PORTABILITY OR NO: DEATH OF THE CREDIT SHELTER TRUST?

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I. Guidance Under the Temporary and Proposed Regulations for Electing Portability

A. Portability Made Permanent. Portability refers to the ability of a surviving spouse to inherit the unused Federal estate tax shelter of a predeceased spouse. Portability became effective for married persons dying after 2010.[2] It was scheduled to be eliminated from the tax system at the end of 2012. As a result, many did not view portability as significant. Now, the American Taxpayer Relief Act of 2012 ("ATRA") has made portability permanent.[3] On June 15, 2012, the Department of the Treasury issued temporary and proposed regulations on portability clarifying, in many cases in favorable ways, the applicable rules.[4]

B. Temporary Regulations Provide Helpful Guidance. The portability regulations[5] answer many questions regarding how to elect portability and make electing portability far easier for many small and medium-sized estates. They also clarify how a deceased spouse's unused exclusion amount ("DSUE amount") will be computed, and how a surviving spouse may use the first deceased spouse's DSUE amount.

C. Simplification? Although portability was advocated as a tax simplification measure, adding another tax election requires analysis in each case of the potential advantages of its use. As a result, portability has certainly make life more complicated for estate planners and their clients. It is essential to understand the opportunities under the new rules.

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[1]This outline is excerpted or otherwise derived predominantly from the following articles: H. Zaritsky & D. Zeydel, "New Portability Temp. Regs. Ease Burden on Small Estates, Offer Planning for Large Ones," 117 JTAX 180 (October 2012); J. Blattmachr, A. Bramwell and D. Zeydel, "Portability or No: The Death of the Credit Shelter Trust?" 118 JTAX 232 (May 2013); and J. Blattmachr, M. Gans, and D. Zeydel, "Supercharged Credit Shelter Trust[SM] versus Portability", 28 Prob. & Prop. 11 (March/April 2014). The author thanks her co-authors for their gracious permission to use their work for purposes of preparing this outline.

[2]Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, Title III, § 302(a)(1), § 303(a), 111th Cong. 2nd Sess. (Dec. 17, 2010), 124 Stat. 3296, 3302 (2010) as amended by the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, Title I, § 101(c)(2), 112th Cong. 2nd Sess. (January 2, 2013), 126 Stat. 2313.

[3]H.R. 8, 112d Cong., 2d Sess. (2012).

[4]TD 9593, 77 Fed. Reg. 36229-02 (June 18, 2012) and 77 Fed. Reg. 36150-01 (June 18, 2012).

[5]In this outline, a reference to the portability regulations or the regulations refer to the proposed and temporary regulations.

II. How to Elect Portability

A. **Portability Is Elective**. Portability is elective, rather than automatic: the regulations, following the Code,[6] require the deceased spouse's executor to make the portability election on a timely-filed estate tax return.[7] The regulations clarify that upon the timely filing of a complete and properly-prepared estate tax return an executor of an estate of a decedent survived by a spouse will have elected portability.[8] In that sense only, the election is automatic. An estate that elects portability is deemed required to file an estate tax return, even if the estate has a value below the filing threshold under Section 6018.[9] Therefore, in order to elect portability, a Federal estate tax return must be filed within nine months after the date of death (plus the period of any extensions actually granted).

B. **Notices Concerning Portability**. The Department of Treasury and the Internal Revenue Service ("IRS" or "Service") have issued certain Notices concerning portability. The first such Notice, Notice 2011-82, 2011-42 I.R.B. 516, issued prior to the Temporary Regulations, indicated that filing an estate tax return would be necessary to elect portability and that no portability election would be available to estates of decedents dying prior to December 31, 2010. Notice 2012-21, 2012-10, I.R.B. 250, dealt with decedents dying after December 31, 2010 and before July 1, 2011 with a gross estate having a fair market value not in excess of $5 million. The Notice permitted an executor to apply for an extension of time to file Form 706 within 15 months of the decedent's death (confirming the availability of an extension of time to file a return that was not otherwise required) by filing Form 4768, and subsequently to file a timely return within that 15 month period.

C. **Discretionary Relief for Failed Elections**. Whether discretionary relief to obtain the benefits of portability would generally be granted if a timely return were not filed remained an open question. The regulations do not expressly state whether discretionary relief will be allowed for late estate tax returns electing portability, where no return would otherwise have been required. Sections 301.9100-1 to 301.9100-3 of the regulations permit the IRS to grant a reasonable extension of time to make an election the date for which is not set by statute. Relief will be granted if the taxpayer provides the evidence to establish to the satisfaction of the

[6]All references to a Section or "§" of the Code or regulations refer to the Internal Revenue Code of 1986, as amended and the Treasury Regulations promulgated thereunder.
[7]I.R.C. § 2010(c)(5)(A); Temp. Regs. § 20.2010-2T(a).
[8]Temp. Regs. § 20.2010-2T(a)(2).
[9]Temp. Regs. § 20.2010-2T(a)(1). I.R.C. § 6018 requires the filing of a Federal estate tax return if the gross estate exceeds the basic exclusion amount reduced by adjusted taxable gifts.

Service that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.[10]

The preamble to the portability regulations suggests that Section 9100 relief may be available. Treasury states in the preamble that the Code does not specify a due date for filing the estate tax return for an estate that has a value under the filing threshold and that is filed solely to elect portability. The regulations require such estates to file a timely return in order to elect portability, and treat such an estate as required to file a timely return under the Code.• [11] It seems the fact that the Code does not impose a specific filing date for a return with respect to an estate with a value under the filing threshold, should cause Treasury to view the filing date for a return that is filed solely to elect portability as regulatory in nature, and permitting Section 9100 relief.

A number of private letter rulings (not precedent), indicate that Section 9100 relief is available for failure to file a timely Federal estate tax return, provided no return was required to be filed.[12] In the private letters rulings granting such relief, the IRS has agreed with the foregoing analysis, stating:

"Sections 2010(c)(5)(A), 6075(a), and 6018(a), when construed jointly, prescribe a due date for electing portability for those estates required to file an estate tax return under § 6018. Accordingly, with respect to those estates, the portability election is a statutory election as defined in § 301.9100-1(b). However, when an executor is not required to file an estate tax return under § 6018, the Code does not specify a due date for an estate tax return filed for the purpose of making a portability election. Rather, the regulations under § 20.2010-2T(a), which are applicable to all estates electing portability, specify that the portability election must be made on a timely-filed Form 706. Accordingly, with respect to estates not required to file an estate tax return under § 6018, the portability election is a regulatory election as defined in § 301.9100-1(b)."

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[10]Regs. § 301.9100-1(c).
[11]See Temp. Regs. § 20.2010-2T(a)(1). The preamble justifies this position as benefitting both the Service and taxpayers, because the records required to compute and verify the DSUE amount are more likely to be available at the time of the death of the first deceased spouse than at any later date. The preamble also states that this rule is consistent with the legislative history. See Staff of the Joint Committee on Taxation, 111th Cong., 1st Sess. "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," p. 52 (Dec. 10, 2010) (Committee Print) ("JCT Technical Explanation") (the DSUE amount is available to a surviving spouse "only if an election is made on a timely filed estate tax return (including extensions) of the predeceased spouse * * * regardless of whether the predeceased spouse otherwise is required to file an estate tax return."); and Staff of the Joint Committee on Taxation, 111th Cong., 2d Sess. "General Explanation of Tax Legislation Enacted in the 111th Congress," p. 554-555 (March 2011) (Committee Print) (incorporating the same language from JCT Technical Explanation).
[12]See, e.g., PLR 201421002 (Dec. 17, 2013), PLR 201418014 (Dec. 19, 2013 and PLR 201418009 (Dec. 17, 2013).

D. **Portability for Same-Sex Couples**. More recently, the IRS published Revenue Procedure 2014-18, 2014-7 I.R.B. 513, addressing the applicability of portability to same-sex couples. In light of the Supreme Court decision in *United States v. Windsor* 570 U.S. __, 133 S.Ct. 2675 (2013) striking down § 3 of the Defense of Marriage Act (DOMA), the IRS issued Rev. Rul. 2013-17, 38 I.R.B. 201 which holds that for Federal tax purposes, the terms "spouse," "husband and wife," "husband," and "wife" include individuals married to a person of the same sex if the individuals are lawfully married under state law, and the term "marriage" includes such a marriage between individuals of the same sex. The IRS adopted the general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex, even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages (the so-called "state of celebration" rule). As a result, same-sex couples would not have known their union would be recognized for Federal tax purposes prior to *Windsor*.

Rev. Proc. 2014-18 applies to all estates of decedents dying after December 31, 2010 and before January 1, 2014, and includes estates of decedents survived by a same-sex spouse that were not eligible to elect portability prior to *Windsor*; provided that the executor was not required to file an estate tax return and did not file. The executor must comply with the requirements of the revenue procedure, including filing a complete and properly-prepared Form 706 and stating at the top of the return "FILED PURSUANT TO REV. PROC. 2014-18 TO ELECTION PORTABLITY UNDER § 2010(c)(5)(A)."

E. **Special Valuation Rules for Marital and Charitable Deductions**. The regulations require that any estate tax return electing portability be prepared in accordance with the instructions for the return and the applicable regulations.[13] The regulations create a very important exception, however, for returns filed on behalf of estates which are not otherwise required to file, because they are under the filing threshold. The returns filed for such estates need not report the value of most assets transferred in a manner that qualifies for the marital or charitable deduction.

1. Instead, the executor is required only to estimate the total value of the gross estate (including the value of the property that qualifies for the marital or charitable deduction), based on a determination made in good faith and with due diligence. Apparently, no appraisals will be required. The regulations state that future instructions will provide ranges of dollar values, and the executor will be required to identify the particular range within which the

[13]Temp. Regs. § 20.2010-2T(a)(7)(i).

executor best estimates the total gross estate will fall.[14] The current instructions to the Form 706 published in August 2014 for estates of decedents dying after December 31, 2013, state that for the asset schedules, the executor must "calculate" the executor's best estimate of value for the qualifying assets. Then the executor must compute the total of the estimated values of the qualifying assets, and apply a table that generally rounds the aggregate value up to the nearest multiple of $250,000, with an aggregate estimate of value of $5,250,000 being rounded up to $5,340,000 for a 2014 estate, and presumably to $5,430,000 for a 2015 estate. The value so estimated is inserted in Line 10 of Part 5 (Recapitulation) in place of the executor's estimated values.

2. **When the Special Valuation Rules Do Not Apply**. The exception to providing values for property qualifying for a marital or charitable deduction does not apply if:

   a. The value of the property relates to, affects, or is needed to determine the value of property passing from the decedent to another recipient, as would occur under a formula nonmarital gift;

   b. The value of such property is needed to determine the estate's eligibility for the provisions of Sections 2032, 2032A, 6166, or another provision of the Code, though it seems hard to envision how an estate would need the benefit of Section 6166 if it is below the applicable exclusion amount filing threshold;

   c. Less than the entire value of an interest in property includible in the gross estate is marital or charitable deduction property, for example, in the case where an interest in property is transferred in part to the surviving spouse and in part to a child;

   d. A partial disclaimer or partial QTIP election is made with respect to the property; or

   e. The executor fails to exercise due diligence to estimate the fair market value of the gross estate including the marital and charitable deduction property. The instructions to Form 706 will eventually provide ranges of dollar values, and the executor must identify the appropriate range. Until the ranges are provided, the executor must include his or

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[14] Temp. Regs. § 20.2010-2T(a)(7)(ii)(A).

her best estimate to the nearest $250,000 on an attachment to the return, signed under penalties of perjury.[15]

3. Examples of Special Valuation Rules.

a. Example 1. H, a U.S. citizen, dies in 2011, leaving an estate that consists of a parcel of real property and bank accounts held jointly with W with rights of survivorship, a life insurance policy payable to W, and a survivor annuity payable to W for her life. H made no lifetime taxable gifts. E is the executor of H's estate. E files an estate tax return on which these assets are identified on the proper schedule, but E provides no information on the return with regard to the date of death value of these assets. To establish the estate's entitlement to the marital deduction (except with regard to establishing the value of the property) and the instructions for the estate tax return, E includes with the return evidence verifying the title of each jointly held asset, to confirm that W is the sole beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for W's life. E certifies on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of Temp. Regs. § 20.2010-2T. The estate tax return is complete and properly prepared for purposes of portability, and by filing this return E has elected portability.[16]

b. Example 2. H, a U.S. citizen, dies leaving a valid will that is probated. The will leaves H's entire probate estate to a QTIP trust for the lifetime benefit of W. H's non-probate assets include a life insurance policy owned by H and payable to his children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no lifetime taxable gifts. E, the executor of H's estate, files an estate tax return on which all of the assets includible in the gross estate are identified on the proper schedule. No information is provided with respect to the probate assets and the IRA, with regard to date of death value in accordance with the regulations, but E makes a QTIP election and attaches a copy of H's will (the QTIP trust is a testamentary trust created under H's will). The estate tax return describes each asset and its ownership to establish the estate's entitlement to the marital deduction in

[15]Temp. Regs. § 20.2010-2T(a)(7)(ii)(A).
[16]Temp. Regs. § 20.2010-2T(a)(7)(ii)(C), Ex. 1.

accordance with paragraph (a)(7)(ii)(B) of Temp. Regs. § 20.2010-2T (except with regard to establishing the value of the property). The return reports the life insurance policy payable to H's children and establishes the fair market value of the proceeds. E certifies on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate. The estate tax return is considered complete and properly prepared and E has elected portability.[17]

c. Example 3. Assume the same facts as in Example 2, except that there are no non-probate assets, and E elects to make only a partial QTIP election. The small-estate rules do not apply where a partial QTIP election is made, and the regular return requirements apply to all of the property includible in the gross estate. If E does not provide full information regarding the value of the assets passing to the QTIP, the return is not deemed complete and portability may not be elected.[18]

d. Example 4. H, a U.S. citizen, dies leaving a valid will that is probated. The will leaves 50 percent of the residuary estate to a marital trust for W and 50 percent to a trust for W and the descendants of H and W. The amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the will. The value of the property of the marital trust relates to or affects the value passing to the trust for W and the descendants, and so the small estate rules do not apply. The general return requirements apply to all of the property includible in the gross estate.[19]

4. **How Useful Are the Special Valuation Rules?** The small estate exception, while useful, is less generous than some would have liked. Preparing an estate tax return, even with these lenient rules, will still require a reasonable expenditure of time and money, which very small estates may not be able to afford. In the most egregious situation, an insolvent estate will have its full DSUE amount to pass on to the surviving spouse, and no funds with which to hire an attorney or accountant to prepare the estate tax return.

[17]Temp. Regs. § 20.2010-2T(a)(7)(ii)(C), Ex. 2(i).
[18]Temp. Regs. § 20.2010-2T(a)(7)(ii)(C), Ex. 2(ii).
[19]Temp. Regs. § 20.2010-2T(a)(7)(ii)(C), Ex. 3.

5. **Allocation of the Estimated Value**. The instructions do not appear to provide guidance on how to allocate the estimated value if, for example, part of the property qualifies for a marital deduction and part of the property qualifies for a charitable deduction. It seems no allocation would be done; instead, the total estimated value would be entered on Line 23 of Part 5, without any allocation. Suppose the property qualifies for those deductions under different sections of the Code, for example part outright to the surviving spouse and part as a qualified terminable interest property trust ("QTIP" trust) under Section 2056(b)(7). How basis of the assets passing among the surviving spouse, charity, and trusts for the surviving spouse or charity would be allocated is not clear. Depending upon the nature of the assets, it seems somewhat of a risky proposition for an executor with no particular valuation expertise to engage in value estimates without professional assistance.

F. **Portability Election is Irrevocable**. The portability election is irrevocable, once it has been made and the time for filing the estate tax return (including extensions actually granted) has passed. The executor who makes the portability election, or a successor, can revoke the election at any time before the date for filing the estate tax return (including extensions actually granted) has passed.[20]

G. **Who May Elect Portability**. Only the decedent's executor can elect portability.[21] The decedent's "executor" is the person who is appointed, qualified, and acting within the United States on behalf of the estate (for this purpose, the "appointed executor"). If there is no appointed executor, the "executor" for this purpose is any person in actual or constructive possession of property of the decedent (a "non-appointed executor").[22] The non-appointed executor includes, for example, "the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country."[23]

1. **Multiple Executors**. Multiple appointed executors are all required to sign an estate tax return in order for the return to be valid.[24] There is no exception made for a return electing portability, so that all of the appointed executors must sign the estate tax return in order to be deemed to have elected portability. If there is no appointed executor, a non-appointed executor may file an estate

[20]Temp. Regs. § 20.2010-2T(a)(4).
[21]Code § 2010(c)(5); Temp. Regs. § 20.2010-2T(a)(7).
[22]Code § 2203; Temp. Regs. § 20.2010-2T(a)(6).
[23]Regs. § 20.2203-1.
[24]Regs. § 20.6018-2.

tax return. There may be many non-appointed executors of an estate, because each person in actual or constructive possession of any portion of the decedent's gross estate can be a non-appointed executor. These persons may not agree on who should file the estate tax return and whether portability should be elected.

2. **Non-Appointed Executors**. The regulations state that a portability election made by a non-appointed executor may not be superseded by a contrary election made by another non-appointed executor. Presumably this means both an election to have portability apply as well as an election not to have portability apply, although that is not absolutely clear. Thereafter, only that non-appointed executor can modify that election on another timely estate tax return. Another non-appointed executor cannot change the decision of the first non-appointed executor, unless the second non-appointed executor is the successor to the first non-appointed executor.[25] This makes it important for the attorney representing the surviving spouse quickly to determine whether the spouse can become the appointed executor or whether the surviving spouse is eligible to be a non-appointed executor and, if so, to file an estate tax return electing portability. The difficulty will be filing a return with sufficient information to constitute a return under the statute if the spouse is not in possession of adequate information to file a "complete and properly-prepared" return. This may be a basis for a surviving spouse to challenge a return filed by another non-appointed executor that makes an election adverse to the surviving spouse.

H. **Opting Out of Portability**. The mere act of filing a timely, complete and properly-prepared estate tax return reflecting an estate that has not utilized all of the married decedent's applicable exclusion amount is deemed to have elected portability.[26] There is no separate election on the return; no box needs to be checked. An executor who does not want portability to apply must either not file an estate tax return (if the estate is not otherwise required to file) or file a return that includes an affirmative statement that the portability election should not apply. In fact, there is a box to check in Section A of Part 6 of Form 706 to elect out of portability.[27]

1. **Surviving Spouse May Not Elect**. An executor who does not believe that the surviving spouse will really require the DSUE amount may decide not to elect portability, in order to save the cost of filing an estate tax return. In such a situation the surviving spouse, if he or she is not an executor, cannot validly elect

[25] Temp. Regs. § 20.2010-2T(a)(6)(ii).
[26] Temp. Regs. § 20.2010-2T(a)(3).
[27] Temp. Regs. § 20.2010-2T(a)(3).

portability. Allowing a surviving spouse to elect portability would have been useful, though Treasury is correct that the Code requires that the election be made on an estate tax return, and that only an executor can file a valid estate tax return. Furthermore, allowing the surviving spouse to elect portability when there was an appointed or non-appointed executor would have led inevitably to disputes and conflicting elections. If the surviving spouse is otherwise a beneficiary of the probate estate, perhaps the executor has a fiduciary duty to make the tax elections that benefit the surviving spouse, particularly since electing portability has no potential to harm any other beneficiary.

2. **Settling A Dispute Concerning the Election**. The first litigated case concerning a portability election has already occurred. In Walton v. Estate of Swisher, 2014 WL 325666, Wife's estate entered into a settlement with husband. Wife's estate files a Federal estate tax return resulting in a portability election. Accordingly, Husband's estate obtained the benefits of portability. Daughter as beneficiary of Wife's estate brings an action claiming unjust enrichment. Husband had agreed to pay estate and income taxes of Wife's estate as part of negotiated settlement and the Wife's estate "relinquished any and all claims to any tax benefits or refunds after the date of death on any tax returns filed by Husband and Wife (or the Estate) prior or subsequent to the date of death". Daughter's lawyer apparently omitted to include compensation to Wife's estate for the value of the portability election. Court denies daughter's request for relief holding her to her settlement. Moral -- Get a better lawyer!

III. **Computing the DSUE Amount**. An executor who elects portability must include on the estate tax return a computation of the decedent's DSUE amount.[28] New Part 6 of Form 706 provides the computation of the DSUE amount. The computation begins with Line 9c of Part 2 of the return which constitutes the DSUE amount that may have been inherited by the decedent from one or more predeceased spouses, plus the decedent's own basic exclusion amount. It then follows with a calculation of the amount remaining after application to the decedent's taxable estate and adjusted taxable gifts. The DSUE may not exceed the basic exclusion amount, consistent with the Code.

A. **What is the DSUE Amount**: Section 2010(c)(4) states that the DSUE amount is the lesser of:

(A) the basic exclusion amount, or

[28]Temp. Regs. § 20.2010-2T(b)(1).

(B) the excess of (i) the applicable exclusion amount of the last deceased spouse, over (ii) the amount with respect to which the tentative tax is determined under Section 2001(b)(1) on the estate of such deceased spouse.

The regulations confirm that the reference to the basic exclusion amount in Section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death for the deceased spouse whose DSUE amount is being computed.[29] That is the only basic exclusion amount that is likely to be known at the time the DSUE amount must be computed and reported on the deceased spouse's estate tax return.[30] The regulations corrected what appears to have been a legislative drafting error in the formula set forth in the original legislation by which the DSUE amount was calculated. This technical glitch was corrected by ATRA when portability was made permanent.

B. **Lifetime Taxable Gifts**. The Code does not specifically address how one should account for gifts that are made by a deceased spouse on which gift tax is actually paid, if the applicable exclusion amount is thereafter increased. Section 2010(c)(4)(ii) requires that the last deceased spouse's basic exclusion amount should be reduced by the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. Fortunately, the regulations clearly state that the DSUE amount is not reduced by taxable gifts made by the deceased spouse on which gift tax was actually paid. Temp. Regs. § 20.2010-2T(c)(2).

1. **Example 1**. In 2002, having made no prior taxable gift, H makes a $1 million taxable gift and reports it on a timely-filed gift tax return. H's applicable exclusion amount in 2002 was $1 million, and the $345,800 credit allowed against H's gift tax brings the gift tax liability to zero. H dies in 2011, survived by W. Both H and W are U.S. citizens and neither has ever been married to anyone else. H's taxable estate is $1 million. H's executor, E, files a timely estate tax return for H's estate, electing portability. E computes H's DSUE amount at $3 million (the lesser of the $5 million basic exclusion amount in 2011, or the excess of H's $5 million applicable exclusion amount over the sum of his $1 million taxable estate and his $1 million adjusted taxable gifts).[31]

2. **Example 2**. Assume the same facts as in Example 1, except that the value of H's taxable gift in 2002 is $2 million. After application of the applicable credit amount, H owed gift tax on $1

[29] Temp. Regs. § 20.2010-2T(c)(1)(i).
[30] 77 Fed. Reg. at 36153.
[31] Temp. Regs. § 20.2010-2T(c)(5), Ex. 1.

million, the amount of the gift in excess of the applicable exclusion amount for that year. H pays the gift tax owed on the transfer in 2002. On H's death, E computes the DSUE amount as $3 million (the lesser of the $5 million basic exclusion amount in 2011, or the excess of H's $5 million applicable exclusion amount over the sum of the $1 million taxable estate and $1 million adjusted taxable gifts). H's $2 million of adjusted taxable gifts were reduced for purposes of this computation by the $1 million amount of taxable gifts on which gift taxes were paid.[32]

C. **Nonresident Alien Decedents**. Each deceased nonresident alien receives a unified credit of $13,000, which is equivalent to a $60,000 exemption. Code § 2102(b)(1). Nonresident alien decedents do not receive the applicable exclusion amount available to U.S. citizens and resident aliens. Section 2010(c)(4) explains that the DSUE amount is computed by reference to the deceased spouse's basic exclusion amount, defined in Section 2010, rather than the unified credit under Section 2102. The regulations correctly state, therefore, that portability is not available if the decedent was not a U.S. citizen, unless otherwise provided by treaty.[33]

1. **Example 1**. H, a citizen and resident of Nation A, dies in 2011, with a total worldwide estate of $10 million and a U.S. estate of $5 million. There is no estate tax treaty between the United States and Nation A, and H is entitled to a $13,000 unified credit against his U.S. estate tax. H leaves his entire estate outright to W, who is a U.S. citizen. W receives no DSUE amount from H, because H has no applicable exclusion amount or basic exclusion amount under U.S. estate tax law.

2. **Example 2**. Assume the same facts as in Example 1, except that W is not a U.S. citizen and H leaves his estate to a charity for which an estate tax deduction is allowed under U.S. estate tax law. W receives no DSUE amount from H, because H has no applicable exclusion amount or basic exclusion amount under U.S. estate tax law.

The regulations recognize that treaty provisions may affect the availability of portability for the estate of an NRA. Section 2102(b)(3)(A) recognizes that the unified credit available to an NRA may be increased by U.S. treaty obligations, up to the amount which bears the same ratio to the applicable credit amount in effect under section 2010(c) for the calendar year which includes the date of death as the value of the part of the decedent's gross estate which at the time of his death is situated in the

[32]Temp. Regs. § 20.2010-2T(c)(5), Ex. 2.
[33]Temp. Regs. §§20.2010-2T(a)(5), 20.2010-3T(e), 25.2505-2T(f).

United States bears to the value of his entire gross estate wherever situated.

D. Noncitizen Surviving Spouses. A U.S. decedent may pass his or her DSUE amount to a surviving spouse who is not a U.S. citizen. However, if a decedent leaves property to a non-citizen spouse in a qualified domestic trust ("QDOT"), the computation of the DSUE amount is delayed until the estate tax on the QDOT has been paid in full.

1. **No Estate Tax Marital Deduction for a Noncitizen Spouse**. The estate tax marital deduction is not available for transfers to a surviving spouse who is not a U.S. citizen.[34] A U.S. decedent can, however, deduct the value of property passing to a surviving spouse who is not a U.S. citizen, if the property is left to a qualified domestic trust (QDOT).[35] The principal distributions to the non-citizen surviving spouse from a QDOT are subject to U.S. estate tax, and the entire principal of the trust is subject to U.S. estate tax on the non-citizen surviving spouse's death.[36] Most marital deduction trusts are taxed as part of the surviving spouse's gross estate, either under Section 2044 for a qualified terminable interest property trust ("QTIP trust") of Section 2041 for a general power of appointment marital deduction trust. A QDOT, on the other hand, is taxed as part of the estate of the first deceased spouse, generally, when principal is distributed to the surviving spouse (other than for hardship). Thus, the tax on a QDOT is computed without regard to the surviving spouse's other assets, deductions, or credits.

2. **Delay of Computation of DSUE Amount**. The regulations provide that the value of the deceased spouse's DSUE amount cannot be calculated until all of the assets of any QDOT created by that spouse have been subjected to U.S. estate tax.[37] This generally means that a surviving spouse who is not a U.S. citizen and for whom a QDOT was created will be able to use the DSUE amount from the deceased spouse only against the surviving spouse's estate tax liability, and not against any gift tax liability, unless the QDOT has been entirely distributed to the surviving spouse or the surviving spouse has become a U.S. citizen.

3. **Example**. H, a US citizen, makes a $1 million taxable gift, his first, in 2002, and he reports the gift on a timely-filed gift tax return. No gift tax is due because the applicable exclusion amount for that year ($1 million) equals the fair market value of the gift. H

[34] I.R.C. § 2056(d)(1).
[35] I.R.C. §§ 2056(d)(2), 2056A.
[36] I.R.C. § 2056A(b).
[37] Temp. Regs. § 20.2010-2T(c)(4).

dies in 2011 with a gross estate of $2 million. H's wife (W) is a U.S. resident but not a citizen of the United States, and H's will leaves $1.5 million to a QDOT for the lifetime benefit of W. E, H's executor, timely files an estate tax return and makes the QDOT election for the property passing to the QDOT. H's estate is allowed a marital deduction of $1.5 million under Section 2056(d) for the value of that property. H's taxable estate is $500,000. On H's estate tax return, H's executor, E, computes H's preliminary DSUE amount as $3.5 million (the lesser of the $5 million basic exclusion amount in 2011, or the excess of H's $5 million applicable exclusion amount over the sum of the $500,000 taxable estate and the $1 million adjusted taxable gifts). No taxable events within the meaning of Section 2056A occur during W's lifetime with respect to the QDOT, and W makes no taxable gifts. In 2012, W dies and the value of the assets of the QDOT is $1.8 million. H's DSUE amount is redetermined to be $1.7 million (the lesser of the $5 million basic exclusion amount in 2011, or the excess of H's $5 million applicable exclusion amount over $3.3 million (the sum of the $500,000 taxable estate augmented by the $1.8 million QDOT assets and the $1 million adjusted taxable gift).

E. **Other Credits**. The Code does not state explicitly whether the DSUE amount is determined before or after the application of the other credits, including the credit for tax on prior transfers (Section 2013), the credit for foreign death taxes (Section 2014), and the credit for death taxes on remainders (Section 2015). Treasury received some comments asking for an explanation of how the DSUE amount affects the application of other credits, and it has reserved this issue for further study and guidance.[38]

IV. **The Surviving Spouse's Use of the DSUE Amount**. The sum of the surviving spouse's DSUE amount and his or her own basic exclusion amount constitutes the surviving spouse's applicable exclusion amount, for both gift and estate tax purposes. The addition of the DSUE amount to the surviving spouse's basic exclusion amount is deemed to occur on the date of the first spouse's death.[39] The surviving spouse may, therefore, begin making gifts to utilize the deceased spouse's DSUE amount on the day after the date of death of the deceased spouse, even though no estate tax return has yet been filed and no portability election been made. Nevertheless, if the deceased spouse's executor elects not to have the portability rules apply or elects not to file an estate tax return for the first deceased spouse, the surviving spouse will not inherit any DSUE amount.

A. **Identifying the "Last Spouse Survived."** The surviving spouse may use only the DSUE amount of the last deceased spouse. A question arose as to the effect of lifetime use of the DSUE amount if the surviving spouse

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[38]Temp. Regs. § 20.2010-2T(c)(3).
[39]Temp. Regs. §§ 20.2010-3T(c)(1) and 25.2505-2T(d)(1).

remarries or survives a second spouse. The regulations take a very practical approach. First, the regulations explain that merely remarrying has no effect on the DSUE amount that a surviving spouse has received from a deceased spouse, because remarrying does not itself change the identity of the last spouse survived.[40] Therefore, for gift tax purposes, a surviving spouse who has remarried is still free to use the DSUE amount of a prior spouse until the death of a subsequent spouse.

B. **Effect of Remarriage**. A surviving spouse who remarries and then survives another spouse does, however, lose any DSUE amount from the earlier predeceased spouse. Therefore, if gifts are appropriate, a surviving spouse who inherits DSUE amount from a deceased spouse should make such gifts as early as possible because the DSUE amount is a "use it or lose it" proposition. A surviving spouse can inherit only the DSUE amount from literally the <u>last</u> deceased spouse, even if the executor of the estate of the last deceased spouse elects not to have portability apply, or the last deceased spouse leaves no DSUE amount or a smaller one because the exclusion is otherwise used by the last deceased spouse's estate plan. Temp. Regs. § 20.2010-3T(a)(2).

1. **Example**. H1 dies on January 15, 2011, survived by W. Both H1 and W are U.S. citizens, and neither has made any taxable gifts during H1's lifetime. H1's executor elects portability. H1's DSUE amount is $5 million. On December 31, 2011, W makes $2 million in taxable gifts to her children, and reports them on a timely gift tax return. W is considered to have applied $2 million of H1's DSUE amount to the 2011 gifts, and, therefore, W owes no gift tax. W is considered to have an $8 million applicable exclusion amount remaining ($3 million of H1's remaining DSUE amount plus W's own $5 million basic exclusion amount). After H1's death, W marries H2, who dies on June 30, 2012. H2's executor elects portability, and H2's DSUE amount is $2 million, as reflected on H2's estate tax return. The DSUE amount to be included in determining W's applicable exclusion amount available for gifts during the second half of 2012 is $4 million, determined by adding the $2 million DSUE amount of H2 and the $2 million DSUE amount of H1 that was applied by W to W's 2011 taxable gifts. Thus, W's applicable exclusion amount during the balance of 2012 is $9 million rather than the $10 million W had originally. Thus, W has benefitted from $2 million of the $5 million DSUE amount inherited from H1 by making an immediate gift and may add that to the $2 million DSUE amount inherited from H2.[41]

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[40]Temp. Regs. § 20.2010-3T(a)(3).
[41]Temp. Regs. § 25.2505-2T(c)(2).

2. **DSUE Not Lost Upon Remarriage**. The regulations adopt what may be viewed as a very generous construction of the DSUE amount rules, to permit a surviving spouse to use a deceased spouse's DSUE amount to make gifts, and then to obtain an entirely new DSUE amount by remarrying and surviving another spouse. First, the regulations create an ordering rule that a surviving spouse's taxable gift is deemed made first from the DSUE amount of the last deceased spouse on the date of the gift, and only if the amount of the gift exceeds the DSUE amount is the surviving spouse's own basic exclusion amount applied.[42]

3. **Cumulative DSUEs**. Second, the regulations compute the DSUE amount available to a surviving spouse (or his or her estate) in a manner that preserves the benefits of the DSUE amount used by the surviving spouse to shelter from tax lifetime gifts made after the death of the first spouse survived and before the death of the next spouse survived. This is accomplished by including in the surviving spouse's DSUE amount both the DSUE amount of the last deceased spouse, and, if the spouse has survived more than one spouse, any DSUE amount actually applied to taxable gifts made by the surviving spouse between the deaths of the two spouses survived.[43] This computation appears to make it possible for a surviving spouse to have an applicable exclusion amount in excess of two basic exclusion amounts, which might appear to be a generous result, but does require surviving multiple spouses and having the funds to engage in substantial lifetime gifting.

4. **Exception**. A decedent's DSUE amount is not included in the surviving spouse's applicable exclusion amount, if

   a. If the executor of the first decedent's estate supersedes the portability election by filing a subsequent estate tax return revoking the election, before the filing deadlines (including extensions actually granted);

   b. To the extent that the DSUE amount subsequently is reduced by a valuation adjustment or the correction of an error in calculation; or

   c. To the extent that the surviving spouse cannot substantiate the DSUE amount claimed on the surviving spouse's return.[44]

[42]Temp. Regs. § 25.2505-2T(b)(1).
[43]Temp. Regs. §§ 20.2010-3T(a), 20.2010-3T(b), 25.2505-2T(a), 25.2505-2T(c).
[44]Temp. Regs. § 20.2010-2T(c)(1).

C. **Authority to Examine Returns of Deceased Spouses**. The Code extends the statute of limitations for an estate that elects portability indefinitely, for the sole purpose of confirming the amount of the surviving spouse's DSUE amount. The ability to examine returns of a deceased spouse includes returns (such as gift tax returns) of a surviving spouse reporting transfers to which DSUE amount is applied.[45] The regulations clarify that the Service may adjust or eliminate the DSUE amount reported on a return after the normal period of limitations, but that it can assess additional tax with respect to the deceased spouse's return only within the normal period of limitations. The Service can re-examine this issue every time that the surviving spouse uses some of his or her DSUE amount.

V. Planning With Portability

A. **Background**. Since 1948, spouses have effectively been able to share in each other's lifetime gift tax exemptions by electing, under the "gift-splitting" provisions, to treat each other's gifts during a calendar year (other than those to each other) as having been made one-half by each of them.[46] For example, if the wife is wealthier than the husband and the couple wishes to make a large gift to their children, the wife, using her assets alone can make the gift. The husband, by consenting to split gifts for the year, can allow his exemption to shelter one-half the gift and the wife's exemption would shelter the other half. Gift-splitting similarly permits married couples to share in the lifetime use of their GST exemptions.[47]

Portability may be viewed as a paradigm shift in estate planning for married couples. Although it was promoted as a way to simplify estate planning,[48] it may make it more complex and even costly in some cases. Portability also creates significant planning opportunities, especially for the very wealthy but also for "merely" affluent.

Portability would generally be available in two situations. The first would be if a married decedent has insufficient asset fully to use her available exclusion amount. The second situation would involve a more deliberate choice to rely on portability, by implementing planning that

[45]I.R.C. § 2010(c)(5)(B); Temp. Regs. §§ 20.2001-2T(a), 20.2010-2T(d), 20.2010-3T(d), and 25.2505-2T(e).
[46]See I.R.C. § 2513. See, generally, D. Zeydel, "Gift-Splitting – A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules," 106 JTAX 6 (June 2007).
[47]I.R.C. § 2652(a)(2); Regs. § 26.2652-1(a)(4). Once the "unlimited" gift tax marital deduction came into effect in 1982, one spouse could give property to the other without gift tax and the recipient spouse could make a gift of the property as a gift from him or her without the necessity of gift splitting. See I.R.C. § 2523(a) of the Internal Revenue Code of 1986 as amended. However, under current rules, a spouse may not use the gift tax marital deduction in making gifts to his or her spouse who is not a US citizen. I.R.C. § 2523(i).
[48]C. Freid, "Estate and Gift Rules: Some Clarity for Now," *The New York Times*, February 12, 2011 ("the new 'portability' feature that Congress added to simplify estate planning for married couples").

makes the election available. One common suggestion is that instead of splitting the estate of the first-to-die into a traditional credit shelter or by-pass trust and a marital trust, the entire estate would pass in a form qualifying for a marital deduction (or at least the portion in excess of any state estate tax shelter), thereby creating a taxable estate having a value less than the first-to-die's available applicable exclusion amount. That excess would be ported to the surviving spouse.

1. **Example 1**: Suppose the value of a first decedent's gross estate, reduced by deductions for debts, funeral expenses and expenses of administering his or her estate, is not be large enough to use his or her estate tax exemption in full. In that case, the unused exemption can be preserved for the surviving spouse if the first decedent's executors make a portability election. For example, the first decedent's gross estate (reduced by deductions for debts and administration expenses) may be only $1 million and his or her basic exclusion amount in 2015 would be $5,430,000. Even if no part of the first decedent's estate qualifies for the estate tax marital or charitable deduction (such as if the first decedent leaves the entire $1 million to his or her descendants), $4,430,000 of exemption is not used. Accordingly, the surviving spouse may "inherit" the unused exemption if the first decedent's executors make a timely portability election. Hence, regardless of the estate plan used (including one that uses a credit shelter trust), portability can preserve the unused applicable exclusion amount of a married decedent of relatively modest wealth.[49]

2. **Example 2**. The second way in which portability can be used is to have the first decedent's estate pass in a form qualifying for the estate tax marital deduction (or at least have a sufficient portion of it so pass as to reduce the first decedent's taxable estate to less than the applicable exclusion amount).[50] In that case, the marital deduction will reduce the first decedent's taxable estate to an amount that is less than his or her estate tax exemption amount. Nevertheless, by filing an estate tax return and making a timely portability election, the first decedent's executors can "port" the

[49]There is no true estate tax exemption. Rather, the exemption is essentially the amount of taxable estate a decedent may have which does not generate estate tax by reason of the unified or applicable credit allowed under I.R.C. § 2010. The Code uses the phrase "applicable exclusion amount" and not "estate tax exemption." See I.R.C. § 2010(c).

[50]The applicable exclusion amount of the spouse dying first also can be preserved for the survivor by having the estate of the first spouse to die qualify for the estate tax *charitable* deduction under I.R.C. § 2055(a). Even if the first decedent has substantial charitable intent, that likely would be suboptimal from a tax perspective. Rather than bequeathing the estate of the first decedent to charity, the estate could pass to the surviving spouse in a form qualifying for the marital deduction and the survivor could thereafter transfer it to charity. In both cases, there is no estate tax and the exemption is preserved. But in the second case (where the estate passes to the surviving spouse and the survivor transfers the property to charity), the survivor would be entitled to an income tax charitable deduction as well.

unused exemption to the surviving spouse. The first decedent's unused exemption is thereby preserved for use by the survivor.

B. Portability Advantages.

1. **Simplicity**. As mentioned above, an alleged advantage of relying on portability is simplicity, at least in the eyes of many married couples. They may perceive that portability permits the first decedent's assets to be left outright to the surviving spouse, rather than bequeathed to a so-called credit shelter trust[51] equal to the otherwise unused applicable exclusion amount of the first decedent.[52] Although the first decedent's entire estate in that case will qualify for the marital deduction (provided that the surviving spouse is a U.S. citizen), the first decedent's unused exemption can still be inherited by the surviving spouse. Hence, many taxpayers may assume that a simple "sweetheart" form of will (or will substitute, such as a revocable trust) can be used.[53] As will be seen, however, it will often be preferable, at a minimum, for the first decedent's estate to pass to QTIP trust that can qualify for the estate tax marital deduction to the extent that the first decedent's executors elect.[54]

2. **Second Basis Adjustment**. A second advantage of portability is that the assets acquired from the first decedent will generally receive a new (or second) automatic change in basis under Section 1014 when the surviving spouse dies.[55] If it is anticipated that the survivor will consume property inherited from the first decedent during the survivor's lifetime, however, no "second" automatic change in basis will occur. Although that might make the second automatic change in basis appear unimportant, neither the performance of the assets nor the timing of the survivor's death can be predicted with certainty; therefore, a second change in basis always has the potential to reduce future income taxes. If an

[51]It is called a "credit shelter trust" because the trust is structured so, even though the surviving spouse may benefit from the trust property it will be sheltered from estate tax when the survivor dies, and is equal to the unused estate tax credit allowed under I.R.C. § 2010.

[52]If the survivor is not a US citizen, the marital deduction will be allowed only if the assets pass into qualified domestic trust (QDOT) described in I.R.C. § 2056A. See I.R.C. § 2056(d).

[53]Other ways to have the entire estate of the spouse dying first pass outright to the surviving spouse are by operation of law if property is titled jointly between the spouses with a right of survivorship, under beneficiary designation forms applicable to some assets (such as an individual retirement account or IRA or a policy of life insurance) by which the successor is designated on a form, or through a "payable upon death" account where the surviving spouse succeeds directly to the ownership of the asset.

[54]See I.R.C. § 2056(b)(7).

[55]Not all assets included in the gross estate of an individual receive the automatic change in basis (often called the "income tax free step up in basis"). For example, it does not apply to the right to income in respect of a decedent ("IRD") described in I.R.C. § 691. See I.R.C. § 1014(c). In any case, there could also be a reduction in basis if the property declines in value by the time of the death of the surviving spouse.

amount equal to the unused estate tax exemption of the first decedent is placed into a credit shelter trust that will not be included in the estate of the surviving spouse, no automatic change of basis will occur upon the death of the surviving spouse.[56]

3. **Solution to IRD**. A third advantage arises where the estate of the first decedent includes sufficiently large amounts of right to income in respect of a decedent ("IRD")[57] property that the first decedent's unused estate tax exemption would need to be funded with IRD property. If a credit shelter trust is funded with rights to IRD, income taxes on the IRD will erode the wealth that ultimately passes to the couple's descendants at the death of the surviving spouse, in effect wasting exemption on assets used to pay income taxes. The DSUE amount, by contrast, is fixed as of the first decedent's death, so long as the surviving spouse does not fail to use up the DSUE amount prior to remarrying and surviving a second spouse.[58]

4. **No Risk of Decline During Survivor's Lifetime**. A fourth advantage of portability is that it is not reduced even if the assets inherited from the first decedent decline in value. If the first decedent creates a credit shelter trust, partial relief against market declines can be obtained by making the so-called alternate valuation election under Section 2032. With proper (albeit sometimes complex) planning, the alternate valuation election will permit the burden of market declines to be shifted to the marital share that will ultimately be included in the surviving spouse's gross estate.[59] The election is not available, however, unless both the value of the gross estate and the amount of the estate tax due decline as a result of the election.[60] In addition, the alternate valuation election cannot protect a credit shelter trust against market declines that occur more than six months after the first decedent's death. The DSUE amount, by contrast, is fixed as of the death of the first decedent.

5. **Decoupled State**. A fifth advantage of portability arises where the first decedent's estate could be subject to a state estate tax and the state exemption amount differs from (usually, is smaller than) the federal estate tax exemption. In order to avoid state estate tax when the first decedent dies, the first decedent may wish to limit

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[56]A type of simulated change in basis, as will be discussed below, may be achieve by using a so-called "supercharged credit shelter trust[SM.]" a brief discussion about which is set forth below.
[57]See I.R.C. § 691.
[58]See Regs. § 20.2010-3T(a)(3).
[59]Blattmachr & Lo, "Alternate Valuation – Now Perhaps, More Important than Ever", 111 JTAX 90 (August, 2009).
[60]See I.R.C. § 2032(c).

the share of his or her estate that does not qualify for the marital deduction (such as any share passing to a credit shelter trust) to the state death tax exemption amount. By leaving the balance of his or her estate to the survivor in a form that qualifies for the estate tax marital deduction, no state estate tax should arise at the first decedent's death.[61] Even if assets qualifying for the marital deduction are ultimately included in the survivor's gross estate, state death taxes on such assets will be avoided altogether if, for example, the surviving spouse moves to a state, such as Florida, that does not have a state death tax. Planners who "hardwire" a couple's documents so that state death taxes will necessarily be paid at the first decedent's death, therefore, may face criticism if it turns out that such taxes had been paid unnecessarily. One draw back of this approach if that the DSUE amount is not indexed once the first spouse dies. However, an immediate gift by the survivor of the DSUE amount to the couple's descendants (except, perhaps, a gift by a surviving spouse domiciled in Connecticut, which is the only state with a gift tax, or of real or tangible personal property situated in Connecticut) will normally remove the property transferred from the state death tax base.[62] Thus, if the first decedent's executors elect portability and the surviving spouse uses up the DSUE amount during lifetime, state death tax on the entire federal estate tax exemption amount of the first decedent can be avoided. Further, as discussed later in this article, the surviving spouse can to a significant extent retain beneficial access to the property that he or she transfers by gift in order to use up the DSUE amount.

6. **Income Tax Leverage of the First Decedent's Shelter**. A sixth advantage of portability is that it creates a simple way to "supercharge" the first decedent's exemption amount. That is, as discussed below, the surviving spouse can use the DSUE amount to fund a "grantor trust" for descendants of which he or she will be treated as the owner for income tax purposes. For reasons discussed later in this article, a grantor trust for descendants is likely to be more efficient from an estate and gift tax perspective than a conventional testamentary credit shelter trust. Hence, as will be seen, portability opens up additional estate tax planning opportunities, at least for the very wealthy.

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[61]See, generally, M. Gans & J. Blattmachr, "Quadpartite Will: - and the Next Generation of Instruments," 32 Estate Planning, 3 (April 2005); "Quadpartite Will Redux: Coping with the Effects of Decoupling," 32 Estate Planning, 15 (October 2005).

[62]See B. Sloan, "Spousal Transfers -- During Life, At Death and Beyond," 47th Annual Heckerling Institute on Estate Planning, Chapter 14 (2013). However, under current New York law, gifts made within three years of death will be brought back into the New York gross estate.

7. **Avoid Use of Formulas**. A final advantage of portability is that it permits a couple to avoid using so-called "optimum" or "reduce-to-zero" funding formulas. In general, such formulas limit the property passing from the first decedent that qualifies for the marital deduction to the smallest possible amount that will not cause estate tax to be due at the first decedent's death. Although long seen as a virtually inevitable consequence of sound estate tax planning, so-called "optimum" formulas have always had drawbacks. They include:

   a. Complexity: Reduce-to-zero funding formulas are complex both in manner they are expressed and in the administration of them. Tax driven formulas in particular are unavoidably tied to provisions of the Code which makes for highly technical drafting.

   b. Administrative complexity. A reduce-to-zero funding formula essentially divides the first estate's estate into multiple shares. Those shares must be initially calculated based on the first decedent's remaining exemption amount. With some types of formulas, such as "fractional" formulas, the shares are also a function of the value of the assets of the first decedent's estate. The shares may thereafter need to be recalculated every time that the marital or non-marital share is funded.[63] In some cases, such as where the first decedent had used up most of his or her exemption amount via lifetime gifts, the administrative costs of a reduce-to-zero formula may even exceed the actual amount of the non-marital share.

   c. Dispositive uncertainty. A reduce-to-zero funding formula leaves it to Congress (and, in some cases, state legislatures) to fill in the terms of the first decedent's dispositive plan. This may have unintended consequences. In 2010, for example, several states passed legislation to correct the unintended consequences of tax driven formulas.[64] Some have contended that it can be difficult to predict the actions of Congress. Especially where marital and non-marital shares have different beneficiaries, it may not be wise to permit politicians to have a say in how the first decedent's assets will be disposed of.

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[63]The need for recalculation is most obvious when a so-called "fractional" formula is used but is in fact present even where the marital or non-marital share is defined as a pecuniary, pre-residuary gift, as "separate shares" must then be calculated (and/or recalculated upon a partial distribution) for income tax purposes. Regs. § 1.663(c)-2(b)(1); Regs. 1.663(c)-5 Example 6.

[64]See, e.g., New York's Estates Powers and Trusts Law ("NY EPTL") 2-1.13.

d. Gain recognition on funding. With some types of reduce-to-zero formula clauses, the funding of the marital or non-marital share with appreciated assets will cause the first decedent's estate to recognize capital gain. With portability, the foregoing drawbacks of reduce-to-zero funding formulas can be avoided.

C. Apparent Disadvantages of Portability. Portability is alleged to have several disadvantages.

1. Loss of First Decedent's GST Exemption. One alleged disadvantage is that the unused GST exemption of the first decedent is not portable and will be lost (wasted) to the extent not otherwise used by him or her. By contrast, if property equal to the unused GST exemption of the first decedent passes to a credit shelter trust, the GST exemption can be allocated to the credit shelter trust. A credit shelter trust, however, absorbs estate tax exemption and thereby restricts or eliminates the ability to port the first decedent's unused exemption to the surviving spouse.[65]

2. Creditor Claims. A second alleged disadvantage is that assets passing outright to the surviving spouse will be subject to the claims of creditors of the survivor, including any subsequent spouse if the surviving spouse remarries. Such a subsequent spouse may have claims against the survivor in the event of divorce or death. Even if the couple resides in a state that exempts inherited property from claims in divorce, the couple may move to a state, such as Connecticut, where all property owned by either spouse, regardless of how or when acquired, is subject to division in the event of divorce.[66] Moreover, the burden to prove the "pedigree" of property, so that it is a type not subject to division in the event of divorce, is on the spouse making that claim. In a long-term marriage, that burden may prove difficult to overcome. In addition, in virtually all non-community property jurisdictions, a surviving spouse will have a claim to a portion of the estate of a deceased spouse, even with respect to property that would not be subject to division if the marriage had ended in divorce.[67] Hence, even if the spouses in the first marriage agree that their property should pass exclusively to the descendants of their marriage, the "inheritance" rights of a subsequent spouse may prevent that from occurring. Of course, the survivor could enter a prenuptial

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[65]The unused estate tax exemption may be greater than, the same as or smaller than the unused GST exemption. See discussion in Blattmachr, Gans, Zaritsky and Zeydel, "Congress Finally Gives Us A Permanent Estate Tax," 118 JTAX 75 (February 2013).

[66]See, generally, Medlin, Zaritsky & Boyle, "Construing Wills and Trusts During the Estate Tax Hiatus in 2020, 36 ACTEC L. J. (2010-2011).

[67]See, e.g., F.S. 732.201 et seq.

agreement with the new spouse. But that may not occur, and such an agreement might be challenged. Suffice it to say that placing the property of the first decedent into trust is most likely the best means to preserve it to the exclusion of any subsequent spouse or other creditor of the survivor.

3. **No Protection Against Improvidence**. A third apparent disadvantage of portability is that, if assets are left outright to the surviving spouse, he or she will not be protected from "unwise" financial decisions, such as to fulfill a request for funds made by a friend or relative.[68]

4. **Lack of Indexing**. A fourth apparent disadvantage is that, unlike one's own estate and gift tax exemption, the DSUE amount ported over to the survivor is not indexed for inflation. Property passing from the first decedent may grow by the time the survivor dies. If the growth occurs within a credit shelter trust that uses up all of the first decedent's estate tax exemption, more property will be protected from estate tax than if the first decedent's estate tax exemption is instead ported to the surviving spouse. One study estimates that if the survivor lives for 15 years after the death of the first decedent, the additional wealth in the credit shelter trust may exceed the inherited shelter by more than $2 million.[69] That study assumed the first decedent dies after 5 years and the survivor lives another 15 years. Federal income taxes on the credit shelter trust were taken into account.[70]

5. **Loss of Tax Credits**. A fifth apparent disadvantage occurs when the first decedent's estate would be entitled to one or more estate tax credits[71] (other than the unified credit). These credits would be wasted if the estate of that spouse does not generate any "gross" federal estate tax against which a credit can be applied. There can be no gross estate tax, however, unless the entire estate tax exemption is used, which will prevent any portability election from being made. Even if the first decedent's estate would not be

[68]See, generally, J. Blattmachr, "The Right Answer: Put It All In Trust," Trust & Investments, (September/October 1998), republished in 10 NYSBA Elder Law Attorney 12 (Winter 2000), and updated and republished in J. Blattmachr & D. Blattmachr, "Even Without Estate Tax, The Right Answer Is Still the Same: Put It All in a Trust," Alaska Trust Company Newsletter (June 2011).
[69]See R. Weiss, "A Comparison of Wealth Transfer Techniques in Light of Portability: Do We Need to Change Our Thinking?" 49th Annual Heckerling Institute on Estate Planning, Special Session (2015) (using JP Morgan proprietary MAPS software)..
[70]See Gassman, Crotty, Buschart & Moody, "The $28,000,000 Mistake: Underestimating the Value of a Bypass Trust and Overestimating the Value of Spousal Estate Tax Exclusion Portability" LISI Estate Planning Newsletter #2061 (Feb. 7, 2013) suggesting it could be much more where a credit shelter trust is invested in Dow Jones Industrial Average securities.
[71]For example, a decedent's estate may be entitled to a prior transfer credit under I.R.C. § 2013 or a foreign tax credit under I.R.C. § 2015.

entitled to a credit (other than the unified credit), a credit may arise before death, such as a prior transfer credit arising from an inheritance from someone else.

6. **Loss of DSUE by Remarriage**. A sixth apparent disadvantage is that if the surviving spouse remarries and survives a second spouse, the DSUE amount of the first spouse, if not previously used to make gifts, is forfeited.[72]

D. **Why Many Advantages of Conventional Planning Are Not Lost with Portability**. Many of the apparent disadvantages of portability can be overcome with proper planning. For example, a portability election does not necessarily mean that the GST exemption of the first decedent will be "wasted." As mentioned above, unused GST exemption of the first decedent is not portable and will be lost to the extent not used by him or her. Hence, an individual who desires to avoid tax with respect to grandchildren or more remote descendants should probably make it possible for unused GST exemption to be allocated at his or her death. Using GST exemption may seem unimportant where it is highly probable that the value of any property passing to grandchildren will never exceed the GST exemption of the person from whom the grandchild receives the property (such as a parent who is the child of the spouse dying first). Of course, by premise, it likely would take quite a while for the first decedent's assets to wind their way to grandchildren. On the other hand, the first decedent's children might well acquire additional wealth or the amount of estate tax exemption of the grandchild's parent might be reduced.[73]

1. **Use of a QTIP**. If the first decedent's assets pass at least in part to a conventional credit shelter trust, his or her GST exemption could be allocated to the credit shelter trust. However, a credit shelter trust will reduce (or eliminate) the DSUE amount. As an alternative, which also preserves the ability to elect portability, the estate of the first decedent may pass into a so-called QTIP trust[74] which, by election, can be made to qualify for the estate tax marital deduction and, by another election,[75] can allow the unused GST exemption of the spouse dying first to be allocated that trust. Because the trust to which the GST exemption is allocated qualifies for the marital deduction, the estate tax exemption of the first decedent can be preserved and ported over to the survivor. Moreover, because the QTIP trust will be included in the gross estate of the surviving spouse, the automatic change in basis of the

[72]See Regs. § 20.2010-3T(b)(2) Example.
[73]From time to time, the Federal estate tax exemption has declined. See www.irs.gov/pub/irs-soi/ninetyestate.pdf.
[74]See I.R.C. § 2056(b)(7).
[75]See I.R.C. § 2652(a). The election under this section is called the "reverse" QTIP election.

trust's assets will occur upon the death of the survivor. The survivor, by directing the estate tax on the trust to be paid out of other assets, such as the residue of the survivor's probate estate, can also prevent the GST-exempt QTIP trust from being depleted by estate tax.

2. **Reduction of GST Leverage If a QTIP Is Used**. To be sure, the income from a QTIP trust must be paid to the surviving spouse, which erodes the amount that can pass free of GST tax. It may be better, in order to maximize the property protected from GST tax, to use a credit shelter trust, especially one that has been "supercharged."[76] Alternatively, the surviving spouse can cause the income of a reverse QTIP trust to be accumulated for the benefit of descendants if he or she uses up the DSUE amount (and/or his or her "basic" exemption amount) by making a gift of the income interest in the QTIP trust to a trust for descendants. Such a gift, as will be discussed, enables income to be accumulated for the benefit of the couple's descendants yet remains effectively exempt from GST tax.

3. **Preserving Creditor Protection While Using Portability**. A portability election does not mean that a couple must forego creditor protection for the surviving spouse or protection against unwise financial decisions. On the contrary, if the first decedent leaves his or her assets in a QTIP trust, the assets (other than any income distributed to the survivor) will be protected both from the survivor's creditors and from any poor financial decisions that he or she might if the assets were held outright. Hence, if there is any concern about subsequent creditors of the surviving spouse or his or her ability to manage assets prudently, a QTIP trust seems a better choice than an outright disposition.

4. **Preserving Available Credits**. Portability planning does not mean that a couple cannot take advantage of estate tax credits. For example, the first decedent could leave all of his or her assets to a trust that can qualify as QTIP to the extent his or her executors elect. If a credit, such a foreign death tax credit, might be available to the first decedent's estate, the first decedent's executors could then fail to make the QTIP election and thereby generate a gross tax against which the credit can be applied. If, on the other hand, no credit (other than the unified credit is available), the executors could make the QTIP and portability elections and thereby cause the first decedent's unused estate tax exemption to be inherited by the surviving spouse. Portability planning is likewise compatible

[76]See M. Gans, J. Blattmachr & D. Zeydel, "Supercharged Credit Shelter Trust[SM]," 21 Probate & Property 52 (July/August 2007).

with generating a prior transfer tax credit for the estate of the surviving spouse: if the survivor dies soon after the first decedent or has a condition that may significantly reduce his or her life, the first decedent's executors can deliberately fail to make the QTIP election and thereby generate a potentially significant prior transfer credit for the survivor's estate.

5. **Post Mortem Gifting To Preserve Leverage of the DSUE**. A portability election does not mean that a couple loses the opportunity to cause returns on the DSUE amount to pass free of estate tax at the survivor's death. If the survivor uses the DSUE amount to make a gift to or for the benefit of descendants, returns on the property transferred by gift can pass to descendants free of estate tax (and, if GST exemption is allocated, also free of GST tax), just as if the property had passed from the first decedent to a credit shelter trust. (Meanwhile, as noted, the first decedent's GST exemption is not lost so long as it is allocated to a reverse QTIP trust.) The funding of a credit shelter trust, by contrast, will often carry out taxable income from the first decedent's estate. The gift can also be "supercharged" if it is made to a trust that is treated as owned for income tax purposes by the surviving spouse. Moreover, as discussed in detail later in this article, it is even possible for the surviving spouse to make a gift of the DSUE amount yet still (i) retain a beneficial interest in the property transferred by gift and (ii) the first decedent's GST exemption.

E. Real Disadvantages of Portability.

1. **Complexity**. Even though many of the alleged disadvantages of portability can be overcome, real disadvantages remain. One such disadvantage may, ironically enough, be complexity: as is seen throughout this article, there are many advantages to portability, but they can often only be achieved through additional planning.

2. **Reduction in Potential Income Tax Planning**. Another disadvantage is that, if the first decedent fails to create a credit shelter trust, significant opportunities for income tax planning may be lost. In general, with a portability election, all of the income earned on the assets passing from the first decedent to the surviving spouse will be taxed to the survivor and/or any marital trust for her benefit. The income tax planning opportunities of a discretionary credit shelter trust include the ability to shift the trust's income over to any trust beneficiary, which may include descendants of the couple, and thereby reduce or eliminate federal, state and/or city income taxes that otherwise would be imposed. On the other hand, trusts are subject to the highest tax brackets at

much lower thresholds than individuals.[77] In addition, the limits on the amount of a trust's net investment income that are subject to the so-called "Medicare" surtax on investment income are much lower for trusts than they are for individuals.[78] As noted, a trustee may, through discretionary distributions to the beneficiaries, be able to minimize the trust's and the beneficiaries' overall income tax burden. That will not be possible or desirable, however, in all cases. For example, if GST exemption is allocated to a credit shelter trust, it may be preferable for income to be accumulated in the credit shelter trust for the ultimate benefit of skip persons, even if distributions could reduce the combined income tax burden of the trust and the beneficiaries.

3. **Need to File a Return**. A third potentially adverse effect of portability is that, to elect portability, an estate tax return must be filed even if the return is not due.[79] That may increase the costs of administering the first decedent's estate. On the other hand, in some cases, the IRS permits executors who file an estate tax return solely for purposes of electing portability not to report the value of the assets qualifying for the marital deduction.[80] Further, estates often choose to file a return, even though none is required, in order to commence the running of the statute of limitations for assessment of tax.[81] Another reason, independent of portability, to prepare an estate tax return is that a pro forma federal estate tax return may need to be filed with a state taxing authority even if no return is required to be filed with the IRS. Finally, many of the costs associated with preparing an estate tax return, such as valuing assets to determine their basis for income tax purposes, may need to be incurred even if no return is filed. Thus, the marginal additional cost of completing an estate tax return may not be as great as anticipated.

4. **Protecting Against Loss of Inherited DSUE**. It may also be unwise to rely entirely on portability if the first decedent inherited exemption from a prior spouse but did not make sufficient adjusted taxable gifts to use the inherited exemption in full.[82] For example, if the first decedent has used none of the first decedent's own

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[77] I.R.C. § 1(e).
[78] I.R.C. § 1411(a)(2)(B)(ii).
[79] Under I.R.C. § 6018, an estate tax return must be filed if the gross estate of a citizen or domiciliary of the United States exceeds (1) the applicable exclusion amount (estate tax exemption) over (2) the sum of adjusted taxable gifts made after December 31, 1976 and the amount allowed as the "old" gift tax exemption under old Section 2521 between September 8, 1976 and December 31, 1976.
[80] Regs. § 20.2010-2T(a)(7)(ii).
[81] See Section 6501.
[82] An adjusted taxable gift is a gift made after December 31, 1976 that is not included in the decedent's gross estate. Section 2001(b).

exemption and has inherited $3 million of DSUE from a prior spouse and dies in 2015 when the "basic" exemption amount is $5.43 million, then, under Section 2010(c)(4)(A),[83] the maximum amount of exemption that the first decedent's surviving spouse could inherit from the first decedent is $5.43 million. The first decedent, therefore, to the extent that he or she does not use the exemption inherited from a prior spouse by making lifetime gifts, should consider creating a credit shelter trust at least equal to the remaining unused DSUE from the prior spouse.[84]

F. **Portability and the Subsequent Marriage**. The marital deduction for QTIP trusts was to some extent inspired by the fact that many Americans die in second or subsequent marriages with descendants from a prior marriage. Often, even in a subsequent marriage, the spouses will desire to provide for each other to the maximum extent possible and to postpone estate tax until the survivor dies. Before 1981, the ultimate disposition of property that qualified for the marital deduction in the estate of the first decedent was generally left to the discretion of the survivor. Since the enactment of the QTIP provisions, however, the first decedent has been able to have property passing at his or her death qualify for the marital deduction yet still control where the property goes when the surviving spouse dies.[85]

1. **Alternatives to Using a QTIP**. Of course, in lieu of a QTIP trust, the spouses may promise that the survivor will leave equal shares of their combined wealth to the spouses' respective descendants. Such promises are not always kept, although they might be made enforceable with a marital agreement. If the survivor seeks to disregard the wishes of the first decedent, the first decedent's descendants may effectively be disinherited, in whole or in part, and considerable litigation may ensue after the survivor's death.[86]

2. **Diversion of Inherited DSUE**. A similar conflict between the surviving spouse and the first decedent's descendants may arise if the first decedent's estate passes to a QTIP trust and the DSUE amount is ported to the surviving spouse. The surviving spouse in that case may decide to use the DSUE amount (as well as his or her

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[83]Temp. Regs. § 20.2010-2T(c)(1)(i).

[84]As discussed in the next section, a spouse who inherited estate tax exemption from a prior spouse is at risk of losing the DSUE amount if he or she survives a subsequent spouse. Under a special rule in the temporary portability regulations, however, the DSUE amount from the prior spouse may be "locked in" with taxable gifts made prior to the subsequent spouse's death. Temp. Regs. § 20.2010-3T(b). A surviving spouse who inherits exemption and remarries, therefore, should consider making taxable gifts before the second spouse dies. A discussion of the many techniques for making taxable gifts in this circumstance is beyond the scope of this article.

[85]See, generally, General Explanation of the Economic Recovery Tax Act of 1981, prepared by the Staff of the Joint Committee on Taxation of the Congress, pp. 233-237.

[86]See, e.g., Oursler v. Armstrong, 10 NY 2d 385, 223 NYS 2d 477 (1961).

own "basic" exemption amount) to protect transfers to his or her own descendants to the exclusion of the first decedent's. Meanwhile, the QTIP trust will be included in the estate of the surviving spouse under Section 2044. Section 2207A essentially provides that the increase in estate tax attributable to the inclusion of a QTIP trust in the survivor's gross estate must be paid out of the QTIP trust, unless the surviving spouse provides otherwise. Thus, even though the surviving spouse may not be able to divert the assets in the QTIP trust, he or she can still deny the remaindermen any benefit of the first decedent's estate tax exemption.

a. Some might claim that any transfer to the surviving spouse could be conditioned on the survivor agreeing to pay estate taxes at the survivor's death from other assets so that the DSUE amount will shelter the QTIP trust except to the extent used to make gifts in favor of the descendants of the first decedent. At a minimum, however, the imposition of such a condition would no doubt complicate the estate planning documents. The condition may also be difficult to enforce and there may be questions of whether such an agreement could cause gift, estate or income tax issues to arise.[87]

b. Moreover, the surviving spouse may not retain the DSUE if he or she remarries. In that case, the DSUE amount inherited from the first decedent will be lost if the second spouse predeceases the surviving spouse. (The surviving spouse might then acquire a new DSUE amount from the subsequent spouse, but only if the subsequent spouse does not use his or her own exemption, and his or her executors make the portability election.) Therefore, to ensure that the DSUE amount from the first decedent is actually used, the surviving spouse must use it before the subsequent spouse dies. If the survivor has descendants from a prior marriage, he or she may resist using the DSUE in favor of the first decedent's family. The survivor might just prefer to let it expire when the subsequent spouse dies.

3. **Contrasting View**. Notwithstanding the foregoing discussion, some commentators suggest that portability should be considered seriously even in the second marriage situation. This view appears based upon the paradigm of a couple that may not have sufficient

[87]Among other issues, it is unclear how would the preservation of the DSUE amount occur if the surviving spouse made taxable gift. The DSUE amount is used before the survivor's own exemption is used and use of gift tax exemptions is not optional—they are used whenever taxable gifts are made. It could even be that the survivor is treated an having made an inadvertent gift. See, e.g., CCA 201208026.

assets (and in not anticipated to have assets) fully to absorb the available shelters. In that case the potential income tax advantages of achieving a second step-up in basis (assuming assets appreciate) may be worth considering. The possible loss of DSUE by remarriage would need to be managed by requiring the QTIP Trust formed at the first death to become sheltered by the DSUE at that time. One suggestion is to trigger a current taxable gift of the QTIP Trust by triggering the application of Section 2519.

G. **Cases Where Portability May be Appropriate**. Although portability may not be appropriate in second or subsequent marriage situations in most cases, it may be appropriate in other cases. Probably the most common circumstance where portability will be used is where the first decedent's estate is too small to absorb his or her remaining estate tax exemption. In that case,[88] the only reason, it seems, for not electing portability is the cost of filing an estate tax return if none were otherwise due. For example, if a married New Yorker dies without a will and no descendants, the whole of his or her estate will pass to the surviving spouse.[89] It is likely, in that case, that the surviving spouse will become the administrator of the estate of the first decedent. He or she can then decide whether to incur the cost of filing a return and electing portability.[90]

1. **Property Passing Outright By Title or Beneficiary Designation**. A similar result may occur where all assets of the first decedent pass automatically to the survivor, such as where the spouses' property is held jointly with rights of survivorship or where the survivor is the successor owner of the first decedent's property (such as under the beneficiary designation of a qualified retirement plan, IRA or life insurance). It should be noted that, if a return is filed and portability elected, the IRS may audit the return at any time for purposes of determining the DSUE amount, even after the period to assess estate tax has expired. Hence, the survivor's use of the DSUE amount at any time after the first decedent's death may effectively cause an audit of the first decedent's estate tax return.[91]

2. **Extremely Wealthy Couple**. A second circumstance where portability may be appropriate is where a couple is extremely wealthy. In lieu of a conventional credit shelter trust, the first

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[88] It is understood that most adults (55%) in the United States do not have wills. Go to http://wiki.answers.com/Q/What_percentage_of_people_in_the_US_die_without_a_Will.

[89] NY EPTL 4-1.1(a)(2).

[90] SCPA 1001.1(a).

[91] This may not create any additional burden when compared to filing to elect probability because if no return is filed, the IRS could audit the estate and assess tax at any time. However, if no estate tax return is filed, the probability of an audit occurring likely is very small in most cases.

decedent's unused exemption amount can be ported to the surviving spouse, who can then fund a grantor trust for the benefit of descendants. (To avoiding wasting the first decedent's GST exemption, a "reverse" QTIP trust would be created for the surviving spouse under the first decedent's will or will substitute; the grantor trust for descendants would then be funded with assets other than those that pass to the reverse QTIP trust.) The grantor trust can then earn returns free of income tax during the surviving spouse's lifetime, even as the surviving spouse's estate is depleted by the income tax liability.[92] Over the survivor's remaining lifetime, the income tax liability on a grantor trust funded initially with, for example, $5.43 million (the maximum DSUE amount that can currently be ported to a surviving spouse) may be very significant. If a second grantor trust is created using the survivor's available shelter and GST exemption, the results over traditional credit shelter planning improve dramatically. Indeed, it may be that the major downside of having the surviving spouse fund a grantor trust with the DSUE inherited from the first decedent is that the plan is "too" efficient, in that it will deplete the survivor's resources too rapidly. For all but the very wealthiest couples, therefore, it will be important to take steps, such as enabling grantor trust status to be "turned off," to ensure that a portability plan will not result in more wealth-shifting than he or she can afford. Nevertheless, it seems that a far more significant wealth shift would occur if the surviving spouse, prior to the first decedent's death, funded a grantor trust using both spouses' shelters and both spouses' GST exemption. Of course this would require "knowing" who will be the survivor.

3. **Preserving Flexibility With Portability**. A third case where portability is appropriate arises where a couple is unsure whether, at the death of the surviving spouse, the benefits of a second change in basis will outweigh the benefits of permitting assets to pass free of estate tax at the survivor's death. Such a couple may wish to preserve as much flexibility as possible. As discussed below, portability is itself an important flexibility tool, as the surviving spouse can choose to use the DSUE amount at any time after the first decedent's death. Further, through the use of QTIP trusts, it is possible for the surviving spouse to convert a marital trust that will be included in the surviving spouse's gross estate (and qualify for a change of income tax basis) into the equivalent of a credit shelter trust that will not be so included (but will pass free of estate tax at the survivor's death). There will not be any loss of the first decedent's GST exemption, if allocated to the QTIP trust. A portability election combined with QTIP trusts thus

[92]Under Rev. Rul. 2004-64, the payment of the income tax liability is not a gift to the grantor trust.

enables a couple to decide at any time after the first decedent's death when the first decedent's exemption amount should be used.

4. **Avoiding State Estate Tax on the First Death**. A fourth situation favoring portability occurs where the first decedent dies in a state whose estate tax exemption amount is lower than the federal estate tax exemption amount. In that case, as discussed previously, state death tax on the difference between the two exemption amounts can be deferred by leaving assets to the survivor in a form that qualifies for the marital deduction. By not paying state death taxes at the first decedent's death, a couple may ultimately avoid such taxes altogether if, for example, the surviving spouse moves to a state that does not have state death tax. Even if the surviving spouse does not move to such a state, state death taxes on the first decedent's federal estate tax exemption amount can still be avoided if the surviving spouse makes lifetime gifts equal to the DSUE. If the gifts are made to a self-settled trust or by an assignment of the income interests in one or more QTIP trusts, the survivor does not, as will be discussed below, lose all beneficial access to the assets transferred by gift.

5. **Remaining Unused Shelter Is Small**. A fifth case favoring portability occurs where the non-marital share would otherwise be relatively small. Creating such a small credit shelter trust may not be worth the administrative costs. For example, if the credit shelter bequest is defined as a fractional share of the first decedent's estate, it may not be practicable or desirable to transfer a pro rata share of each asset of the first decedent's estate to the marital and non-marital shares. To avoid pro rata funding, all assets of the first decedent's estate may need to be revalued so that the shares can be properly funded. Rather than incur the cost of revaluing all assets, it may be easier and more efficient to make a portability election and have the surviving spouse use the DSUE to make a gift of the credit shelter amount.

6. **Couple Does Not Have Other Beneficiaries to Protect**. Some couples may not have other beneficiaries to protect. Perhaps they do not have descendants, or believe their descendants already have sufficient wealth. In that case, the couple may be satisfied to leave the portability election in the hands of the survivor, to use or not use as the survivor determines.

H. How To Keep Your Options Open. Determining whether it may be best to rely on portability or preserve the estate tax shelter of the first spouse to die with traditional planning is difficult to forecast in many cases. A more serious look at post mortem estate planning techniques may be appropriate.

1. **Disclaimers and Portability**. One option that provides flexibility is to leave the entire estate of the first decedent to the survivor and, to the extent appropriate for any reason, have the surviving spouse disclaim. The disclaimed property could then pass under the terms of the first decedent's will into (for example) a credit shelter trust for the survivor and, perhaps, the descendants of the couple. The disclaimer would be a qualified disclaimer even if the surviving spouse has beneficial interests in the disclaimer trust.[93] However, the surviving spouse may not have a power of appointment over the trust estate.[94] Alternatively, for additional flexibility, the property disclaimed could first pass into a QTIP trust that can qualify for the marital deduction to the extent the first decedent's executors elect. If the surviving spouse also disclaims his or her interest in the QTIP trust, the disclaimed property could then pass into a traditional credit shelter trust. Such "cascading" disclaimers might provide great flexibility.[95] However, it may be foolhardy to rely on the surviving spouse to disclaim.[96]

2. **Partial QTIP Elections**. Another technique for preserving flexibility is to have the first decedent's assets pass directly to a QTIP trust. The first decedent's executors may then elect to qualify all, part or none of the trust for the marital deduction.[97] The determination of the extent of the marital deduction will also determine the extent to which first decedent's estate tax exemption is used up at his or her death, which in turn determines how much unused exemption can be ported to the surviving spouse. Thus, if a six-month extension of time to file the first decedent's estate tax return is obtained, the first decedent's executors will have fifteen months to decide the extent to which it is better to cause a portion of the first decedent's estate to pass outside of the survivor's gross estate or instead to be included in the survivor's gross estate so that

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[93]See I.R.C. § 2518(c)(4) permitting property passing as a result of a qualified disclaimer to pass to the surviving spouse.

[94]See Regs. § 25.2518-2(e)(2) ("In the case of a disclaimer made by a decedent's surviving spouse with respect to property transferred by the decedent, the disclaimer satisfies the requirements of this paragraph (e) if the interest passes as a result of the disclaimer without direction on the part of the surviving spouse either to the surviving spouse or to another person. If the surviving spouse, however, retains the right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to Federal estate and gift tax (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless such power is limited by an ascertainable standard. See examples (4), (5), and (6) in paragraph (e)(5) of this section.")

[95]Cf. discussion in I. Lustgarten & J. Blattmachr, "The Choice Between Pecuniary and Fractional Marital Deduction Formula Provisions: The Ultimate Ambulatory Will," 32 S. Cal. Tax Inst. 13-1 (1980).

[96]As Professor Jeffrey Pennell has observed, among the world's greatest lies are: (1) "The check is in the mail"; (2) "I'm from the government and I want to help you"; and (3) "Of course I'll disclaim if it will save taxes." From II.E.3 footnote 42 in Pennell, ESTATE TAX MARITAL DEDUCTION, 843 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2012).

[97]Regs. § 20.2056(b)-7(b)(2).

the assets (other than IRD) may qualify for a second change in basis. One downside of this type planning is that the first decedent's executors only have the limited period of time in which make or not make a QTIP election. An additional downside of a partial QTIP election is that income from the portion that does not qualify for the marital deduction must (because the trust was designed to qualify for the marital deduction) be paid over to the surviving spouse, which increases the value of the surviving spouse's property that will potentially be subject to estate tax. This downside may not be as adverse in the current economic climate of relatively low income returns.

3. **Clayton QTIPs**. Another important flexibility technique is known as a Clayton QTIP. The QTIP regulations allow an estate tax marital deduction for property passing into a trust designed to qualify as QTIP, even if the will provides that the property will pass in a form not qualifying for the marital deduction to the extent the executor does not make the QTIP election.[98] For example, if the executors fail to make the QTIP election, the property that would otherwise be held in a QTIP trust might pass instead to a discretionary credit shelter trust. Unlike in the case of property passing to a credit shelter trust by reason of a disclaimer by the surviving spouse, with Clayton provisions, the surviving spouse may control the benefits of the property in the non-marital deduction trust. This means it would be permissible for the surviving spouse to hold a special power of appointment over the trust upon the surviving spouse's death, for example, in additional to having a beneficial interest in the trust. However, the surviving spouse should not be the executor empowered to make (and not make) the election to have the property qualify for the marital deduction, as she or he may be deemed to make a gift to the extent the marital deduction is not elected.[99] Clayton QTIPs may provide great flexibility in determining the extent to which portability should be used. (One drawback, however, is that Clayton provisions may, depending on the terms of the trust for which the executors did not make the QTIP election is held, prevent the first decedent's executors, if they deemed it appropriate, from causing estate tax to be payable at the first decedent's death in a way that will enable the surviving spouse's estate to obtain a prior transfer tax credit under Section 2013.) *Example 6* of the QTIP regulations provides as follows:

[98]See Regs. § 20.2056(b)-7(d)(3)(i); Estate of Clayton v. Commissioner, 97 TC 327 (1991), *rev'd*, 976 F. 2d 1486 (5th Cir. 1992).

[99]J. Blattmachr, S. Heilborn & M. Gans, "Gifts By Fiduciaries By Tax Options and Elections," 18 Probate & Property 39 (November/December 2004), republished in Digest of Tax Articles, March 2005.

"D's will established a trust providing that S is entitled to receive the income, payable at least annually, from that portion of the trust that the executor elects to treat as qualified terminable interest property. The portion of the trust which the executor does not elect to treat as qualified terminable interest property passes as of D's date of death to a trust for the benefit of C, D's child. Under these facts, the executor is not considered to have a power to appoint any part of the trust property to any person other than S during S's life."

4. **How a Portability Election May Itself Be the Ultimate Flexibility Technique**. As discussed, disclaimers, partial QTIP elections and Clayton provisions can all be used to defer the decision whether to use up the first decedent's exemption amount. A disadvantage of those techniques, however, is that they force a decision to be made relatively soon after the first decedent's death. A qualified disclaimer must be made by the surviving spouse within nine months of the first decedent's death.[100] A QTIP election (or non-election) must be made on the first decedent's estate tax return, which is generally due nine months after the decedent's death (unless an extension is obtained).[101] Similarly, the portability election must be made on a timely filed estate tax return.[102] If portability is elected, however, the surviving spouse is not forever "stuck" with an inheritance from the first decedent that will be included in the survivor's gross estate. On the contrary, as discussed, the surviving spouse may at any time after the first decedent's death choose to use up the DSUE amount by making lifetime gifts. As with a credit shelter trust, such gifts can cause future returns on the first decedent's exemption amount to pass free of both federal and state estate tax at the surviving spouse's death. Further, if the gifts are made to a grantor trust, the surviving spouse, by substituting low basis for high basis assets, can achieve the equivalent of a second change in basis of the assets transferred to the trust. In this way, portability itself preserves flexibility: whereas a decision to use up the first decedent's exemption via a credit shelter trust is irreversible, the DSUE amount can be put to work at any time between the deaths of the two spouses.

5. **Potential Drawbacks of Gifts Using DSUE**. Gifts that use up a surviving spouse's DSUE amount may be perceived to have at least two drawbacks. First, to prevent gifts that use up the DSUE amount from being included in the surviving spouse's gross estate at death, the surviving spouse must generally relinquish beneficial

[100] Section 2518(b)(2).
[101] Section 6075(a).
[102] Temp Regs. § 20.2010-2T(a)

access to the gifts. Second, the first decedent's GST exemption cannot generally be allocated to the surviving spouse's gift of the DSUE amount.

I. Solutions to Potential Drawbacks of Portability Planning with QTIPs. Rather than make a gift of conventional assets, such as cash or securities, the surviving spouse can make a gift of an income interest in one or more QTIP trusts created by the first decedent.[103] A gift of the income interest will cause the surviving spouse to be deemed to have transferred principal under Section 2519. For example, if the surviving spouse has $5 million of DSUE amount and is the beneficiary of a QTIP trust worth $5 million, a gift of even a portion of the income interest will cause the surviving spouse to have made gifts of both the portion of the income interest transferred and the entire principal, i.e., the entire $5 million.[104] To the extent any portion of the income interest is retained, Section 2036(a)(1) would apply to cause inclusion of the trust principal associated with the retained income interest in the surviving spouse's gross estate.[105] However, it seems that except for the drawback of inclusion of future appreciation that could have been avoided, the effective use of the DSUE amount would nonetheless be preserved under Section 2001(b) which would exclude from adjusted taxable gifts, gifts that are included in the gross estate. In addition, a second potential step-up in basis may be achieved. To the extent the entire income interest is transferred during lifetime, both future income and appreciation would pass free of both federal and state estate tax at the surviving spouse's death. Meanwhile, if the first decedent's GST exemption was allocated to the QTIP trust, it appears the trust will remain wholly exempt from GST tax, both as to principal[106] and as to the income that remains in the QTIP trust prior to distribution.[107] To put it another way, a gift of a reverse QTIP trust, even

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[103]This type of planning is explained in further detail in "A. Bramwell & V. Kanaga on PLR 201243004," LISI Estate Planning Newsletter #2040 (December 20, 2012), A. Bramwell, "How to Use Portability to Avoid (Not Just Defer) State Death Taxes," LISI Estate Planning Newsletter #1991 (July 24, 2012) and A. Bramwell & V. Kanaga, "The Section 2519 Portability Solution," Trusts & Estates (June 2012). See also A. Bramwell, "Using Section 2519 to Enhance Estate Planning with QTIPs," Estate Planning, Vol. 38. No. 10 (October 2011).

[104]The example assumes that the surviving spouse does not have a power over the trust, such as a special power of appointment, that may cause the deemed gift of principal to be incomplete for gift tax purposes. Cf. Regs. § 25.2511-2(b). In addition, a deemed transfer under Section 2519 is a transfer for purposes of Section 2036. Regs. § 25.2519-1(a). Thus, to avoid gross estate inclusion under Section 2036(a)(1), the surviving spouse should not have any power to make principal distributions (even if limited to an ascertainable standard) over the QTIP trust principal following the deemed transfer under Section 2519.

[105]Inclusion under Section 2044 is avoided under Section 2044(b)(2) to the extent Section 2519 applied.

[106]Regs. § 26.2652-1(a)(3).

[107]Regs. § 26.2652-1(a)(5) Example 4. Assuming the QTIP trust permits distributions of corpus to the surviving spouse, valuation of the income interest seems to be covered by Rev. Rul. 75-550, 1975-2 C.B. 357 (indicating that the value of an income interest is affected by anticipated distributions of corpus). Accordingly, caution would appear to dictate making an allocation of the surviving spouse's GST exemption to the recipient trust that acquires the gift of the income interest. If such an allocation is unnecessary, Regs. § 26.2632-1(b)(4)(i) would render it void ("Except as provided in 26.2642-3 (relating to

though it is made by the surviving spouse, can be shielded by the *first decedent's* GST exemption.

J. Marital Agreement Provisions. A surviving spouse who has a DSUE amount from an earlier survived spouse should take this into account when negotiating a premarital agreement with a new spouse, and either obtain compensation for the DSUE amount that will be lost, or obtain assurances that the estate plan of the new spouse will preserve at least as much DSUE amount (or create a comparable nonmarital trust) as that surrendered from the earlier survived spouse. It may also make sense to enter into an agreement to permit the surviving spouse to inherit the first-to die's DSUE amount if the survivor is willing to pay the costs of making the necessary filing. Whether such a clause might lead to conflicts concerning other positions taken on the return and the need for an independent fiduciary to balance competing interests would need to be addressed.[108]

1. **More Complicated Planning**. It has been suggested that a portability election may be appropriate even in the case of a second marriage.[109] This type of planning will add yet another layer of complication. Suppose that the couple believes that relying on portability and permitting the assets of the first decedent to pass into a QTIP trust in order to allow for a basis adjustment on the second death is potentially advantageous. The difficulty is that the surviving spouse may use the DSUE amount prior to death. This may occur by making taxable gifts, which under the temporary regulations causes the DSUE amount to be applied first. This might also occur as a result of gift-splitting with a new spouse. The authors suggest that the spouses enter into a marital agreement to cover this possibility so that the benefit of a tax shelter at least equal to the DSUE amount will be applied to the QTIP trust. The difficulty may be that the surviving spouse may have insufficient assets to accomplish this. Suppose the surviving spouse's only

charitable lead annuity trusts) an allocation of GST exemption to a trust is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust"). Upon the death of the surviving spouse, the income interest expires, and Example 4 cited above supports the conclusion that the "unpaid income" remaining in the QTIP trust that would have funded the now expired income interest are sheltered by the first decedent's GST exemption allocation. For example, suppose the surviving spouse assigns the income interest to a new trust and the income interest at the time of the assignment has a fair market value of $1,000,000. The following year the surviving spouse dies and only $25,000 of income has been earned and paid to the new trust. It seems that the balance of the $1,000,000 that would have funded the income interest had the surviving spouse lived out her life expectancy (which balance remains in the QTIP trust) continues to be sheltered by the first decedent's GST exemption.

[108]See G. Karibjanian & L. Law, "Portability and Prenuptials: A Plethora or Preventative, Progressive and Precautionary Provisions," 38 BNA/Tax Management's Estates, Gifts and Trusts Journal 175 (March-April 2013).

[109]See R. Franklin & G. Karibjanian, "Portability and Second Marriages -- Worth a Second Look," 39 BNA/Tax Management's Estates, Gifts and Trusts Journal 179 (Sept. - Oct. 2014).

asset is the QTIP trust and the DSUE amount is absorbed through gift splitting with a future spouse. How would the agreement between the spouses be enforced?

2. **Triggering Section 2519**. Suppose the spouses instead agree to trigger the application of Section 2519 if the surviving spouse remarries or determines to make a taxable gift.[110] As described above, the suggestion is that a gift of a sliver of the income interest in the QTIP trust be made to cause a deemed gift of the entire remainder interest. It appears that if GST exemption has been allocated to the QTIP trust, this proposal would not upend the GST exempt status of the trust.[111] In addition, inclusion of the portion of the QTIP associated with the retained income interest would make the DSUE amount available at death and eliminate the adjusted taxable gift caused by Section 2519. Nonetheless, because the restoration of the DSUE amount at death is computational, ensuring that the benefit of the DSUE amount will be allocated to the QTIP is challenging to say the least. It may be that the complications of drafting the marital agreement and the tax apportionment provisions necessary to protect the remainder beneficiaries of the QTIP trust will not be worth the potential benefit of the basis adjustment at the death of the surviving spouse.

3. **An Even More Intriguing Suggestion**. An even more intriguing suggestion has been made that a surviving spouse might consider making a Section 2519 transfer of the entire income interest in the QTIP trust, and that the transfer, even if made to grandchildren, would not trigger GST tax as a result of the GST regulations cited above.[112] It seems to this author difficult to imagine that what would otherwise be a direct skip gift by the surviving spouse would be sheltered by the allocation of the first spouse's GST exemption to the QTIP, as opposed to having a shift of transferor occur as to the gift of the income interest. The reason is that the Chapter 12 voluntary transfer of the income interest by the surviving spouse is expressly not covered by Section 2519.[113] Thus, the GST regulation cited does not, by its terms, apply to the Chapter 12 transfer of the income interest by the surviving spouse because that transfer is not a Section 2519 transfer, it is a transfer under Section 2511. The support for the idea that a transfer of an

[110]See Id.

[111]See Regs. § 26.2652-1(a)(3) which provides that solely for purpose of Chapter 13 the identity of the transferor in the case of a reverse QTIP election is determined without regard to I.R.C. §§ 2044, 2207A and 2519 and that transferor status is determined without regard to the effects of I.R.C. § 2519, which appears to mean that the deemed disposition under I.R.C. § 2519 which would then implicate inclusion under I.R.C. § 2026 is ignored for purposes of Chapter 13.

[112]See A. Bramwell and V. Kanaga, "The Portability Solution," Trusts & Estates, p. 14 (June 2012).

[113]Regs. § 25.2519-1(c)(1).

income interest in a trust would not shift the identity to the transferor of a GST exempt trust is found in *Example 4* of regulation § 26.2652-1(a)(5) which states that a transfer of an income interest in a trust to an unrelated third party does not change the identity of the transferor of the trust for purposes of Chapter 13. Because the regulation does not squarely address the identity of the transferor of the income interest, it is difficult to conclude with certainty whether or not the transferor of the income interest has shifted for GST purposes. Nonetheless, the strategy does eliminate the Section 2036 issue, so that the DSUE amount would be effectively used. The suggestion that a discretionary interest in the principal of the QTIP trust could be retained seems problematic. Any distribution of principal would have the effect of reducing the income interest, thereby implicating both Section 2036(a)(1) and Section 2036(a)2). Although it might appear that the entire income interest, in this example, is transferred, so that inclusion under Section 2036 based upon an implied understanding would be foiled, it seems doubtful the IRS would view this metaphysical division as having a practical effect. If an amount equal to the actuarial value of the income interest were set apart in a separate trust, it would likely be construed as a mere division of the principal into two trusts, each retaining their proportionate income interests. If, on the other hand, the trust is not divided, any distribution of principal to the surviving spouse would reduce the future income interest, perhaps impermissibly if the right to income has effectively been transferred to someone else, and thus this possibility may be construed as a retention of the income interest likely negating the desired result of excluding the trust from estate tax inclusion.

K. Portability, the QTIP Trust and Rev Proc 2001-38. It seems that if portability is desired using a QTIP trust may be a better choice than an outright distribution to the surviving spouse. A question arises as to the effect of an unnecessary QTIP election, meaning one not needed to reduce the estate tax to zero.

1. Details on Rev. Proc. 2001-38. In Rev. Proc. 2001-38, 2001-1 CB 1335, the IRS ruled that the estate of the surviving spouse may apply to "reverse" or "undo" a QTIP election made by the first decedent's executors, provided that the election was unnecessary. As has been observed, undoing a prior QTIP election under Rev. Proc. 2001-38 prevents the trust property from being included in the survivor's gross estate and thereby may enable the couple to avoid state death tax on the first decedent's entire federal exemption amount.[114] For example, if the first decedent was domiciled in New York and directed that the amount by which his or her federal estate tax exemption exceeded the New York exemption (limited to $2,062,500 through March 31, 2015) should pass into a separate QTIP trust (called the "Excess Exemption QTIP Trust") and the first decedent's executors elected for it to qualify for the federal estate tax marital deduction, the Excess Exemption QTIP Trust would also qualify for the New York marital deduction. At the survivor's death, his or her executors could then apply to "undo" the QTIP election, which would effectively remove the Excess Exemption QTIP Trust from the survivor's gross estate for both federal and New York estate tax purposes.

2. **What Was the Problem**? Prior to Rev. Proc. 2001-38, the first decedent faced a dilemma: (1) pay more New York estate tax when he or she dies or (2) cause an increase in the gross estate of the surviving spouse because the full federal estate tax exemption was not used. Portability now provides another way to avoid that same dilemma. A married New Yorker (if he or she has not made adjusted taxable gifts) may provide that only $2,062,500[115] of his or her estate will not to qualify for the estate tax marital deduction. Consequently, neither New York nor federal estate tax will be due. Thereafter, even if the surviving spouse remains domiciled in New York, New York estate tax can be avoided if the surviving spouse makes gifts that use up the DSUE amount.

3. **Possible Solution To the Excess QTIP Election Made for State Purposes**. Structuring the estate plan to use the separate Excess Exemption QTIP Trust makes it possible either to rely on either portability or Rev. Proc. 2001-38 in order to avoid state estate tax on the difference between the federal and state exemption amounts. If an Excess Exemption QTIP Trust is created, the first decedent's may elect to have the Excess Exemption QTIP Trust qualify for the marital deduction. With that election made, either (1) the surviving spouse (or his or her estate) may invoke Rev. Proc. 2001-38, if appropriate, when the surviving spouse dies and/or (2) the first decedent's executors may make the portability election. Indeed, in theory, there could even be a double federal estate tax benefit: If the surviving spouse uses up the DSUE amount as well as his or her "basic" exemption amount and the QTIP election with respect to the Excess Exemption QTIP Trust is undone, the couple will be able to use the equivalent of three exemption amounts.

[114]This is discussed more fully in M. Gans & J. Blattmachr, "Decoupling, Portability and Rev. Proc. 2001-38," LISI Estate Planning Newsletter # 1965 (May 21, 2012) at http://www.leimbergservices.com.
[115] This is the New York basic exclusion amount in effect through March 31, 2015.

4. **No Government Whipsaw**. It is likely, if not certain, however, that the IRS will rule either that (1) the revenue procedure may not be used if portability has been elected or (2) the inherited exemption will be disallowed if the revenue procedure is invoked. Of course, if the surviving spouse used the inherited exemption during lifetime, its use could not be effectively disallowed at the survivor's death unless there was a "recapture" for estate tax purposes of the exemption so used during lifetime. It seems most likely that the IRS will simply deny the use of the revenue procedure if portability has applied during lifetime.

5. **Additional Considerations**. In deciding whether to use portability or Rev. Proc. 2001-38, two additional considerations need to be taken into account. First, if the revenue procedure is invoked, all appreciation of the Excess Exemption QTIP trust property between the deaths of the first decedent and the survivor will be excluded from the survivor's gross estate. In contrast, if a portability election is made, such appreciation will be included in the survivor's gross estate unless the surviving spouse makes gifts that use up the DSUE amount. Second, if a couple relies on portability, the property inherited by the surviving spouse, including the Excess Exemption QTIP Trust, will receive an automatic change in income tax basis when the surviving spouse dies. If the revenue procedure is invoked, by contrast, the basis of the Excess Exemption QTIP Trust will not be adjusted at the survivor's death.

6. **Is Rev Proc 2001-28 Optional?** Some have questioned whether a couple may intentionally plan to use Rev. Proc. 2001-38.[116] It has been suggested that the revenue procedure may only be invoked if the estate of the surviving spouse establishes that making an unnecessary QTIP election was "inadvertent" and not done to enhance planning opportunities. There is no such limitation in the revenue procedure. Of course, the IRS could attempt to foreclose its use other than where the taxpayer can establish that the unnecessary election was inadvertent. In any case, as discussed, if the first decedent's estate passes to a QTIP trust and the QTIP election is made, both options would appear to be available: the first decedent's executors could either elect portability or instead not elect portability but rely on Rev. Proc. 2001-38 when the survivor dies.[117]

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[116]See Gans & Blattmachr, "Decoupling, Portability and Rev. Proc. 2001-38," LISI Estate Planning Newsletter #1965 (5/21/12).

[117]As explained in the articles cited in footnote 14, it may be better to secure a change in basis for the assets in the QTIP trust than to have them excluded from the gross estate of the survivor.

L. Grantor Trust Status and Portability. Grantor trusts are among the most powerful estate planning tools. Among other things, the grantor is liable for the income tax on the trust's income yet is not treated as making a gift by, in effect, paying the tax on the trust's behalf.[118] To the extent the estate of the first decedent passes outright to the surviving spouse, the survivor can transfer those assets to a trust that is a grantor trust with respect to the survivor and protect the trust from gift tax to the extent of the inherited DSUE amount. In addition, although this trust presumably will be structured not to be included in the gross estate of the surviving spouse, the survivor, prior to the death, could substitute high basis assets of his or her own for lower basis assets of the trust and thereby obtain, in essence, a tax-free change in basis.[119]

1. Drawbacks of a Gift to a Grantor Trust Using DSUE. A potential drawback of making a lifetime gift to a trust is that the survivor would lose access to the trust property unless the survivor is a beneficiary. A trust the survivor creates or settles for himself or herself (a so-called "self-settled trust") will be included in his or her gross estate (thereby eliminating any benefit of grantor trust status) if he or she is entitled to the income,[120] he or she retains the power to control the beneficial enjoyment of the trust property[121] or his or her creditors can attach the assets of the trust.[122] However, even if the grantor is a discretionary beneficiary,[123] the property should not be so included if none of those "strings" exist. That said, the survivor would have less access to and control over a self-settled trust than a "standard" credit shelter trust. In addition, a self-settled trust that is not included in the survivor's gross estate likely must be created under the laws of a limited number of jurisdictions. Hence, the couple must balance whether transferring the DSUE amount to a grantor trust so it will grow free of income tax is sufficiently compelling to reduce the interest and control that the surviving spouse otherwise could have. They must also decide how confident they are that a self-settled trust created by the survivor will not be included in his or her gross estate at death.[124] Finally, they should keep in mind that a credit shelter trust created by the first decedent for the benefit of the surviving spouse could

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[118]See Rev. Rul. 2004-64, 2004-2 CB 7, which is discussed in detail in M. Gans, S. Heilborn & J. Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," 31 Estate Planning 467 (October 2004).
[119]This is discussed in detail in J. Blattmachr, M. Gans & H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (September 2002).
[120]See Section 2036(a)(1).
[121]See Section 2036(a)(2) and 2038.
[122]See, e.g., Rev. Rul. 2004-64, supra, and Rev. Rul. 77-378, 1977-2 CB 347.
[123]See, e.g., PLR 200944002 (not precedent); Estate of German v. United States, 85-1 USTC para. 13,610.
[124]G. Rothschild, D. Blattmachr, M. Gans & J. Blattmachr, "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Estate Planning 3 (January 2010).

provide probably unquestioned complete asset protection and other benefits of trust ownership.

2. **Preserving GST Exemption**. Having the survivor create a grantor trust for descendants using the DSUE amount inherited from the first decedent probably should be considered only by couples with substantial wealth. And, perhaps, if the couple is wealthy, it would be better for the survivor to use his or her own wealth to create a grantor trust rather than use the property inherited from the deceased spouse. At a minimum, if the first decedent's GST exemption has been allocated to a "reverse" QTIP trust, the assets of that trust should not be distributed to the surviving spouse, as the distribution would waste the first decedent's GST exemption.

3. **Using a Supercharged Credit Shelter Trust℠**. An alternative that may be safer than having the surviving spouse create as self-settled trust is to use supercharged credit shelter trusts℠.[125] Such a trust also is a grantor trust with respect to the surviving spouse and may equal the unused estate tax exemption of the first spouse to die. Moreover, it is perhaps less likely that the IRS would contend that it is included in the estate of the surviving spouse than it would with respect to a self-settled trust. Furthermore, it may permit the survivor to have greater interest and control than he or she could or should have over a grantor trust that the survivor could create after the death of the first spouse to die using the DSUE amount inherited by the survivor. Supercharged credit shelter trusts℠ also may provide greater opportunities for a change in basis of all the couple's property when the first spouse dies by making each trust revocable by the spouse who created it until it is certain which spouse will die first.[126]

M. **Direction For or Against Portability**. As mentioned above, the executor of the first decedent's will is empowered to make the portability election or not to make it.

1. **Problems Causing the Election to Be Made**. In some cases, an executor may refuse to make the election because of the additional cost of filing an estate tax return or from spite or other reason. It is difficult to know if using portability will be wise or unwise.

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[125]See M. Gans, J. Blattmachr & D. Zeydel, "Supercharged Credit Shelter Trust℠," 21 Probate & Property 52 (July/August 2007).

[126]Note that Rev. Rul. 2004-64, supra, held that the grantor trust would be included in the gross estate of the grantor for Federal estate tax purposes if the grantor was entitled to payments from the trust to "cover" the income tax on the trust's income attributed to the grantor under the grantor trust rules, or if the trustee was authorized but not required to reimburse the grantor for those income taxes where applicable state law allowed the grantor's creditors access to the trust on account of the reimbursement authority or where there was an implied understanding that the trustee would reimburse the grantor.

Directing that the election must be made or cannot be made may not be appropriate unless the surviving spouse will be named the executor and is viewed as likely to make the wisest decision whether to implement portability.[127] If a married person does not want a portability election, he or she can dispose of his or her estate in a manner that will use up his or her estate tax exemption. Of course, if the first decedent does not have adequate wealth to use his or her exemption, then an estate tax return presumably would not be required to be filed. It seems that the cost of filing, even if the return is not required to be filed, should be deductible for estate or income tax purposes, as the expenses seem to ordinary and necessary costs of administering the decedent's estate.[128]

2. **Possible Remedies?** If the executor refuses to file the return or make the election for an insufficient reason, the surviving spouse may have recourse to the court having jurisdiction over the estate. The court might order the executor to file the return and make the election or to appoint the equivalent of a special executor who would be authorized to file the return and make the election.[129]

3. **Express Direction**. If might be possible for the first decedent to direct that the executor must elect portability if the surviving spouse so directs. It also seems that he or she could direct that the election will be made only if the survivor "pays" for the cost of filing the return (if not otherwise required to be filed) and making the election. Assuming the cost is an estate tax deductible expense, the taxable estate will not increase: although charging the expense to property otherwise passing to the surviving spouse would reduce the estate tax marital deduction, there presumably would be an offsetting estate tax administration expense deduction for the cost incurred in filing the return. Perhaps, if the estate of the surviving spouse is so small that virtually nothing passes to the surviving spouse who wants to inherit the DSUE amount, a direction in the Will that the survivor must pay for the cost of filing the return and making the election would not seem to

[127]Although a strong case can be made that an executor is empowered by Federal law to make or not make the election, challenges to making Federal tax elections have been made under state law. See, e.g., *Matter of Schuman*, N.Y.L.J. 12/23/09 (Surr. Ct. N.Y. County) (denying a petition by trustees of a QTIP trust to compel the preliminary executor of decedent to make an election to defer payment of estate tax under Section 6166). Even if the executor is not inhibited in making the election under state law, the executor might be sued for waste by incurring the cost of filing the return. Hence, it may be appropriate expressly to authorize the executor to do so.
[128]See Section 2053 and Regs. § 1.212-1(i).
[129]Cf. Matter of Fales, 106 Misc. 2d 419 (Surr. Ct. NY Cnty 1980). But cf. Matter of Colp, NYLJ Jan 20, 1976, p. 8, col.2. See, also, Estate of Pearl B. Kalikow, Nassau County (New York) Surrogate's Court (J. Riordan) (3/28/07) granting limited letters testamentary for one purpose); Matter of Breitstone, NYLJ (6/14/07); but, also, cf. Estate of Schuman, New York County (New York) Surrogates' Court, NYLJ (12/11/09).

generate taxable income to the estate. Presumably, the expense would be an administrative expense deductible for income tax purposes.

VI. Supercharged Credit Shelter Trust^{SM} vs Portability: More Details on Comparing the Alternatives

A. Introduction. This portion of the outline will compare the results of simply relying on portability with no further planning (the "Pure Portability Plan") to (1) using portability coupled with an immediate gift by the surviving spouse of the DSUE amount to a grantor trust (the "Portability Plan"), (2) creating a traditional "Credit Shelter Trust" at the death of the first spouse to die, (3) using a Supercharged Credit Shelter Trust^{sm}, and (4) using the spouses' exemptions as early in lifetime as possible.

B. Comparing the Alternative Plans.

1. **The Pure Portability Plan**. The Pure Portability Plan benefits from indexing of the couple's gift and estate tax shelters. The DSUE amount is indexed until the first death and the survivor's shelter is indexed until the second death. For a couple who may need all available assets for consumption, waiting until the second death to use the combined shelters may avoid an allocation to property that declines in value or is consumed. It also permits the couple's appreciated assets potentially to receive a second step-up in basis. However, the Pure Portability Plan will cause the GST exemption of the first spouse to die to be lost. Therefore, it seems that a couple with sufficient wealth to be concerned about eventual transfers to so-called "skip persons" (grandchildren and more remote descendants) is well advised to engage in some estate planning. The question then becomes which alternative plan is likely to transfer the greatest wealth. The analysis depends not only on economic factors, but also on psychological factors. The latter, of course, may be difficult to gauge. Taking both factors into account, we conclude that for a wealthy couple, deliberate planning that takes effect as early as possible will, in most cases, significantly improve the overall wealth transferred to the family.

2. **<u>Benefits of Using Exclusions and Exemptions Early</u>**. It is nearly axiomatic that an exemption or exclusion under the tax law should be used as early as practicable for at least two reasons. First, the exemption or exclusion may be eliminated or reduced.

   a. A common example is the annual exclusion under Section 2503(b) of the Internal Revenue Code of 1986 as amended ("Code"), which is now $14,000. Even though the exclusion is indexed for inflation, the failure in any year to use it means the exclusion for that year cannot be recaptured or used in a later year. Hence, annually, it is a "use it or lose it" wealth transfer tax reduction opportunity. Even if the property given away under the annual exclusion declines in value, it is efficient to use it each year if that is practicable (e.g., the donor can afford to give up the property), because the exclusion expires annually and does not diminish any future planning opportunities.

b. A second reason to use an exemption or exclusion as early as practicable is that, if the property grows in value after it is transferred, the value of the exemption or exclusion applied also effectually grows. For example, if $5 million of property is transferred 30 years prior to death, under the protection of the gift tax exemption, and grows at an annual after tax compounded rate of 6%, about $30 million will be excluded from the donor's gross estate at death.

c. The gift and GST exemptions are now also indexed for inflation. Nevertheless, assuming property given away under one or both of them grows in value, it is most efficient, at least as a general rule, to use them as early as practicable. If the property declines in value, tax benefits may be lost, but if the time horizon until an estate tax would be due is sufficiently lengthy, the probabilities are strongly in favor of early use. Certainly, as a general rule, it is most efficient to give away those assets that will grow the most after the transfer. And early use does not prevent additional gifts to take advantage of additional shelter that becomes available by indexing.

3. **<u>Potential Inhibitions on Early Use of Shelters</u>**. Individual taxpayers in the United States may now transfer up to $5,430,000 under the protection of their lifetime gift and GST exemptions (and, as indicated, that amount is indexed for inflation for future years). Although early use of the available shelters is likely most tax efficient, it may not be practicable for many reasons. Probably, the principal one is that the owner wishes to continue to own the wealth and to be able to use or benefit from and to control it. The continued use of property given away during lifetime or the ability to control its benefit after it is given away typically will be ineffectual to achieve any wealth transfer tax efficiency because the property may be included in the transferor's gross estate at death as though he or she had not made the transfer.[130] Moreover,

[130]See Sections 2036(a)(2) and 2038.

the retention of benefits from or the use of the property may permanently subject the property to the claims of the transferor's creditors.[131]

4. **Non-Reciprocal Trusts for Spouses**. Although many will not be willing to give up the benefits and control over property by making lifetime transfers under the protection of the gift tax and GST exemptions, it seems that married persons may use their exemptions by creating "non-reciprocal" trusts for each other which should make the property potentially available for their use until they both die and, perhaps, permit retention of some control over the assets in the trusts. Such trusts are not without tax risk, as discussed below. And at best, non-reciprocal spousal trusts should be regarded by the couple as no more than a "rainy day" fund. Accordingly, a couple should have income or other assets to secure lifestyle, rather than being dependent on the transferred assets.[132]

   There may be cases where the couple is comfortable with access to only one-half of the wealth in trust, greatly reducing the potential tax issues. In such a case, the couple would form the gift trusts, but only one spouse, presumably the wealthier one, would give the other spouse access to the trust he or she creates. This means that there would be no reciprocal spousal interests. Although the reciprocal trust doctrine has been applied to gifts to third parties, meaning trusts created by the spouses where neither spouse has an interest in the other spouse's trust, the application of the reciprocal trust doctrine in such a case is typically the result of crossed trusteeships where each spouse makes the other spouse a trustee of the trust he or she creates, which is easily avoided.

C. **Income Tax Basis Matters**. There can be, however, some offsetting considerations in using exemptions during lifetime. One is minimizing future capital gains. The income tax basis of property owned at death or otherwise included in the owner's gross estate for Federal estate tax purposes (subject to exception) is equal to its estate tax value (usually, fair market value as of the date of death).[133] Property not included in the gross estate does not have its basis so changed.

1. **Use of a Grantor Trust to Simulate Basis Step-Up**. If the property is transferred during lifetime to a trust that is a grantor trust for income tax purposes with respect to the transferor, the transferor (or the transferor's spouse) may substitute or sell without income tax recognition higher basis assets for the trust's

[131]See, e.g., New York EPTL 7-3.1; Restatement (Third) Trust, Section 60, comment f.
[132]See, generally, Blattmachr & Blattmachr, "Efficient Use of the $5+ Million Gift and GST Tax Exemptions," Estate Planning Studies (Oct. 2012).
[133]Section 1014(a).

lower basis assets, basically simulating, if efficiently timed, the equivalent of a so-called "step up" in basis under Section 1014(a).[134]

2. **Raising Funds for A Substitution**. One issue may be the possibility of raising the funds needed for an effective substitution. If this technique is planned in advance, it can work. The strategy would be to put in place an third party line of credit that would be drawn upon to reacquire the assets shortly prior to death in exchange for cash. Once the first spouse passes away, the now stepped-up assets could be repaid formerly grantor trust in exchange for the proceeds of the loan, which would then be returned to the lender.

D. **Choosing Not to Use the Exemption**. A spouse might consciously decide not to use the exemption for many reasons. For example, the spouse might decide that the "hassle" of using the exemption, such as by creating a Credit Shelter Trust, just is not worthwhile. A spouse might also not use the exemption because it is anticipated that the value of their combined wealth (which will not pass to charity) at the survivor's death and that of the survivor at that time will be less than the survivor's estate tax exemption. That might well be the case for a couple in their 80s whose combined wealth is only $1 million and whose prospects of accumulating significant additional wealth by the death of the survivor is remote. In such a case, the spouse dying first might simply leave all of his or her wealth at death directly to his or her spouse.

E. **Use of Exemption with a Credit Shelter Trust**. Of course, there is a way to use the estate tax exemption of the spouse dying first while making the entire estate available for the benefit of the surviving spouse and without causing the assets protected by that exemption to be included in the gross estate of the surviving spouse (and subjecting them to claims of the survivor's creditors). That is by creating a Credit Shelter Trust equal to the estate tax exemption of the first spouse and of which the surviving spouse is a beneficiary or the only beneficiary until death. (Such a trust is called a Credit Shelter Trust because its size is determined by and equal to the amount of the taxable estate that is sheltered by the unified or applicable credit under Section 2010, which credit can be "converted" into an estate tax exemption equivalent.)

1. **Benefits of a Credit Shelter Trust**. The survivor may be granted significant interests in and powers over such a trust without causing it to be included in his or her gross estate at death. For

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[134] See Rev. Rul. 85-13, 1985-1 CB 182; Section 1041. (A trust is a grantor trust to the extent the under subpart E of part 1 of subchapter J of chapter 1 of the Code (see Sections 671-679) the trust's grantor (or another) is treated as the owner of the trust.)

example, the survivor can be given (1) the right to income, (2) the right to withdrawal each calendar year the greater of $5,000 and 5% of the amount of the trust, (3) the right to direct trust investments (provided, if there is a right to income, the duty of impartiality is not waived), (4) the right to withdraw trust property pursuant to an ascertainable standard relating to his or her health, education, maintenance and support, (5) the right to remove and replace trustees, as described in Rev. Rul. 95-58, 1995-2 CB 191, who can distribute property for reasons other than or in addition to health, education, maintenance and support, and (6) the power both during lifetime and at death to appoint any or all of the trust property to anyone (other than himself or herself, his or her creditors or estate or the creditors of his or her estate) without causing any of the trust property (other than any amount subject to an outstanding $5,000/5% right of withdrawal which can be limited by allowing the power to be exercised only on December 31 of each year) to be included in his or her gross estate at death. To the extent property has not been distributed to the spouse by the time he or she dies and is not then subject to withdrawal by him or her, it will not be included in his or her estate and, therefore, will pass free of estate tax to others. Not infrequently, descendants are also beneficiaries of a Credit Shelter Trust created at death by the first spouse to die to whom distributions of trust property may be made in the discretion of the trustees. This feature reduces the need for the surviving spouse to make gifts to descendants that might use the surviving spouse's own gift tax shelter and/or GST exemption, thereby preserving those tax benefits for other purposes.

2. **Drawbacks of Mandating Income to the Surviving Spouse**. Of course, mandating payments (such as income) to the surviving spouse will reduce what will pass estate tax free when the survivor dies. Hence, if an important goal of the couple is to provide for the ultimate beneficiaries of their wealth (e.g., their descendants), it usually will be preferable not to mandate payments to the survivor. The survivor may still enjoy the full benefits of all of the couple's wealth by the expenditure, for example, of assets that will be in the survivor's gross estate at death (such as his or her own assets or assets in a marital deduction trust). It may be appropriate to give a trustee the power to invade and pay over corpus of the Credit Shelter Trust to the surviving spouse and the power to acquire assets for the rent-free use by the survivor (and such rent free use should not cause the property to be included in the survivor's gross estate).

F. **Critical Aspect of Portability Plan: DSUE Amount to Grantor Trust**. The fact that the DSUE amount is frozen in size and the fact that a Credit

Shelter Trust may grow between the deaths of the two spouses has caused some to suggest that the survivor should immediately use the DSUE amount after the first spouse dies, which we are calling the Portability Plan. That approach would increase what the ultimate takers (e.g., the descendants) would receive for a number of reasons.

1. **Avoid State Death Tax**. For example, unless the survivor's gift under the protection of the DSUE amount is subject to gift tax (as in Connecticut and Minnesota), using the DSUE amount avoids state death tax (e.g., in New York[135] or any of the other American jurisdictions that do not also impose a gift tax) because that amount will have been transferred to the surviving spouse and qualify for the state death tax marital deduction or exemption as well as the Federal estate tax marital deduction. Because the gift of an amount equal to the DSUE amount would be made nearly immediately after the first spouse dies, the amount protected from estate tax at the generation of the spouses would not be frozen but would grow (assuming some growth after the gift). However, as explained below, a similar, if not an enhanced, result of avoiding state death tax when the first spouse dies, may be achieved using Rev. Proc. 2001-38.

2. **Income Tax Free Compounding**. Another potential benefit for the ultimate takers of the couple's property (e.g., their descendants) of using portability is that the survivor could make a gift to a trust that is a grantor trust with respect to him or her but for the primary or exclusive benefit of the ultimate takers which would mean the trust would grow free of income tax because the burden of paying the income tax on the income earned by the trust will be imposed on the surviving spouse. Cf. Rev. Rul. 2004-64, 2004-2 CB 7. When compared to the estate tax benefits of a Credit Shelter Trust, transferring the DSUE amount to a grantor trust in the Portability Plan is superior.

3. **Survivor as Beneficiary of Grantor Trust**. It is possible that this gift by the survivor equal to and under the protection of the DSUE amount could be made to a trust of which the survivor is the beneficiary or is one of the beneficiaries. That, however, raises two issues which may foil the attempted use the DSUE amount. First, under the law of most American jurisdictions, the trust may be subject to the claims of survivor's creditors.[136] If so, that means that the trust would be included in the gross estate of the survivor even if the survivor never benefitted from the property.[137] It may

[135] Please note that, while New York does not impose a gift tax, current New York law requires gifts made within three years of death to be brought back into the New York gross estate.
[136] See, e.g., New York EPTL 7-3.1.
[137] See, e.g., Rev. Rul. 77-378, 1977-2 CB 347; Estate of Paxton v. Commissioner, 86 TC 785 (1986).

be possible to avoid that automatic estate tax inclusion if the trust is created under the law of a jurisdiction that does not allow creditors of the settlor to attach the trust assets.[138] However, according to the IRS, even if the creditor access is sufficiently retarded so as to not cause automatic estate tax inclusion, the trust nonetheless may be included if there is a finding of an understanding between the grantor and the trustee that the trustee would exercise discretion by making distributions to the grantor.[139] That likely means that distributions to the surviving spouse would have to be irregular and minimized and, if the goal is to maximize what the ultimate beneficiaries receive, it will be best if the survivor is not a beneficiary of the trust at all so as to eliminate any risk of estate tax inclusion in his or her gross estate. In no event could the survivor retain any control over the beneficial enjoyment of the trust property (other than one limited by an ascertainable standard relating to health, education, maintenance and support) as doing so would cause it to be included in his or her gross estate under Section 2036(a)(2) and/or 2038. Of course, that is contrary to our premise that the principal estate planning mission of the spouses is to make all of their property available to both of them until they both die.

4. **Contrast to Credit Shelter Trust**. On the other hand, as indicated above, if the first spouse to die creates a Credit Shelter Trust at death using his or her estate tax exemption, the surviving spouse may be a "complete" beneficiary and can be given lifetime and testamentary non-general powers of appointment (including, for example, the unilateral power to withdraw property for his or her health, education, maintenance and support) without concern about estate tax inclusion. A major "difference" between such a Credit Shelter Trust and the Portability Plan (that is, portability coupled with an immediate gift by the surviving spouse equal to the DSUE amount to a grantor trust) is that the grantor trust expected to be created under the Portability Plan will grow free of income tax which may be the most powerful opportunity in wealth transfer tax planning. Hence, the couple must weigh the benefits

[138]See, e.g., PLR 200944002 (not precedent); PLR 8037116 (not precedent); Estate of German v. United States, 7 Cl Ct 641 (1985); Estate of Uhl v. Commissioner, 241 F.2d 867 (7th Cir. 1957); and see discussions in Stephens et al., Federal Estate and Gift Taxation, ¶ 4.08[4][c]; Covey, Practical Drafting, published by United States Trust Company, July 1997, p. 4891; Rothschild, Blattmachr, Gans & Blattmachr, "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Estate Planning 3 (Jan. 2010). But see In re Huber, 201 B.R. 685 (Bankr. W.D. WA May 17, 2013).

[139]See PLR 200944002 ("[T]he trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036. * * * We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036.").

of tax free compounding with the loss of benefits to the survivor that a Credit Shelter Trust may provide. Fortunately, virtually all of the benefits for the surviving spouse of a Credit Shelter Trust and income tax free compounding may be achieved by implementing a Supercharged Credit Shelter Trust[sm], as discussed below.

G. **GST Exemption Problem with Portability Plan: Leakage**. One of the other "problems" with the Portability Plan compared even to a traditional Credit Shelter Trust is that the GST exemption of the surviving spouse is not portable and will be lost unless it is used in some way other than allocating it to a Credit Shelter Trust, for there will be no such trust with portability. It has been suggested that it be allocated to a QTIP trust that first spouse to die will create at death for the survivor and with respect to which the estate of the first to die will make the so-called "reverse" QTIP election under Section 2652(a)(3) and his or her unused GST exemption will be allocated to that trust. There are two "limitations" or issues to consider.

1. **Potential Erosion By Estate Tax**. First, the QTIP trust will be included in the gross estate of the survivor and, therefore, will be eroded by any estate tax it must pay when the survivor dies and thereby reduce the amount protected by the GST exemption, unless the survivor directs that payment of any estate tax on the QTIP trust be imposed upon other assets (if available).

2. **Leakage by Mandatory Income Interest**. Second, even if other assets are available to pay the estate tax, the GST exemption allocated to the QTIP trust will "leak" by the income required to be paid to the surviving spouse. There does not seem to be any way that the GST exemption of the spouse dying first can be allocated to a trust that is a grantor trust as to the surviving spouse. So whether a traditional Credit Shelter Trust (created at the death of the spouse dying first) or a Portability Plan is adopted, the GST exemption of the spouse dying first cannot be allocated to a trust that is a grantor trust with respect to the surviving spouse. However, if it is allocated to a traditional Credit Shelter Trust, the amount protected from GST tax will not "leak" by mandatory income distributions to the surviving spouse because such a trust need not mandate income payments.

H. **Development of Supercharged Credit Shelter Trust[sm]**. A Credit Shelter Trust not only preserves the estate tax exemption of the first spouse to die but also provides an opportunity to leverage the exemption of the first spouse during the remaining lifetime of the surviving spouse. To the extent there is appreciation and/or accumulated income in the trust, it may pass upon the surviving spouse's death free of estate tax (and free of generation-skipping transfer tax through succeeding generations of the ultimate beneficiaries of the couple's property, assuming an allocation of GST exemption to the trust). The amount in the trust passing tax-free at the surviving spouse's death would be enhanced, of course, if trust distributions to the surviving spouse are minimized. The amount in the trust would be further enhanced if the credit shelter trust were the surviving spouse's grantor trust so that the survivor could pay the tax on all the trust's taxable income without adverse transfer tax consequences. The reason for this second enhancement is that the payment by the surviving spouse of the income tax on the trust's income would permit the trust estate to grow income tax free. The trust, in other words, would enhance the estate and GST tax benefits of a Credit Shelter Trust by income tax free compounding. In other words, it would become "supercharged."[140] Although that was developed before portability was even considered (much less enacted), we believe it produces a substantially better result for both the ultimate takers of the couple (e.g., their descendants) and for the surviving spouse than does the Portability Plan.

1. **Structure of a Supercharged Credit Shelter Trust[sm]**. In the Supercharged Credit Shelter Trust[sm] plan, at least one spouse, if not each of the spouses, creates a lifetime QTIP trust for the other spouse if the other spouse is a US citizen so that by making the QTIP election, under Section 2523(f), transfers to the trust will qualify for the gift tax marital deduction. If only one lifetime QTIP is created, the spouse who creates the lifetime QTIP would be the spouse anticipated to survive. (Under Section 2523(i), no lifetime marital deduction is allowed if the beneficiary spouse is not then a US citizen.) A lifetime QTIP trust will be a wholly grantor trust with respect to the spouse who has created the trust, pursuant to at least Sections 676 and 677 of the Code, if the beneficiary spouse is also at least a discretionary recipient of trust principal. Under Section 2044, the lifetime QTIP trust will be included in the gross estate for Federal estate tax purposes of the spouse who is the beneficiary of the trust but it will remain a grantor trust for Federal income tax purposes with respect to the spouse who created it even though it has been included in the gross estate of the other spouse (as long as the first spouse was not granted and did not exercise a general power of appointment granted to that spouse in the lifetime QTIP (which would be rare).[141] Treas. Regs. § 1.671-2(e)(5) provides:

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[140]See Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust[SM]," 21 Probate & Property 52 (Jul/Aug 2007).

[141]See Regs.§ 1.671-2(e)(5). One commentator has disputed the interpretation of the regulation based upon an incorrect statement that the regulation predates the enactment of QTIP (which is not correct) and alternatively because the particular regulation may have been addressed primarily to foreign trusts.

"If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However **if a person with a general power of appointment over the transferor trust *exercises* that power in favor of another trust, then such person will be treated as the grantor of the transferee trust,** even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code." (emphasis added)

Example 9 of that regulation considers the situation where G creates and funds a trust, T1, for the benefit of B and G retains the power to revest the assets of T1 in G within the meaning of Section 676. B is granted a general power of appointment under the trust agreement, and exercises that power in favor of a new trust, T2. B becomes the grantor of T2 in the example, even though G most certainly has made a taxable gift as a result of the loss of control over the property.[142]

By the terms of the lifetime QTIP trust or pursuant to the exercise of a special power of appointment by the beneficiary spouse, the lifetime QTIP trust will become a Credit Shelter Trust using the unified credit (estate tax exemption) of the first spouse who was the beneficiary of the lifetime QTIP trust and in whose gross estate the QTIP trust is included.

2. **Simulating a Step-Up in Basis**. Because the credit shelter trust formed from the lifetime QTIP trust will remain a grantor trust for Federal income tax purposes with respect to the spouse who created it (and who is the beneficiary of the credit shelter trust), it will grow free of income tax without the spouse who created the lifetime QTIP trust being treated as making a gift. See Rev. Rul. 2004-64.[143] In addition, even though the credit shelter trust will not be included in the gross estate of the surviving spouse and, therefore, the basis of its assets may not be "stepped up" pursuant to Section 1014(a) when he or she dies, he or she may substitute assets with higher bases than those in the trust at any time even just before death, free of income tax by reason of Rev. Rul. 85-13, 1985-1 CB 184. This substitution may simulate the effect of the

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However, the regulations under Section 671 disavow any rule of consistency between transfer tax concepts and income tax concepts. Indeed, the continuation of grantor trust status is certainly consistent with state law on self-settled trusts which would trace the contributor of funds (notwithstanding inclusion in the donee spouse's estate under Section 2044) and find the assets available to creditors absent special legislation to the contrary. See, e.g.,, Fla. Stat. § 736.505(3).

[142] Cf. Diebold v. Comm'r, T.C. Memo. 2010-238, *rev'd on other grounds*, __ F.3d __, 2013 WL 6015660 (2nd Cir. 2013).

[143] 2004-2 CB 7.

tax free step up in basis at death for assets included in the gross estate and, in fact, at least for purposes of gain, may have bases in excess of their values when the surviving spouse dies. See Section 1015 of the Code. It should be noted that the same capacity to substitute higher basis assets also would be available with respect to a grantor trust created by the surviving spouse using the inherited DSUE amount under the Portability Plan.

3. **Uncertainty of Sequence of Deaths**. One benefit of the Portability Plan is that there is no need to guess which spouse will die first to obtain the benefits. So long as each spouse has sufficient assets to use his or her GST exemption, the survivor will be able, either with his or her own assets or with inherited assets, to create an immediate grantor trust with the first spouse's DSUE amount. A way to replicate this advantage with the Supercharged Credit Shelter Trust[sm] Plan is to have each spouse create a lifetime QTIP. This would provide the additional advantage of leveraging both spouses' GST exemptions as discussed below.

I. **More on GST Exemptions and the Supercharged Plan**. If the spouse who created the lifetime QTIP trust (that will become a Supercharged Credit Shelter Trust[sm] for him or her when the first spouse dies) makes the reverse QTIP election under Section 2652(c)(3) and allocates his or her GST exemption to that trust when it is created, the GST exemption will increase, if the trust grows in value, during the balance of the spouse's lifetime as well as after the death of the spouse dying first. The amount of GST exemption available to the spouse who created the lifetime QTIP trust will continue to grow by the inflation adjustment provided under Sections 2010(c)(3)(B) and 2631(c) of the Code.

1. **Assets in Excess of the Shelter**. To the extent, if any, that the value of the lifetime QTIP trust exceeds the remaining unused estate tax exemption of the spouse who was the beneficiary of the lifetime QTIP trust and who dies first, this excess cans be transferred to a separate QTIP trust which also will be GST exempt by reason of the original allocation of GST exemption of and by the spouse who created that trust and who is the surviving spouse.

2. **Double Leverage**. Furthermore, as noted in the original Supercharged Credit Shelter Trust[sm] article, such a plan likely will enhance the amount of property protected from estate and GST tax sometimes by a significant amount (possibly, a multiple) compared to having a Credit Shelter Trust created when the first spouse dies because both the unified credit and the GST exemption of the first spouse have been supercharged by reason of being in a grantor trust with respect to that spouse (and also by the early use of the GST exemption). Having the GST exemption of the first spouse

allocated to the Supercharged Credit Shelter Trust[sm] upon his or her death probably can do no better than having the GST exemption of the surviving spouse applied to the lifetime QTIP trust (and which will become a Supercharged Credit Shelter Trust[sm] when the first spouse dies) upon the death of the first spouse, and typically will do worse because the exemption will not have grown between the time the lifetime QTIP trust was created.

3. **Both Spouses Should Participate**. With the Supercharged Credit Shelter Trust[sm] plan, it probably is best if each spouse creates a lifetime QTIP trust for the other with each making the reverse QTIP election and allocating his or her GST exemption to it. That way, the GST exemption of each spouse will increase in value while both are living if each trust grows in excess of the annual payout to each spouse, which by selecting one of the many jurisdictions that permit the conversion of a QTIP trust to a 3% unitrust, should occur over a relatively long period of time especially because there will be no income tax "drag" on the trusts as they will remain grantor trusts (and, therefore, will not owe any income tax) until the first spouse dies. Upon the death of the first spouse, the lifetime QTIP trust he or she has created for the survivor will cease being a grantor trust although it will continue to be a QTIP trust for the survivor until death.

VII. And Now for the Numbers[144]

A. **Concerns About the Impact of Income and Transfer Tax Rates**. Estate planning has certainly become more challenging now that the estate tax rate is effectively a flat rate of 40% and the marginal federal income tax rate is potentially 43.4% on ordinary income and 23.8% on capital gains (or even 31.5% on collectibles). Although these taxes are imposed on entirely different assets -- the decedent's worldwide estate, on the one hand, and income on the other; a one time event, in the first case, and a hit every year on the other -- the similarity in rates has created a psychological complacency that the estate tax is "not that bad" anymore. Certainly, with the increase in the applicable exclusion amount and indexing, the estate, gift and GST taxes are not a problem for the overwhelming majority of Americans. It strikes this author, based upon no statistically reliable empirical data, that a 50% effective transfer tax rate is the psychological tipping point. If the government is potentially taking half your assets at death, a wealthy person may get excited about that. Forty percent -- well, the attitude seems to be, "maybe we can find a way to handle it." There is no question that state income taxes further

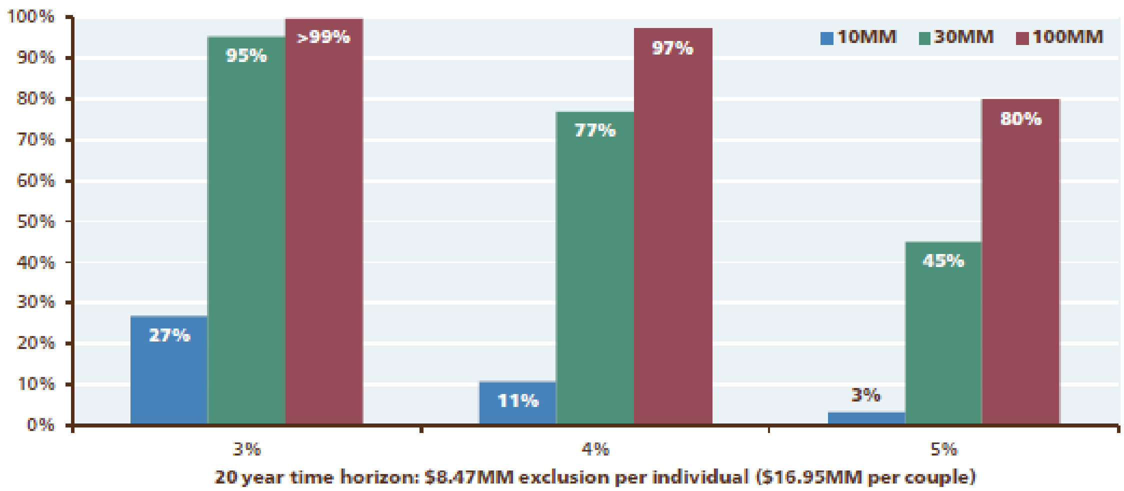
[144]The author thanks Henry F. Millson and Robert A. Weiss for their excellent work in preparing the analytical analysis supporting this portion of the outline. The JP Morgan analytics from this portion of the outline are excepted from the Special Session materials submitted by Robert A. Weiss. Please refer to the Special Session materials for the complete set of charts.

dilute the "awfulness" of the transfer tax system, as combined rates can exceed 50% for a California resident, for example, where the marginal income tax rate is north of 13%.

B. What Do the Numbers Tell Us About Who Has an Estate Tax Problem? In order to determine whether the complacency that has set in when it comes to estate planning is justified, let's examine some projections. JPMorgan, using its proprietary MAPS projection system, has taken a look at who might still fall within the transfer tax net. The results were based upon a 20 year time horizon looking at couples who currently have $10 million, $30 million and $100 million in assets, and spend 3% (of the initial asset value, indexed for inflation), 4% or 5% annually. The results are pictured below.

The likelihood of owing estate tax under current law depends on a number of factors: guidelines based on time horizon and spending may be helpful; below assumes a balanced portfolio

Probability of owing U.S. estate tax



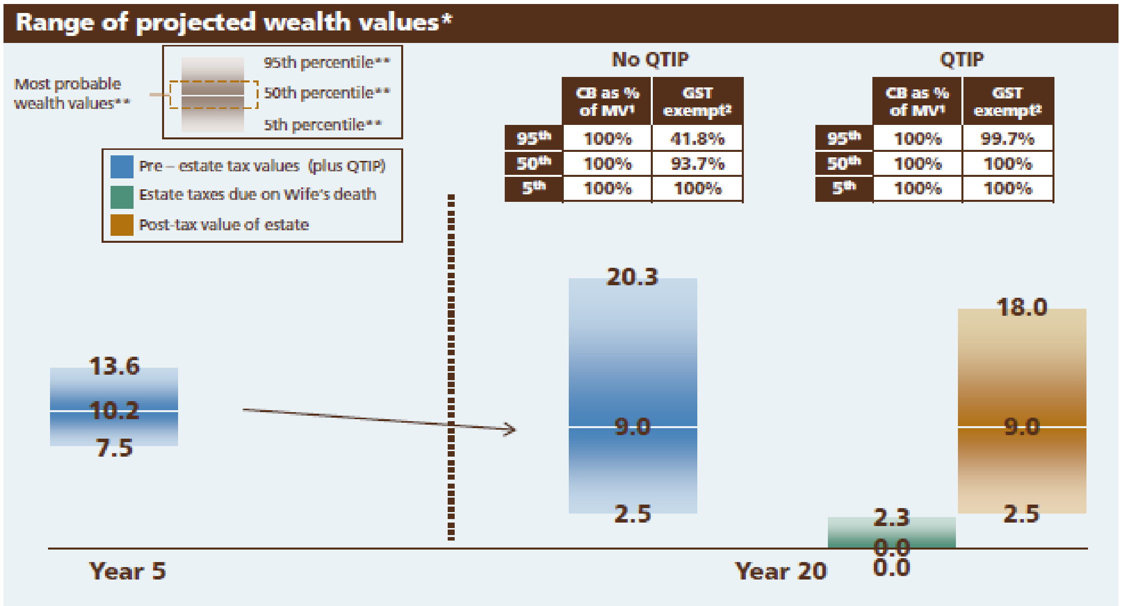
Assumptions: Balanced portfolio (see appendix for assumptions), spending is a fixed dollar amount (rather than fixed percent of asset value) increased by assumed 2.25% inflation annually (e.g., 4% spend on $10MM is $400k increased annually by 2.25% inflation), no inflows for duration of analysis, all assets assumed to be in taxable portfolio (no tax-exempt or tax-deferred assets), Florida resident (U.S. income taxes only), assumes a married couple with both deaths occurring in year 20, "probability" defined as the likelihood of owing at least $1 of U.S. estate taxes (i.e., probability of assets being greater than combined exclusion amounts).

We see that the $10 million couple on the left who spends 3% annually has a 27% likelihood of owing estate tax if deaths occur in 20 years (when their combined applicable exclusion amounts are projected to be $16.95 million). On the other hand, if that couple spends 5% annually, the chance of owning estate tax falls to 3%.

C. Who Can Safely Rely on Portability (at least for tax purposes)? We have discussed all the different reasons why relying on portability may create risk to an estate plan. But suppose a couple is willing to accept those risks in favor of keeping the estate plan relatively simple. A couple with $10 million dollars spending 4% annually, where we assume the first spouse dies in 5 years leaving his entire DSUE amount to the surviving spouse, who passes away 15 years later, in the median case, will not owe estate tax.

"No planning": Estate tax not owed in median outcomes

If create QTIP, GST tax exemption used at first death***= $6.07MM (otherwise $0.0MM); estate tax exclusion used at second death***= $14.54MM; GST tax exemption used at second death***= $8.47MM

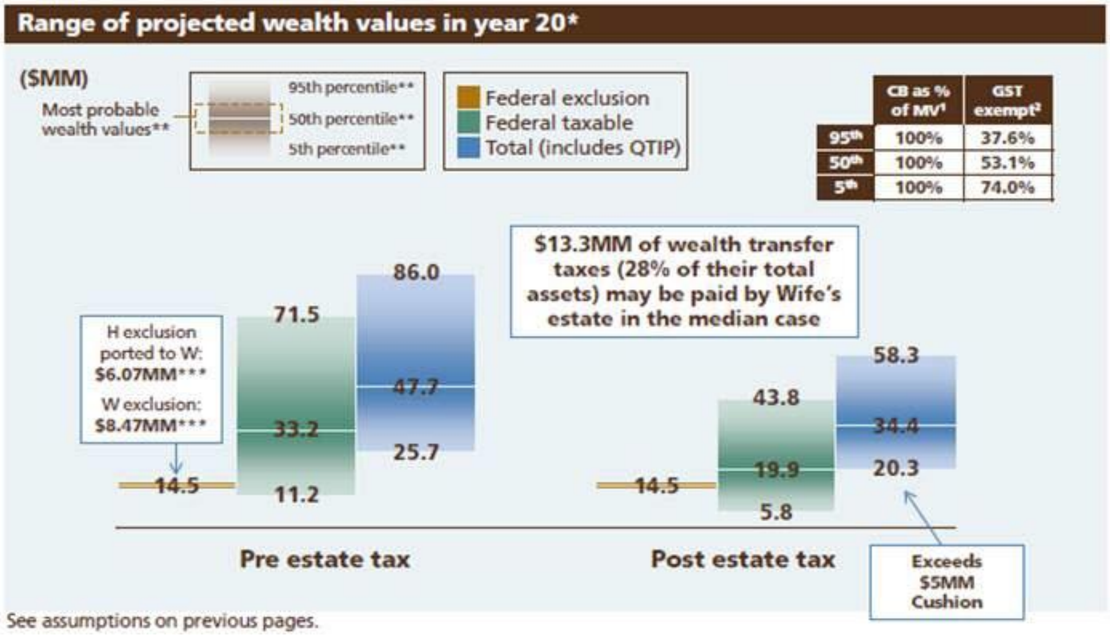


We have assumed that all assets are invested in a balanced portfolio. In that case, the cost basis of the assets at the second death will be 100% of value even in great markets (the 95% case). Therefore, income tax planning would not be a reason to rely on portability. Note that if the couple uses a QTIP trust on the first death to avoid loss of the first spouse's GST exemption, then, in the median case, 100% of the couple's assets will be GST exempt on the second death, as well. In other words, indexing of the shelters has solved all of the couple's transfer tax problems even if a QTIP trust, rather than a Credit Shelter Trust, is used.

D. What About the Couple with $30 Million? If on the other hand, the couple has $30 million of wealth, then on the same facts, substantial estate taxes may be due.

"No planning" with QTIP:
May result in more than $13MM of wealth transfer taxes in the median outcome

GST tax exemption used at first death***= $6.07MM; estate tax exclusion used at second death***= $14.54MM; GST tax exemption used at second death***= $8.47MM

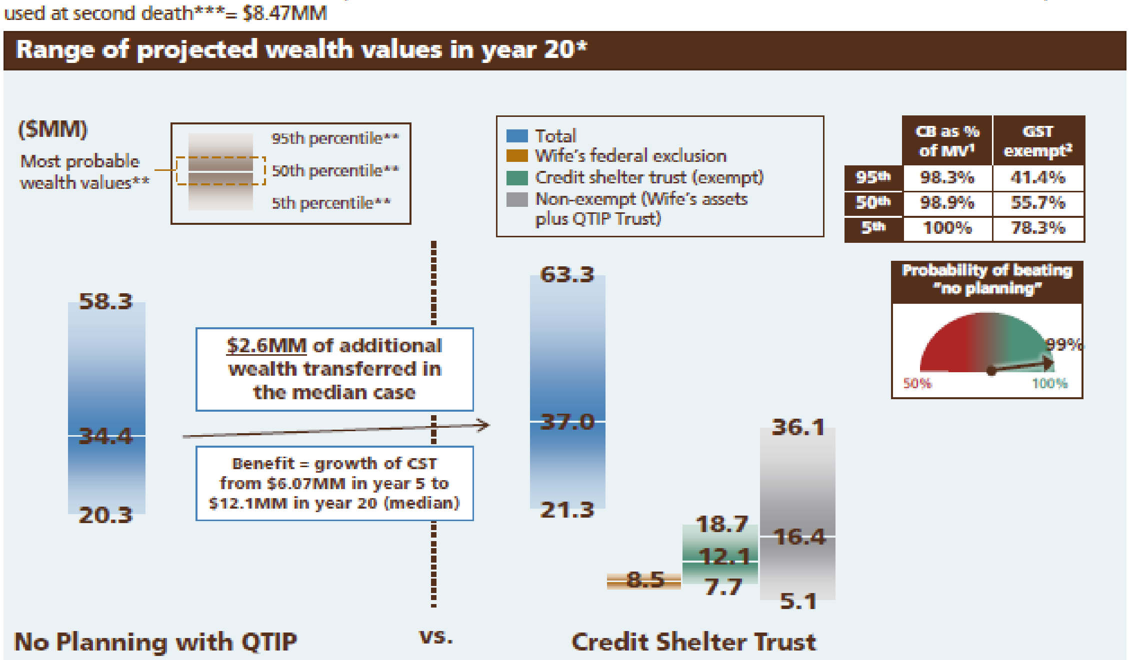


See assumptions on previous pages.

Even if a Credit Shelter Trust is used, significant estate taxes may be due although using a Credit Shelter Trust saves $2.6 million in estate taxes in the median case.

Credit shelter trust may add substantial value

Estate tax exclusion and GST tax exemption used at first death***= $6.07MM; estate tax exclusion and GST tax exemption used at second death***= $8.47MM

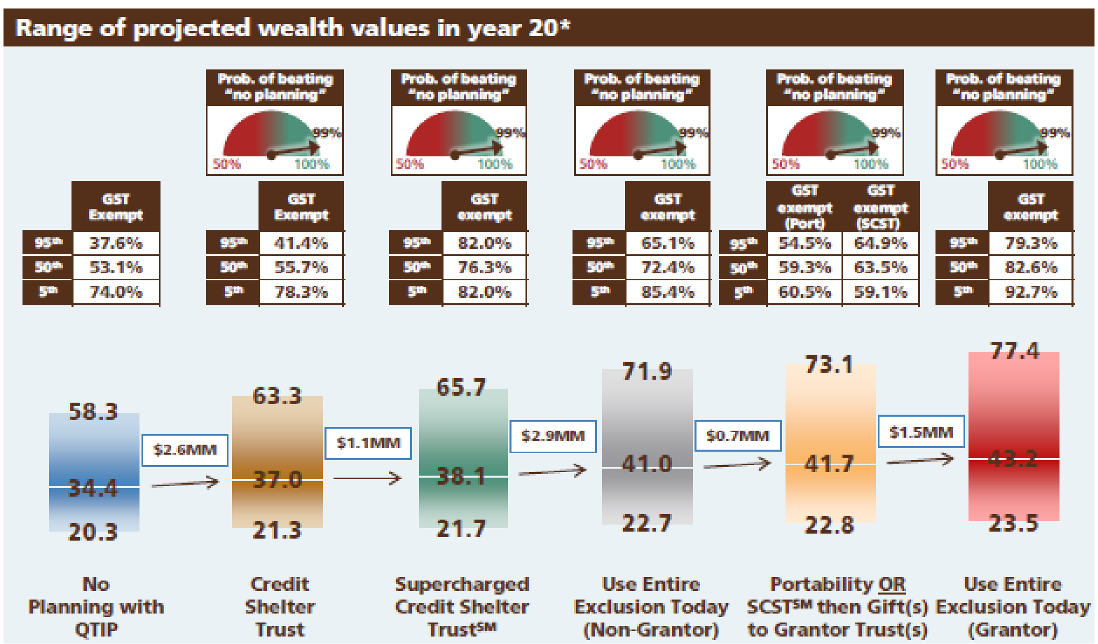


See assumptions on previous pages.

E. Comparison of Planning Alternatives for the $30 million Couple. Thus, the couple with $30 million in assets today should consider engaging in at least some estate planning. That planning would be compared to the above scenario of doing no more than creating a QTIP trust on the first death. The alternatives would be the techniques discussed above, namely: (1) form a Credit Shelter Trust on the first death to capture the first spouse's applicable exclusion amount and GST exemption, (2) form on inter vivos QTIP for the first spouse to die (assuming you can guess which spouse that is), (3) create an immediate gift of both spouses' applicable exclusion amounts ($5,430,000 each) to non-grantor, GST exempt trusts, (4) create two lifetime QTIPs or immediately upon the death of the first spouse create two grantor trusts, one using the first spouse's DSUE and one using the applicable exclusion amount and GST exemption of the survivor, and (5) have both spouses use all their transfer tax benefits immediately by contributing to two grantor trusts.

Comparing the techniques

See assumptions on previous pages.



Each technique reduces the overall estate taxes due. But the real benefit is GST planning. If no planning is done other than to create a QTIP trust on the first death, in the median case 53.1% of the assets will be GST exempt out of $34.4 million available after tax. On the other hand, if immediate gifts of the available shelters are made to grantor trusts, the after-tax estate will be $43.2 million in the median case, and 82.6% of those assets will be forever sheltered from GST tax under current law. This is in the case of a balanced portfolio with, essentially, a 20 year time horizon.

F. **What about a Concentration of Low Basis Stock?**. It can be demonstrated that using tax benefits on a concentration of low basis stock would likely produce less favorable after-tax results in the median case than using a balanced portfolio. Due to the potential for assets to decline in value, and should the assets involved in a lifetime gift have a low, or even zero, income tax basis, some suggest that lifetime use of one's transfer tax shelters on a concentration is usually a mistake. Certainly the fact that the estate tax shelter is no longer strictly "use it or lose it," requires more thought be given to making lifetime transfers. At least some forecast of the probability of being worse off making a lifetime transfer versus not making one should be done. In that regard, not only the current basis of the asset that may be the subject of a lifetime gift must be considered, but also the time horizon until the first estate event would occur.

The charts below assume a lifetime gift that would not incur current gift tax because the gift is less than the available shelters. The first chart shows what rate of return would be needed, given the particular time horizon, in order to break even between making a lifetime gift or holding the asset until death, depending on whether the asset is zero basis, 20% basis or all the way up to 100% basis. The second chart indicates the probability of achieving that break even rate of return.

Example (from previous page): Over a 5-year time horizon, a single stock with an initial 0% basis would need a greater than 19.81% annualized return to make a lifetime gift more beneficial than a testamentary transfer. Given the single stock's characteristics, we estimate the probability of this occurring is 9.06%.

Annualized Return Needed For Gift To Breakeven

Cost basis (% of market value)	Year: 5	10	15	20	25	30
0%	19.81%	9.46%	6.21%	4.62%	3.68%	3.06%
25%	16.01%	7.71%	5.08%	3.78%	3.02%	2.51%
50%	11.64%	5.66%	3.74%	2.79%	2.23%	1.85%
75%	6.46%	3.18%	2.11%	1.58%	1.26%	1.05%
100%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Probability Of Breakeven Return

Cost basis (% of market value)	Year: 5	10	15	20	25	30
0%	9.06%	30.95%	48.20%	61.00%	70.19%	76.93%
25%	16.41%	40.01%	56.31%	67.53%	75.30%	80.78%
50%	29.32%	52.11%	65.44%	74.82%	80.43%	85.44%
75%	48.23%	65.85%	75.62%	82.04%	86.25%	89.47%
100%	72.89%	81.28%	86.19%	89.34%	91.85%	93.38%

Assumptions: Florida resident, long-term capital gains tax of 23.8% and estate tax of 40.0%. The underlying concentrated asset has an expected return of 8.31% (no assumed yield) and an expected volatility of 22.82%, see asset allocation page for more information.

Note that even a single stock with 100% basis has only a 93.38% chance of breaking in a 30 year time horizon due to the possibility of market declines. The shorter the time horizon the greater the risk of loss. If the time horizon is only 5 years, a gift of a single stock with 100% basis has only about a 73% chance of breaking even.

VIII. Other Ways to Get Basis

A. **Can We Avoid the Friction Between Transfer Tax Planning and Income Tax Planning by Getting Basis on the First Death?** We know that couples in a community property state have a distinct advantage. Without incurring any estate tax on the first death or engaging in asset transfers, if the couple holds assets as community property, the couple enjoys a full basis adjustment at the time of the first death regardless of who has title to the assets.[145]

B. **Use of a Grantor Trust**. As suggested earlier in this outline, one might simulate a basis step up on the first death by the use of a grantor trust and the exercise of a swap power. This technique would typically be used when lifetime planning is forecast to be advantageous, even at the cost of a possible loss of a basis adjustment if for whatever reason the swap power cannot be exercised on time.

C. **Suppose the Couple Is Willing to Elect In to Community Property**. It seems that for a couple that it willing to elect into community property, the opportunity to achieve the so-called double basis step-up under Section 1014(b)(6) is available. Each of Alaska and Tennessee has enacted legislation permitting a non-resident of the state to form a trust with an in-state trustee having at least certain administrative powers for purposes of electing that the property held by the trust be treated as community property.[146] See Alaska Stat. § 34.77.100(a) and Tenn Code Ann. § 35-17-103(2). Whether the formation of a community property trust in Alaska or Tennessee would be respected by the couple's home state is a matter of conflicts of laws. Should that matter be resolved favorably, the Federal tax treatment would follow the property law determination.

A similar analysis has been applied in the context of so-called self-settled trusts. In *Estate of German v. U.S.,*[147] the decedent, who was not a resident of Maryland, settled trusts governed by Maryland law which provided that during her lifetime the trustees had the power in their absolute an uncontrolled discretion to pay to or apply for the benefit of the grantor all or any part of the income or principal as the trustees should determine for any reason whatsoever, including the termination of the trust, with the written consent of the trust's remainder beneficiary. The

[145]See, generally, M.R. Moore, "Balancing the Income and Transfer Tax Aspects of Traditional (And Not So Traditional) Estate Planning Techniques: Selected Topic," ACTEC Summer Meeting (2014).
[146]See, contra, Comm'r v. Harmon, 323 U.S. 44 (1944) disallowing elective community property for income tax purposes.
[147]7 Ct. Cl. 641 (1985).

court concluded that under Maryland law, the trusts would not be available to the grantor's creditors because distributions to the grantor would require that the grantor obtain the consent of an adverse beneficiary. Because the government could not establish that the trusts were available to the decedent's creditors at the time of her death under Maryland law, the government's motion for summary judgment for inclusion of the trusts in the decedent's gross estate was denied. More recently, the IRS has ruled that a self-settled trust in a State that does not permit creditors of the settlor to access the trust will result in a completed gift to the trust for federal gift tax purposes.[148] The IRS indicated that the right to discretionary distributions would not, by itself, result in estate tax inclusion under Section 2036[149]

IX. Summary and Conclusions. Estate planning for married couples can be very challenging both for the spouses and for their advisors. For approximately 30 years, many if not most well informed married couples with at least modest wealth have adopted an estate plan that includes the creation at the death of the first spouse of a credit shelter trust for the survivor. Portability provides an alternative option for the couple to avoid creating a credit shelter trust when the first spouse dies. But, in the most basic form of portability, the transfer of all assets outright to the surviving spouse exposes those assets to potential creditor claims and does not achieve other benefits a trust may provide. Also, in the most basic form of portability, the amount that will be protected from estate tax when the survivor dies will be smaller because the inherited exemption (the DSUE amount) is frozen in value. When a numerical analysis is applied, it becomes apparent that the traditional forms of estate planning for an affluent couple continue to have merit, and the after tax results are nearly certain to be superior to relying on portability. Nonetheless, predicting the landscape given all the variables ten or twenty years into the future is challenging. This certainly places a premium on planning with flexibility. Grantor trusts are far more likely to be flexible than non-grantor trusts, for example. Allowing for cascading disclaimers or port mortem tax planning with elections will also maintain the opportunity for a second look. Perhaps the traditional appointment of family member fiduciaries needs to be reconsidered. To the extent the post mortem planning has the potential to shift beneficial interests and tax burdens, those interested in the estate should not be involved.

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[148]See PLR 200944001 and earlier ruling that the gift would be complete, PLR 9837007.

[149] It is beyond the scope of this paper to discuss the more recent case law developments in the area of self-settled trusts. Suffice it to say that if such trusts would not be respected by the creator's home state as shielding the assets from the claims of creditors, then the trusts likely would result in inclusion of the assets in the gross estate of the creator. Those cases may be distinguishable because attempting to avoid creditors with a self-settled trust may violate strong public policy in the creator's home state; whereas, permitting a couple to hold assets as community property may not.