ESTATES, TRUSTS, & GIFTS

Portability or No: The Death of the Credit-Shelter Trust?

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The newest statutory choice in estate planning-the ability to elect to have a surviving spouse "inherit" the deceased spouse's unused estate tax exemption amount-was touted *as providing additional simplicity. The results are anything but simple, however.*

[pg. 232]

Portability became effective for married persons dying after 2010, and was scheduled to be eliminated from the tax system at the end of 2012. As a result, many did not view portability as significant. [1] Now, the American Taxpayer Relief Act of 2012 (P.L. 112-240, 1/2/13) (ATRA) has made portability permanent. Temporary Regulations issued in June 2012 clarified-in many instances, in favorable ways-the applicable rules. [2]

It is important for estate planners to be thoroughly familiar with portability. Although touted as a simplification, portability will make planning more complex for many clients because it is yet another option that requires analysis to determine whether relying on it, or at least preparing an estate plan that makes relying on it possible, is beneficial.

BACKGROUND

Since 1948, spouses effectively have 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. [3] For example, if the wife is wealthier than the husband and they wish to make a large gift to their children, the wife, using her assets, can make the gift. The husband, by consenting to split gifts for the year, can allow his exemption to shelter one-half the gifts while 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. [4]

In contrast, until 2011 no direct mechanism permitted a married couple to use each other's estate tax

[pg. 233]

exemptions when the first spouse died or to preserve the deceased spouse's unused exemption until the survivor died. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 first adopted a regime, known as "portability," which essentially permits the first spouse to die (hereinafter, the "first decedent") to "port" or transfer over to the surviving spouse the unused estate tax exemption of the first decedent. The surviving spouse may then use that exemption, known as the "deceased spousal unused exemption" (DSUE), either to make gifts during lifetime or to transfer property at death. Portability thus allows the surviving spouse to "inherit" and use as his or her own the first decedent's unused exemption amount.

In fact, 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, [5] 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 the "merely" affluent. Various aspects of portability will be discussed below, along with guidelines as to when reliance on it may or may not be appropriate. This article also will suggest techniques for preserving flexibility and discuss alternatives.

PORTABILITY DETAILS

Portability is available only for married couples. For example, if the gross estate of an unmarried decedent is less than his or her remaining estate tax exemption, the unused exemption cannot be preserved for the use of anyone else, such as the decedent's descendants. Likewise, even if an unmarried decedent's gross estate (reduced by deductions for debts and expenses of administration) exceeds his or her estate tax exemption, the exemption cannot be preserved if his or her estate passes in a form qualifying for the estate tax charitable deduction. Most unmarried individuals die with estates lower in value than their unused estate tax exemptions. To that extent, their exemptions are wasted.

In the case of a married decedent, however, under the portability provisions the unused exemption can be preserved for use by the surviving spouse. The opportunity to use portability arises in essentially one of two ways.

First, the value of a first decedent's gross estate, reduced by deductions for debts, funeral expenses and expenses of administering his or her estate, may not be large enough to use his or her estate tax exemption in full. In that event, the unused exemption can be preserved for the surviving spouse if the first decedent's executors make a portability election on a timely filed Form 706 ("United States Estate (and Generation-Skipping Transfer) Tax Return").

For example, the first decedent's gross estate (reduced by deductions for debts and administration expenses) may be only $1 million. His or her estate tax exemption this year would be $5,250,000. 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), $4,250,000 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 estate tax exemption of a married decedent of relatively modest wealth. [6]

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 unused estate tax exemption). [7] In that event, 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 unused exemption to the surviving spouse. The first decedent's unused exemption is thereby preserved for use by the survivor.

ATRA clarified how the DSUE amount is calculated. The DSUE amount with respect to a surviving spouse of a decedent dying after 2010 will be equal to the lesser of (1) the basic exclusion amount or (2) the excess of (a) the applicable exclusion amount of the last such deceased spouse of such surviving spouse over

[pg. 234]

(b) the amount with respect to which the tentative estate tax is determined on the estate of such deceased spouse. By defining the second limitation by reference to the applicable exclusion amount (rather than the "basic exclusion amount") of the last deceased spouse, ATRA conformed the statutory language to what the Treasury already stated it believed to be the legislative intent of the portability rules. [8]

PORTABILITY ADVANTAGES

Eight distinct advantages to portability can be identified.

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, rather than being bequeathed to a credit-shelter trust [9] equal to the otherwise unused estate tax exemption of the first decedent, portability permits the first decedent's assets to be left outright to the surviving spouse.

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 [10]), the first decedent's unused exemption still can 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. [11] As will be seen, however, it will often be preferable, at a minimum, for the first decedent's estate to pass to a "qualified terminable interest property" (QTIP) trust that can qualify for the estate tax marital deduction to the extent that the first decedent's executors elect. [12]

Basis step-up. A second advantage of portability is that the assets acquired from the first decedent generally will receive a new (or second) automatic change in basis under Section 1014 when the surviving spouse dies. [13] To the extent, however, the property inherited from the first decedent will be consumed during the survivor's lifetime, 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 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 on the death of the surviving spouse. [14]

IRD tax-efficiency. A third advantage arises where the estate of the first decedent includes sufficiently large amounts of IRD property that the first decedent's unused estate tax exemption would have 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. [15]

Market declines. A fourth advantage of portability is that the DSUE amount is not reduced 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 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 ultimately will be included in the surviving spouse's gross estate. [16]

The alternate valuation election, however, cannot protect a credit-shelter trust against market declines that occur more than six months after the first decedent's death. And the alternate valuation election is not available unless both the gross estate and the estate tax are reduced. [17] The DSUE amount, by contrast, is fixed as of the death of the first decedent.

Lower state exemption amount. 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 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. [18]

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 have to be paid at the first decedent's death, therefore, may face criticism if it turns out that such taxes had been paid unnecessarily.

Avoiding state death tax. Sixth, even if the surviving spouse dies in a state with a state death tax, portability can still be used to avoid state death tax on the first decedent's full federal exemption amount. [19] A gift by the survivor of the DSUE amount to the

[pg. 235]

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) normally will remove the property transferred from the state death tax base.

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 below, 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.

Grantor trusts. A seventh 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, 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.

Avoidance of funding formulas. A final advantage of portability is that it permits a couple to avoid using "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, "optimum" formulas always have had drawbacks. They include:

- *Complexity.* Reduce-to-zero funding formulas are complex both in the manner in which they are expressed and in their administration. Tax-driven formulas in particular are unavoidably tied to provisions of the Code, making for highly technical drafting.
- *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 also are 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 nonmarital share is funded. [20] In some instances, 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 nonmarital share.
- *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. [21] Some have contended that it can be difficult to predict the actions of Congress. Especially where marital and nonmarital 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.
- *Gain recognition on funding.* With some types of reduce-to-zero formula clauses, the funding of the marital or nonmarital share with appreciated assets will cause the first decedent's estate to recognize capital gain.

[pg. 236]

With portability, the foregoing drawbacks of reduce-to-zero funding formulas can be avoided.

APPARENT DISADVANTAGES OF PORTABILITY

Portability is alleged to have several disadvantages, a half dozen of which are identified below.

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. [22]

Creditors' 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. [23]

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. [24] 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 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.

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. [25]

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 estimated 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. [26] That study assumed the first decedent dies after five years and the survivor lives another 15 years. Federal income taxes on the credit-shelter trust were taken into account. [27]

Estate tax credits. A fifth apparent disadvantage occurs when the first decedent's estate would be entitled to one or more estate tax credits (other than the unified credit). [28] 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 appear to be 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.

Remarriage forfeiture. 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. [29]

PORTABILITY AND CONVENTIONAL PLANNING

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

[pg. 237]

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 estate tax 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 the time the first decedent's assets wend their way to grandchildren, they may have appreciated in value. And 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. [30]

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. A credit-shelter trust, however, 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 QTIP trust [31] that, by election, can be made to qualify for the estate tax marital deduction and, by another election, [32] can allow the unused GST exemption of the spouse dying first to be allocated to 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 trust's assets will occur on 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, also can prevent the GST-exempt QTIP trust from being depleted by estate tax.

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." [33] 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.

Second, a portability election does not mean that a couple must forgo 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 make 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.

Third, 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 as 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. But if no credit (other than the unified credit) were 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 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

[pg. 238]

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.

Finally, 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, often will carry out taxable income from the first decedent's estate. The gift also can 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 below, it is even possible for the surviving spouse to make a gift of the DSUE amount yet still (1) retain a beneficial interest in the property transferred by gift and (2) preserve the first decedent's GST exemption.

REAL DISADVANTAGES OF PORTABILITY

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

Income tax consequences. 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 local 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. [34] In addition, the level at which a trust's net investment income is subject to the Medicare surtax on investment income is much lower than for individuals. [35] As noted, however, 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.

706 must be filed. 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. [36] 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. [37]

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. 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

[pg. 240]

marginal additional cost of completing an estate tax return may not be as great as anticipated.

Effect of inherited exemption. It also may 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. [38] For example, if the first decedent has used none of the first decedent's own exemption and has inherited $3 million of DSUE from a prior spouse and dies in 2013 when the "basic" exemption amount is $5.25 million, then, under Section 2010(c)(4)(A), [39] the maximum amount of exemption that the first decedent's surviving spouse could inherit from the first decedent is $5.25 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. [40]

Second marriages. Finally, as discussed below, portability may not be appropriate for a subsequent marriage situation.

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 union. 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 1982, 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. [41]

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. Sadly, 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. [42]

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 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 remainder beneficiaries any benefit of the first decedent's estate tax exemption.

Some might claim that any transfer to the surviving spouse could be conditioned on the survivor's 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. [43]

Moreover, the surviving spouse may not retain the DSUE if he or she remarries. In that event, 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 the DSUE amount expire when the subsequent spouse dies.

[pg. 241]

For these reasons, using portability in a second or subsequent marriage likely is not a good choice. Rather, if the first decedent wishes to benefit the surviving spouse and ensure that his or her estate exemption is used for the benefit of his or her own descendants, a traditional credit-shelter trust should be considered.

WHERE PORTABILITY MAY BE APPROPRIATE

Although portability may not be appropriate in second or subsequent marriage situations, it may be appropriate in other situations.

Small first estate. 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 instance, [44] the only reason, it seems, for not electing portability is the cost of filing an estate tax return if none otherwise was 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. [45] 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. [46]

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). If a Form 706 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. [47]

Very wealthy clients. 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 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 avoid wasting the first decedent's GST exemption, a "reverse" QTIP trust should be created for the surviving spouse under the first decedent's will or will substitute. The grantor trust for descendants should 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. [48]

Over the survivor's remaining lifetime, the income tax liability on a grantor trust funded initially with, for example, $5.25 million (the maximum DSUE amount that currently can be ported to a surviving spouse) may be very significant. 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.

Flexibility regarding stepped-up basis. A third instance 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. 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 enables a couple to decide at any time after the first decedent's death when the first decedent's exemption amount should be used.

State death tax planning. 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 ultimately may avoid such taxes altogether if, for example, the surviving

[pg. 242]

spouse moves to a state that does not have a state death tax. Even if the surviving spouse does not relocate to such a state, state death taxes on the first decedent's federal estate tax exemption amount still can 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 (as will be discussed below) need not lose all beneficial access to the assets transferred by gift.

Small nonmarital share. A fifth situation favoring portability occurs where the nonmarital share otherwise would be relatively small. For example, suppose that the first decedent made $900,000 of adjusted taxable gifts and dies domiciled in New York. If he or she creates a credit-shelter trust at death equal to the largest amount that can pass free of both federal and state estate tax, the credit-shelter trust's share of the estate will be at most $100,000. [49] 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 nonmarital shares. Consequently all assets of the first decedent's estate may have 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.

IRD assets. A sixth case where portability may be preferred occurs where the first decedent cannot use his or her estate tax exemption amount without funding the nonmarital share at least in part with the right to IRD. As discussed previously, the income tax liability on IRD will erode the net wealth that can pass free of estate tax at the survivor's death. Unless the credit-shelter trust can earn sufficient returns during the survivor's lifetime to overcome the inherent income tax liability on IRD, porting the first decedent's unused estate tax exemption amount to the surviving spouse may protect more of the couple's wealth from estate tax at the survivor's death. Whether this is true will depend on the life expectancy of the surviving spouse and the anticipated expenditure of the inherited assets during the surviving spouse's lifetime.

Older, childless couples. A seventh example of where portability may be appropriate arises where a couple is likely to be beyond childbearing or adopting age and have no descendants. The couple may decide that they have little desire to save estate taxes and therefore will be content to leave all assets of the first decedent to the survivor. Especially if an estate tax return is required to be filed at the first decedent's death, the first decedent's executors may decide that there is no downside in making the portability election, even if the surviving spouse is not very interested in saving estate taxes.

Perhaps a final circumstance where portability may make sense is where the couple does not have children and it is very unlikely that the survivor will bear or adopt a child. That probability no doubt is much lower if the survivor's chances of remarrying are low. [50] Nothing is certain, however, so it may still be wise to include in the couple's plans techniques, including the portability-related techniques discussed herein, that enable the first decedent's unused exemption to shield property against tax at the survivor's death.

Summary. Practitioners probably can expect to discuss with many married couples, especially those whose combined wealth will fall well below the amount of two estate tax exemptions, whether they should use a credit-shelter trust or rely on portability. It is probably reasonable to conclude that portability may or may not prove to be a wise choice. It may be better not to "hardwire" into a couple's documents a plan that will force them either to use portability or reject it. Maintaining flexibility in an estate plan usually is wise and may be especially wise in managing the choice between relying on portability or not.

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.

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. [51] It may be foolhardy, however, to rely on the surviving spouse to disclaim. [52]

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. [53] The determination of the extent of the marital deduction also will 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 15 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 the assets (other than IRD) may qualify for a second change in basis.

[pg. 243]

One downside of this type of planning is that the first decedent's executors only have the limited period in which to 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 potentially will be subject to estate tax.

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. [54]

For example, if the executors fail to make the QTIP election, the property that otherwise would be held in a QTIP trust might pass instead to a discretionary credit-shelter trust. Unlike 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 nonmarital deduction trust. Nevertheless, 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. [55]

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, 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.)

PORTABILITY ELECTION AS THE ULTIMATE FLEXIBILITY TECHNIQUE

As discussed above, disclaimers, partial QTIP elections, and *Clayton* provisions all can 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. [56]
- 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). [57]
- Similarly, the portability election must be made on a timely filed estate tax return. [58]

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.

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

Those drawbacks, however, can be overcome with proper planning. For example, 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. [59] A gift of the income interest will cause the surviving

[pg. 244]

spouse to be deemed to have transferred principal under Section 2519. Thus, if the surviving spouse has $5 million of DSUE and is the beneficiary of a QTIP trust worth $5 million, a gift of the income interest will cause the surviving spouse to have made gifts of both income and principal, i.e., the entire $5 million. [60] Thereafter, it seems that the surviving spouse may, without significant risk of gross estate inclusion, continue to receive principal of the QTIP trust in the discretion of an independent trustee. [61] Both future income and appreciation, in other words, can pass free of both federal and state estate tax at the surviving spouse's death, even though the surviving spouse retains the ability to receive distributions of principal.

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 [62] and as to the income that remains in the QTIP trust prior to distribution, [63] even after the surviving spouse's gift of income and deemed gift of principal. To put it another way, a gift of a reverse QTIP trust, even though it is made by the surviving spouse, can be shielded by the *first decedent's* GST exemption. In effect, a gift of an income interest in a reverse QTIP trust achieves an artificial form of portability of the first decedent's GST exemption.

To summarize, if the portability election is made and the first decedent's estate passes to one or more QTIP trusts, the surviving spouse can, at any time after the first decedent's death, choose to cause the first decedent's unused estate and GST tax exemptions to be held for the surviving spouse's benefit in a trust that is similar to a credit-shelter trust, in that (1) income can be accumulated during the surviving spouse's life, (2) distributions may be made to the surviving spouse in the discretion of an independent trustee, (3) the trust property will not be included in the surviving spouse's gross estate, and (4) the first decedent's GST exemption will make the trust effectively exempt from GST tax.

The reverse, as discussed, is not true: once a credit-shelter trust is created, even if the assets are distributed to the surviving spouse so that they will be included in his or her gross estate, the surviving spouse would not have a restored DSUE amount. By contrast, if the surviving spouse makes a taxable gift of the DSUE amount that is included in the surviving spouse's gross estate, the DSUE amount would be restored for use at death.

PORTABILITY, QTIP TRUSTS, 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.

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. [64]

For example, suppose 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 $1 million) should pass into a separate QTIP trust (the "Excess Exemption QTIP Trust"). If the first decedent's executors elected for that trust to qualify for the federal estate tax marital deduction, the Excess Exemption QTIP Trust also would 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 effectively would remove the Excess Exemption QTIP Trust from the survivor's gross estate for both federal and New York estate tax purposes.

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 $1 million of his or her estate will not 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.

Structuring the estate plan to use the separate Excess Exemption QTIP Trust makes it possible 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 executor 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

[pg. 245]

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.

Nevertheless, it is likely (if not certain) 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.

In deciding whether to use portability or Rev. Proc. 2001-38, practitioners need to take two additional considerations 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.

Some have questioned whether a couple may intentionally plan to use Rev. Proc. 2001-38. It has been suggested that the Revenue Procedure may be invoked only 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 event, 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. [65]

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. [66] 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 use the inherited DSUE to protect the trust from gift tax. 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 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. [67]

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 "self-settled trust") will be included in his or her gross estate (thereby eliminating

[pg. 246]

any benefit of grantor trust status) if he or she is entitled to the income, [68] he or she retains the power to control the beneficial enjoyment of the trust property, [69] or his or her creditors can attach the assets of the trust. [70]

Even if the grantor is a discretionary beneficiary, however, the property should not be so included if none of those "strings" exist. [71] 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.

Accordingly, 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 also must 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. [72] Finally, the couple should keep in mind that a credit-shelter trust created by the first decedent for the benefit of the surviving spouse probably could provide complete asset protection and other benefits of trust ownership.

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, if the couple is wealthy, it perhaps 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.

For the most part, it is not possible for the first decedent's unused GST exemption to be allocated to a grantor trust that the surviving spouse creates for descendants. If the surviving spouse uses the DSUE amount by making a gift to a grantor trust of the income interest in a reverse QTIP trust, the income (when thereafter paid over to the grantor trust) probably would not continue to be shielded from GST tax by the first decedent's GST exemption. On the other hand, the principal of the reverse QTIP trust will continue to be shielded from GST tax. Nevertheless, although it appears that the income of the QTIP trust can be assigned to a grantor trust with respect to the surviving spouse, it would be difficult to cause the principal to be treated as owned by the surviving spouse for income tax purposes.

An alternative that may be safer than having the surviving spouse create a self-settled trust is to use a supercharged credit shelter trust℠. [73]

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 the supercharged trust is included in the estate of the surviving spouse than it would with respect to a self-settled trust.

Furthermore, the supercharged trust 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 decedent, using the DSUE amount inherited by the survivor. Supercharged credit shelter trusts[SM] 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.

What the foregoing discussion of grantor trusts demonstrates is that planning to have the surviving spouse create a grantor trust is complicated. Certainly, it runs counter to the simplicity that was supposed to be the hallmark of portability. It likely should be considered only for families of substantial means. An impecunious surviving spouse likely could not afford to pay additional income tax generated from a grantor trust where the survivor will not be entitled to at least an amount equal to the income tax generated from the grantor trust. [74]

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. 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 reasons. It is difficult to know if using portability will be wise or unwise. 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. [75]

If a married person does not want a portability election, he or she can

[pg. 248]

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 be ordinary and necessary costs of administering the decedent's estate. [76]

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 appoint the equivalent of a special executor who would be authorized to file the return and make the election. [77]

It 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.

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

CONCLUSION

Portability can be an important tool for a married couple. It may be commonly used where the first decedent dies without a will or without having engaged in significant planning or where the estate of the first decedent is so small that the whole exemption of that spouse cannot be used. Portability also may provide some simplification for couples without significant wealth. Even couples of modest wealth, however, should consider having the first decedent leave his or her estate in QTIP trusts rather than outright to the surviving spouse. Yet that complicates rather than simplifies estate planning and administration.

At the other extreme, portability opens up significant planning opportunities for very wealthy couples. Such couples should consider relying on portability and having the surviving spouse make a gift of the DSUE amount to a grantor trust for descendants.

For couples who are "merely affluent," several factors may favor the use of portability (e.g., an automatic change in basis at death) but others at least at first appear to militate against it (e.g., potential loss of GST exemption of the first decedent). Many of the alleged shortcomings of portability, however (e.g., loss of the use of the GST exemption and creditor protection), can be overcome by using a QTIP trust. Portability combined with the use of QTIP trusts also can be used to save state death taxes.

Perhaps the most important lesson of portability is that a couple should preserve as much flexibility as possible and for as long as possible. Disclaimers, partial QTIP elections, and *Clayton* provisions provide substantial flexibility, although, as discussed, there will be only a limited period after the first decedent's death in which to employ these techniques. Further, a *Clayton* "election" probably should be made by an independent executor.

Finally, the portability election itself creates significant flexibility, insofar as it gives the surviving spouse the choice for the balance of his or her lifetime either to use or not use the DSUE amount. If the surviving spouse is given the power to assign the income interests in one or more QTIP trusts to or for the benefit of descendants, he or she can in essence convert them at any time, including those that are GST exempt, into the equivalent of a credit-shelter trust. That creates, perhaps, the ultimate in portability planning flexibility.

1

There were exceptions. See, e.g., Bramwell, "How to Use Portability to Avoid (Not Just Defer) State Death Taxes," LISI Estate Planning Newsletter #1991 (7/24/12); ABA Real Property Trust & Estate Law Section's Estate and Gift Tax Committee, "Portability-Part One," available at www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2012/heckerling_report_2012_portability_part_one.authcheckdam.pdf.

2

TD 9593, 6/15/12. See Zaritsky and Zeydel, "New Portability Temp. Regs. Ease Burden on Small Estates, Offer Planning for Large Ones," 117 JTAX 180 (October 2012).

3

See Section 2513. See generally Zeydel, "Gift-Splitting-A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules," 106 JTAX 334 (June 2007).

4

Section 2652(a)(2); Reg. 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 Section 2523(a). Under current rules, however, a spouse may not use the gift tax marital deduction in making gifts to his or her spouse who is not a U.S. citizen; see Section 2523(i).

5

Freid, "Estate and Gift Rules: Some Clarity for Now," New York Times, 2/12/11 ("the new 'portability' feature that Congress added to simplify estate planning for married couples").

6

There is no true estate tax exemption. Rather, the exemption is essentially the amount of taxable estate a decedent may have that does not generate estate tax by reason of the unified or applicable credit allowed under Section 2010. Section 2010(c) uses the phrase "applicable exclusion amount" and not "estate tax exemption."

7

The unused estate tax exemption 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 Section 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.

8

See Section 2010(c)(4); Temp. Reg. 20.2010-2T(c)(1). See also Zaritsky and Zeydel, *supra* note 2.

9

The trust is structured so that, 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 Section 2010.

10

If the survivor is not a U.S. citizen, the marital deduction will be allowed only if the assets pass into qualified domestic trust (QDOT) described in Section 2056A; see Section 2056(d).

11

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 IRA or a life insurance policy) by which the successor is designated on a form, or through a "payable on death" account where the surviving spouse succeeds directly to the ownership of the asset.

12

See Section 2056(b)(7).

13

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 Section 691; see Section 1014(c). In any event, there also could be a reduction in basis if the property declines in value by the time of the death of the surviving spouse.

14

A type of simulated change in basis, as will be discussed in the text, below, may be achieved by using a "supercharged credit shelter trust[SM]."

15

See Temp. Reg. 20.2010-3T(a)(3).

16

See Blattmachr and Lo, "Alternate Valuation-Now, Perhaps, More Important than Ever," 111 JTAX 90 (August 2009).

17

See Section 2032(c).

18

See generally Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 Estate Planning No. 4 (April 2005), page 3; Gans and Blattmachr, "Quadpartite Will Redux: Coping with the Effects of Decoupling," 32 Estate Planning No. 10 (October 2005), page 15.

19

For more on this type of planning, see Bramwell, *supra* note 1.

20

The need for recalculation is most obvious when a "fractional" formula is used but is in fact present even where the marital or nonmarital share is defined as a pecuniary, preresiduary gift, as "separate shares" must then be calculated (and/or recalculated on a partial distribution) for income tax purposes. See Regs. 1.663(c)-2(b)(1) and 1.663(c)-5, Example 6.

21

See, e.g., N.Y.E.P.T.L. section 2-1.13.

22

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

23

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

24

See, e.g., Fla. Stat. section 732.201 *et seq.*

25

See generally 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 Blattmachr and Blattmachr, "Even Without Estate Tax, the Right Answer Is Still the Same: Put it All in a Trust," Alaska Trust Company Newsletter (June 2011).

26

See Presentation by Robert A. Weiss, "Overcoming Planning Procrastination in Turbulent Times," Boston Estate Planning Council (12/1/11) (modeling done by JP Morgan Private Bank).

27

See Gassman, Crotty, Buschart, and 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 (2/7/13), suggesting it could be much more where a credit-shelter trust is invested in Dow Jones Industrial Average securities.

28

For example, a decedent's estate may be entitled to a prior transfer credit under Section 2013 or a foreign tax credit under Section 2015.

29

See Temp. Reg. 20.2010-3T(b)(2), Example.

30

From time to time, the federal estate tax exemption has declined. See www.irs.gov/pub/irs-soi/ninetyestate.pdf.

31

See Section 2056(b)(7).

32

See Section 2652(a). The election under this section is called the "reverse" QTIP election.

33

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

34

Section 1(e).

35

Section 1411(a)(2)(B)(ii). See generally Seago, Orbach, and Schnee, "Working With the Unearned Income Medicare Tax," 118 JTAX 108 (March 2013).

36

Under Section 6018, an estate tax return must be filed if the gross estate of a U.S. citizen or domiciliary exceeds (1) the applicable exclusion amount (estate tax exemption) over (2) the sum of adjusted taxable gifts made after 1976 and the amount allowed as the "old" gift tax exemption under old Section 2521 between 9/8/76 and 12/31/76.

37

Temp. Reg. 20.2010-2T(a)(7)(ii).

38

An adjusted taxable gift is a gift made after 1976 that is not included in the decedent's gross estate; see Section 2001(b).

39

Temp. Reg. 20.2010-2T(c)(1)(i).

40

As discussed in the next part of this article, 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 Temp. Reg. 20.2010-3T(b), however, the DSUE amount from the prior spouse may be "locked in" with taxable gifts made prior to the subsequent spouse's death. 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.

41

See generally Staff of the Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981,* pages 233-237.

42

See, e.g., Oursler v. Armstrong, 179 NE2d 489 (1961).

43

Among other issues, it is unclear how the preservation of the DSUE amount would occur if the surviving spouse made taxable gifts. 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 as having made an inadvertent gift. See, e.g., CCA 201208026.

44

It is understood that most adults (55%) in the U.S. do not have wills. See wiki.answers.com/Q/What_percentage_of_people_in_the_US_die_without_a_Will.

45

N.Y.E.P.T.L. section 4-1.1(a)(2).

46

N.Y. Surr. Ct. Proc. Act section 1001.1(a).

47

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

48

Under Rev. Rul. 2004-64, 2004-2 CB 7, the payment of the income tax liability is not a gift to the grantor trust. See generally Huffaker and Kessel, "How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts," 100 JTAX 206 (April 2004), and Shop Talk, "New Ruling on Consequences When Grantor Is Taxed on Trust's Income," 101 JTAX 253 (October 2004).

49

New York's estate tax is equal to the lesser of (1) the tentative state death tax credit that would be calculated under Section 2011(b) and (2) the federal estate tax that would be due (under laws enacted through 7/22/98) if the exemption amount were $1 million. With $900,000 of adjusted taxable gifts and an exemption amount of only $1 million, a taxable estate of greater than $100,000 would generate a federal estate tax. Likewise, a tentative state death credit begins to be generated at taxable estates greater than $100,000.

50

"[R]emarriage rates among older widowers are fairly low, and even lower among older widows." See en.wikipedia.org/wiki/Remarriage#Remarriage_following_widowhood.

51

Compare the discussion in Lustgarten and Blattmachr, "The Choice Between Pecuniary and Fractional Marital Deduction Formula Provisions: The Ultimate Ambulatory Will," 32 S. Cal. Tax Inst. 13-1 (1980).

52

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." Pennell, 843 T.M. (BNA), *Estate Tax Marital Deduction,* fn. 42.

53

Reg. 20.2056(b)-7(b)(2).

54

See Reg. 20.2056(b)-7(d)(3)(i); Estate of Clayton, 97 TC 327 (1991), *rev'd*70 AFTR 2d 92-6262, 976 F2d 1486 (CA-5, 1992).

55

Blattmachr, Heilborn, and Gans, "Gifts by Fiduciaries by Tax Options and Elections," 18 Probate & Property 39 (November/December 2004), republished in Digest of Tax Articles, March 2005.

56

Section 2518(b)(2).

57

Section 6075(a).

58

Temp. Reg. 20.2010-2T(a).

59

This type of planning is explained in further detail in "Bramwell & Kanaga on PLR 201243004," LISI Estate Planning Newsletter #2040 (12/20/12); Bramwell, *supra* note 1; and Bramwell and Kanaga, "The Section 2519 Portability Solution," Trusts & Estates (June 2012). See also Bramwell, "Using Section 2519 to

Enhance Estate Planning with QTIPs," 38 Estate Planning No. 10 (October 2011), page 15.

60

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; see Reg. 25.2511-2(b). In addition, a deemed transfer under Section 2519 is a transfer for purposes of Section 2036; see Reg. 25.2519-1(a). Thus, the surviving spouse should not have any power that would cause gross estate inclusion under either Section 2036(a)(1) or (2). For example, the surviving spouse should not have a power to make principal distributions (even if limited to an ascertainable standard) over the QTIP trust principal.

61

For further discussion of this point, see Bramwell and Kanaga, LISI Estate Planning Newsletter #2040, *supra* note 59, and the authorities cited therein.

62

Reg. 26.2652-1(a)(3).

63

Reg. 26.2652-1(a)(5), Example 4. It would seem, however, that the gift by the surviving spouse of the income interest, perhaps to a new trust, would not be sheltered by the principle that a Section 2519 transfer does not change the identity of the transferor for GST purposes. Section 2519, by its terms, addresses only the deemed gift of the corpus; see Reg. 25.2519-1(c). The gift of the income interest is taxable under Section 2511, and is therefore an independent gift by the surviving spouse that would, to retain its GST-exempt status, appear to require an allocation of GST exemption by the surviving spouse. 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 CB 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, Reg. 26.2632-1(b)(4)(i) would render it void ("Except as provided in §26.2642-3 (relating to 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"). On the death of the surviving spouse, the income interest expires, and Example 4 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 an FMV of $1 million. 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 million 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.

64

This is discussed more fully in Gans and Blattmachr, "Decoupling, Portability and Rev. Proc. 2001-38," LISI Estate Planning Newsletter #1965 (5/21/12).

65

As explained in the article cited in note 33, *supra,* 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.

66

See Rev. Rul. 2004-64, *supra* note 48. See also Gans, Heilborn, and Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," 31 Estate Planning 467 (October 2004).

67

As discussed in detail in Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (September 2002).

68

See Section 2036(a)(1).

69

See Sections 2036(a)(2) and 2038.

70

See, e.g., Rev. Rul. 2004-64, *supra* note 48, and Rev. Rul. 77-378, 1977-2 CB 347.

71

See, e.g., Ltr. Rul. 200944002; Estate of German, 55 AFTR 2d 85-1577, 7 Cl Ct 641 (Cls. Ct., 1985).

72

Rothschild, Blattmachr, Gans, and Blattmachr, "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Estate Planning No. 1 (January 2010), page 3.

73

See note 33, *supra.*

74

Rev. Rul. 2004-64, *supra* note 48, 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.

75

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 decedent's preliminary executor 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. It may be appropriate, therefore, expressly to authorize the executor to do so.

76

See Section 2053 and Reg. 1.212-1(i).

77

See Estate of Fales, 106 Misc 2d 419, 431 NYS2d 763 (Surr. Ct. N.Y. County, 1980). *Cf.* Matter of Colp, N.Y.L.J. 1/20/76, page 8, col. 2. See also Estate of Kalikow, Surr. Ct. Nassau County, 3/28/07 (granting limited letters testamentary for one purpose); Matter of Breitstone, N.Y.L.J. 6/14/07; but also *cf.* Estate of Schuman, N.Y.L.J. 12/11/09 (Surr. Ct. N.Y. County).