies first, whether the first or second death occurs before 2026 or after 2025, at least $11 million (or $13 million) passes to the remainder beneficiaries free of estate and gift tax even if the $10 million AEA is not extended.

The permutations are limitless. Truly wealthy spouses and individuals should each make a $10 million lifetime gift before 2026 to lock in the benefit of the increased AEA. For typical married clients unable (or unwilling) to make large lifetime gifts, however, the temporary $10 million individual AEA interjects an irreducible element of uncertainty into the estate planning process for those with more than $10 million and less than $20 million, so too for unmarried clients with more than $5 million and less than $10 million. With that in mind, we would continue to observe the following hierarchy of priorities:

- Make sure you get the desired disposition, at the expense of competing tax objectives. Cap the bypass trust if your primary objective is to protect the other spouse but you still want your kids to get something now. For example, the trust might allocate $5 million to a trust (or trusts) for children and issue, with the excess (if any) of the credit trust passing to a marital deduction qualifying trust with liberal invasion powers (subject to an ascertainable standard) for the surviving spouse. This may limit the survivor's ability to obtain a second step-up in basis at death if the $10 million AEA is extended.
- Subject to the preceding rule, avoid estate tax on the second death. Don't make the QTIP election for an amount that—combined with the survivor's trust—may exceed the DSUE amount and the survivor's AEA if the AEA reverts to $5 million. As noted above, this rule limits the expected survivor's estate to $15 million on death before 2026. This again may limit the survivor's ability to obtain a second step-up in basis at death if the $10 million AEA is extended. Bear in mind that date-of-death basis is a two-way street and may not always be a step up, but may sometimes result in a step down.

- Consider charitable gifts if the alternative is estate tax and the client has at least some charitable intent. As a corollary to the first rule, however, be willing to pay estate tax or even gift tax if the alternative is an undesired disposition to charity.

With respect to the third item, a particularly fruitful planning device for unmarried clients is a charitable deduction formula clause. Modeled on a marital deduction formula clause, the dispositive provision may give to charity the minimum amount or fractional share of trust property needed to completely eliminate estate tax on the settlor's death, with the excess passing to a noncharitable beneficiary. The clause works only in the peculiar circumstance that the settlor is unwilling to pay any estate tax but also does not wish to make any charitable contributions unless absolutely necessary to avoid the tax.

Charity Begins at Home

Another provision rates a mention here. The legislation increases the maximum percentage income limitation on income tax charitable contribution deductions in IRC §170(b)(1)(A) from 50 percent to 60 percent of modified adjusted gross income until 2026. The maximum limitation had been 50 percent (except for qualified farmers and ranchers entitled to deduct up to 100 percent for conservation contributions under IRC §170(b)(1)(E)(iv)) since the dawn of time, or at least since the Tax Reform Act of 1969.

Unused deductions can be carried forward for 5 years under IRC §170(d) (15 years for conservation contributions under IRC §170(b)(1)(E)(ii)), although carryover deductions sometimes may be lost at death if the decedent's estate has insufficient income to use them up. As noted in these pages, the IRS fairly frequently challenges only carryover deductions after the statute of limitations has expired on the original contribution.

We can only assume that some highly motivated donor is in a hurry or has some very large deduction to push through while sufficient income is available to offset the deduction.

The legislation also appropriately clarifies that a charitable deduction by an S corporation passes through to a portion of a trust holding S corporation stock treated as an electing small business trust (ESBT) under IRC §642(c) without regard to the general rule that a trust charitable contribution must be made from trust income pursuant to the terms of the governing instrument, as had been provided by regulation.

One other point: Some have suggested that the $10,000 limitation on the state and local tax deduction under IRC §164 might be avoided by converting state income tax payments into charitable contributions, noting that the IRS had allowed charitable deductions under programs that gave taxpayers a dollar-for-dollar credit in exchange for specified donations in several states, including California. However, the taxes credited in these programs would have been deductible anyway by anyone taking itemized deductions, including charitable deductions. The IRS acceptance of charitable deductions in this context does not appear to imply that it would accept charitable contributions in lieu of nondeductible tax payments.

Back on the Chained Gang

In a last pop culture reference, with apologies to Chrissie Hynde, the significance of the chained CPI has not been fully appreciated. As noted above under "Why a Duck?", the increased revenue resulting from permanent use of the chained CPI together with the phantom savings in premium subsidies from the loss of health insurance coverage, which the leadership insists (and the CBO, on reflection, now estimates) will not in fact occur, was required to offset over $1 trillion per decade in further lost revenue after 10 years from the corporate tax cut. This device allowed the corporate tax cut to be made permanent using the budget reconciliation process, in which any provision that reduces revenue after the budget window (usually 10 years) is deemed extraneous and is disallowed. See 2 USC §644.

Act §11002 provides in relevant part:

SEC. 11002. INFLATION ADJUSTMENTS BASED ON CHAINED CPI.

(a) IN GENERAL.—Subsection (f) of section 1 is amended by striking paragraph (3) and by inserting after paragraph (2) the following new paragraph:

''(3) COST-OF-LIVING ADJUSTMENT.—For purposes of this subsection—

''(A) IN GENERAL.—The cost-of-living adjustment for any calendar year is the percentage (if any) by which— ''(i) the C-CPI-U for the preceding calendar year, exceeds

''(ii) the CPI for calendar year 2016, multiplied by the amount determined under subparagraph (B).

''(B) AMOUNT DETERMINED.—The amount determined under this clause is the amount obtained by dividing— ''(i) the C-CPI-U for calendar year 2016, by

''(ii) the CPI for calendar year 2016.

''(C) SPECIAL RULE FOR ADJUSTMENTS WITH A BASE YEAR AFTER 2016.—For purposes of any provision of this title which provides for the substitution of a year after 2016 for '2016' in subparagraph (A)(ii), subparagraph (A) shall be applied by substituting 'the C-CPI-U for calendar year 2016' for 'the CPI for calendar year 2016' and all that follows in clause (ii) thereof.''.

No, we don't know what it means. But we think we know what it does. The use of 2016 as a base year (with a 2-year lag) for inflation adjustments in 2019 also explains the odd divergence between bracket amounts for ordinary income and capital gains in 2018 noted above under "Talk About Simplification."

The budget sequestration agreed by President Obama and Congress in 2011 continues to require across-the-board spending cuts (including Medicare) to offset the initial estimated $1.5 trillion revenue loss. The cuts are required by the Budget

Control Act unless the requirement is waived by Congress, which it does periodically. See 2 USC §§900-907d. As the recent government shutdown attests, this action requires 60 votes in the Senate and so must be supported by at least nine Democrats, none of whom voted for the Tax Cuts and Jobs Act.

Practitioners and the public should understand that the initial deficit increase associated with the legislation is not free money merely because Congress agreed to it in an earlier budget resolution. Some have suggested that the chained CPI also may be used in future to limit Social Security benefits. But where this all leaves anything is anyone's guess.