PRESERVING INHERITED EXCLUSION AMOUNTS: THE NEW PLANNING FRONTIER

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Editor's Synopsis: Portability has forced estate planners to reconsider how they plan for married couples. But the impact of these rules stretches beyond married couples to affect surviving spouses who choose to remarry. In essence, these rules have created a whole new area of planning—deceased spousal unused exclusion preservation planning—that did not previously exist. This Article examines this new field in detail and the advantages and disadvantages of its various techniques.

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I. Introduction

Discussion of portability has, understandably, focused on planning for married couples. But it is not just married couples who are affected by portability. The portability rules have also created a whole new area of planning for surviving spouses who choose to remarry. In particular, surviving spouses who remarry should consider taking steps to preserve any gift and estate tax exclusion amount inherited from a prior deceased spouse. Estate planners, in turn, must understand and master the various techniques that surviving spouses who remarry can employ in order to preserve their inherited exclusion amounts. This Article examines those techniques in detail and discusses their various advantages and disadvantages.

II. Portability Overview

Every citizen or resident of the United States is allowed an exemption against gift and estate tax that is at least equal to the "basic exclusion amount."[1] Furthermore, an individual who survives a deceased spouse may be allowed an additional exemption, known as the deceased spousal unused exclusion or "DSUE" amount.[2] The DSUE amount is defined as the lesser of the basic exclusion amount (at the time of the deceased spouse's death)[3] and the excess of the last deceased spouse's applicable exclusion amount over the sum of the last deceased spouse's taxable estate and adjusted taxable gifts.[4] The sum of the basic exclusion amount and the DSUE amount is known as the "applicable exclusion amount."[5]

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[1] Strictly speaking, sections 2010 and 2505 of the Internal Revenue Code (Code) do not create an exemption. *See* I.R.C. §§ 2010; 2505. They instead allow a so-called "unified credit" against tax on an individual's cumulative wealth transfers. The credit is equal to the tax that would otherwise be computed on an individual's "applicable exclusion amount." *Id.* §§ 2010; 2505. Historically, by providing a credit rather than an exemption or deduction, Congress ensured that cumulative wealth transfers would be taxed at higher marginal gift and estate tax rates. *See id.* §§ 2001(c); 2010; 2505. However, due to reductions in the estate and gift tax rates and increases in the applicable exclusion amount for United States citizens and residents, the estate and gift taxes are essentially assessed at a flat 40% rate on cumulative transfers that exceed the applicable exclusion amount. *See id.* §§ 2001(c); 2010. Thus, the applicable exclusion amount essentially functions in the same way as an exemption. *See id.* §§ 2010; 2505.

[2] *See* I.R.C. § 2010(c)(4).

[3] *See* Temp. Treas. Reg. § 20.2010-1T(d)(4).

[4] *See* I.R.C. §§ 2010(c)(4)(B); 2001(b). Adjusted taxable gifts are gifts made after 1976 that are not included in the decedent's gross estate. *See id.* § 2001(b).

[5] *Id.* § 2010.

In some cases, under these definitions, a surviving spouse may inherit the deceased spouse's entire applicable exclusion amount. For example, suppose that the wife (in an opposite-sex couple) survives the husband, and the husband, having made no taxable gifts during his lifetime, leaves all of his assets outright to the wife or in a form that qualifies for the estate tax marital deduction.[6] The husband's taxable estate in that case equals $0. Having made no taxable wealth transfers during lifetime or at death, the husband did not use any of his applicable exclusion amount. Thus, if the husband's death occurs in 2015 when the basic exclusion amount is $5,430,000, the wife will be able to inherit the full amount of the husband's applicable exclusion amount, or $5,430,000, if a timely portability election is made.[7] The wife's total applicable exclusion amount would then be $10,860,000, which is the sum of her own basic exclusion amount of $5,430,000 and the DSUE amount of $5,430,000.

Similarly, suppose the husband dies but does not have sufficient assets to use up his applicable exclusion amount in full. For example, all of the couple's assets might be titled in the wife's name, or the couple might not have enough wealth to use up the first decedent's applicable exclusion amount. In those cases, once again, the husband's taxable estate may be as low as $0 and the wife could inherit up to the husband's full $5,430,000 of applicable exclusion.

In other cases, by contrast, a surviving spouse will not be able to inherit any of the deceased spouse's applicable exclusion amount. For example, if the husband is the first decedent and has sufficient assets, he might make a bequest equal to his remaining applicable exclusion amount to a so-called "credit shelter trust," that is, a trust for the benefit of the surviving spouse that does not qualify for the estate tax marital

[6] All examples in this Article assume that the taxpayers in question are United States citizens. A portability election is not available for a non-resident decedent who is not a United States citizen at the time of his or her death. *See* Temp. Treas. Reg. § 20.2010-2T(a)(5). In addition, a nonresident surviving spouse who was not a citizen of the United States at the time of such surviving spouse's death may not take into account the DSUE amount of any deceased spouse of such surviving spouse, except to the extent allowed under a treaty obligation of the United States. *See* Temp. Treas. Reg. §§ 20.2010-3T(e) and 25.2505-2T(f).

[7] In order to inherit DSUE amount, the first decedent's executors must timely file a properly prepared estate tax return. *See* Temp. Treas. Reg. § 20.2010-2T(a).

deduction.[8] The husband could then leave the balance of his assets to, or for the benefit of, the wife in a form that does qualify for the marital deduction. In that case, the husband's estate would not owe any federal estate tax, because the husband's taxable estate would be limited to his remaining applicable exclusion amount.[9] Although the credit shelter trust, if properly drafted, may pass free of estate tax at the surviving spouse's death, the wife would not be able to inherit any unused exclusion from the husband, because the husband's applicable exclusion amount would have been used up in full at the husband's death.

III. ADVANTAGES OF PORTABILITY

Whether and to what extent to rely on portability is a highly complex decision that should be made only after numerous factors are taken into account.[10] In many cases, a married taxpayer will be well-advised not to rely on portability at all, but instead to use up his or her own applicable exclusion amount in full either during lifetime or at death.[11] For many reasons, however, many surviving spouses will end up having inherited at least a portion of the first decedent's unused applicable exclusion amount. Some of those reasons are as follows:

1. *Insufficient wealth.* First, and, perhaps, most commonly, the first decedent may die with too little wealth to use up his or her applicable exclusion amount. In that case, in order to preserve the first decedent's remaining applicable exclusion amount (or, if less, the basic exclusion

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[8] *See generally* Jonathan G. Blattmachr, Mitchell M. Gans & Austin W. Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP. PROB. & TR. J. 413 (2007).

[9] Technically, this occurs because the husband's applicable credit under Code section 2010 would absorb all of the gross estate tax generated by the credit shelter trust. *See* I.R.C. § 2010.

[10] *See* Jonathan G. Blattmachr, Austin W. Bramwell & Diana S.C. Zeydel, *Portability or No: The Death of the Credit-Shelter Trust?*, 118 J. TAX'N 232, 234 (2013); Austin W. Bramwell & Vanessa L. Kanaga, *The Section 2519 Portability Solution*, TR. & EST. June 2012 at 14, 15–16.

[11] Some of the reasons for foregoing portability are as follows: (1) the unused GST exemption of the first decedent is not portable and will be lost to the extent not otherwise used by him or her, (2) assets passing outright to the surviving spouse will be subject to the claims of creditors of the survivor, (3) if assets are left outright to the surviving spouse, he will not be protected from "unwise" financial decisions, (4) the DSUE amount is frozen at the first decedent's death whereas a credit shelter trust can appreciate in value, (5) estate tax credits may be lost if there is no "gross" estate tax generated at the first decedent's death, and (6) the DSUE amount may be forfeited if the surviving spouse remarries and the later marriage ends by death. *See Portability or No*, *supra* note 10, at 236–39.

amount), the first decedent's executors will need to make a portability election.[12]

2. *Simplicity.* Second, a married couple might prefer to avoid the administrative costs and complexities of a credit shelter trust. Thanks to portability, the first decedent can simply leave all of his or her assets outright to the surviving spouse (or in a form, such as a "qualified terminable interest property" or "QTIP" trust, that qualifies for the marital deduction), yet still preserve his or her unused exclusion amount.

3. *Avoidance of "reduce-to-zero" funding clauses.* Third, a married couple might wish to avoid so-called "reduce-to-zero" funding clauses, which are typically used in order to define the non-marital share of the first decedent so that it is precisely equal to the maximum amount that can pass free of estate tax at the first decedent's death.[13] Such clauses are not only technically complex to draft but are often costly to administer. For example, separate marital and non-marital shares may require some or even all of the first decedent's assets to be revalued at the time of distribution. Worse, as such clauses incorporate federal tax concepts by reference, they effectively give a third party—namely, Congress—an unwanted say in the disposition of the first decedent's assets.

4. *Second change in basis.* Fourth, a married couple may prefer to rely on portability in order to obtain a change of basis under Code section 1014[14] at the surviving spouse's death. That Code section generally provides that the income tax basis of property inherited from a decedent (subject to certain exceptions, such as property that constitutes income in respect of a decedent) is equal to its fair market value at the decedent's death (or the property's value at the alternate valuation date under Code section 2032,[15] if an estate tax alternate valuation election is made). Thus, if property passing from the first decedent appreciates in value, a married couple can obtain a step up in basis both at the first decedent's death and at the survivor's death, if the property is bequeathed to the surviving spouse (including in the form of a marital

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[12] *See* Temp. Treas. Reg. § 20.2010-2T(a).

[13] Alternatively, the marital portion can be defined as the *smallest* amount that can qualify for the marital deduction without causing estate tax to be due. *See generally* SEBASTIAN V. GRASSI JR., A PRACTICAL GUIDE TO DRAFTING MARTIAL DEDUCTION TRUSTS 85-105 (2008).

[14] *See* I.R.C. § 1014.

[15] *See id.* § 2032.

deduction trust).[16] Meanwhile, thanks to portability, the first decedent's basic exclusion amount can be preserved for use by the surviving spouse or the surviving spouse's estate. By contrast, if the first decedent's property is bequeathed to a traditional credit shelter trust, the property will typically not meet the requirements of a change in basis under Code section 1014 at the surviving spouse's death.[17]

5. *Protection against erosion of non-marital share consisting of IRD.* Fifth, if the first decedent's assets consist largely of income in respect of a decedent or "IRD," the couple might wish to avoid the erosion of wealth passing free of estate tax at the surviving spouse's death as a result of income taxes payable on the IRD. IRD is generally subject to income tax after the decedent's death when received, or, in some cases, when the right to IRD is transferred.[18] In consequence, if IRD is bequeathed to a credit shelter trust, the inherent income tax liability will reduce the after-tax value of the property ultimately passing at the surviving spouse's death.[19] A portability election, therefore, may be preferable to a credit shelter trust if the credit shelter trust would otherwise need to be funded in whole or in part with assets constituting IRD.

6. *Tax advantages of lifetime gifts of DSUE amount.* Sixth, rather than have the first decedent use up his or her basic exclusion amount with a credit shelter trust, the couple might prefer to have the surviving spouse make lifetime gifts that use up the DSUE amount inherited from the first decedent. For many reasons, lifetime gifts may be more tax-efficient than a credit shelter trust.[20] For example, a credit shelter trust

[16] However, if property declines in value, Code section 1014 will adjust the basis of the depreciated property to its fair market value, resulting in the forfeiture of capital losses. *See id.* § 1014.

[17] *See* I.R.C. § 1014.

[18] *See* I.R.C. § 691.

[19] *See Portability or No*, *supra* note 10, at 242.

[20] A common reason to use up the first decedent's applicable exclusion amount via lifetime gifts by the surviving spouse is that such gifts can be made to a trust that is designed as a grantor trust for income tax purposes. Under Rev. Rul. 2004-64, the surviving spouse can then, free of gift tax, pay income taxes on trust assets, even as his or her own estate is depleted. *See* 2004-2 C.B. 7. The class of couples who are actually willing to engage in this type of planning (other than, perhaps, to save state estate taxes) may be small. After all, if the couple is willing to make substantial gifts after the death of the deceased spouse, they should likewise have been willing to make those gifts before the death of the first decedent.

will usually bear the burden of a portion of the income taxes on taxable income generated during the administration of the estate of the first decedent. By contrast, a trust funded by lifetime gifts will not have taxable income carried out from the settlor to the trust. In essence, portability, when combined with gifts of the DSUE amount by the surviving spouse, makes it possible to trap all of the taxable income of the first decedent's assets in the marital share that will be subject to estate tax at the survivor's death. Prior to portability, this form of planning had effectively been eliminated by the Taxpayer Relief Act of 1997[21] and new Code section 663(c), which made the so-called "separate share rule" applicable to estates as well as to trusts.[22]

7. *Deferral of state death taxes.* Seventh, a couple living in a state that has a death tax might wish to rely on portability in order to defer state death taxes until the survivor's death.[23] State estate tax exemption amounts are often less than the federal exclusion amount.[24] Rather than use up the federal estate tax exclusion amount at the first decedent's death and pay state estate tax, a married couple might want to limit the credit shelter trust bequest to the state exemption amount. With portability, such a couple can now preserve the balance of the first decedent's federal exclusion amount by having a portability election made at the death of the first decedent.

8. *Preserving first decedent's New York basic exclusion amount.* Eighth, a married couple in New York might wish to limit the first decedent's taxable estate to the New York basic exclusion amount in order to avoid wasting the first decedent's New York applicable credit amount. Under legislation enacted in 2014, the New York applicable credit amount is rapidly phased out for New York taxable estates that

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[21] *See* Pub. L. No. 105-34, 111 Stat. 788.

[22] I.R.C. § 663(c).

[23] *See generally* Austin W. Bramwell & Vanessa Kanaga, *How to Use Portability to Avoid (Not Just Defer) State Death Taxes*, LISI EST. PLAN. NEWSL. #1991 (July 24, 2012).

[24] By contrast, New York has recently enacted legislation that will often cause the New York exclusion amount to exceed the federal exclusion amount. *See* State Budget-Fiscal Year-Taxation, 2014 Sess. Law News of N.Y., ch. 59, part X (2014); *see generally* N.Y. Tech. Adv. Mem. TSB-M-14(6)(M) (Aug. 25, 2014). Under this legislation, the New York exclusion amount will equal the federal exemption beginning in the year 2019. *See id.* However, lifetime gifts will generally not use up the New York exclusion amount. *See id.* Thus, for New Yorkers who have made taxable gifts, the New York exclusion amount is likely to exceed the federal exclusion amount. *See id.*

exceed the New York basic exclusion amount.[25] Therefore, in order to take advantage of the New York applicable credit, it is crucial that the first decedent's New York taxable estate be limited to the New York basic exclusion amount. Thanks to portability, the first decedent's remaining unused federal exclusion amount can then still be preserved for use by the surviving spouse.

9. *Avoidance of state death taxes.* Ninth, a married couple might wish to rely on portability in order to avoid (not merely defer) state death taxes on assets passing from the first decedent.[26] Many state death taxes fail altogether to tax lifetime transfers of property.[27] Even those states that do tax lifetime transfers often only tax transfers that occur within a short period before the decedent's death. In those states, it is possible to avoid state death taxes by having the surviving spouse make lifetime gifts. Thus, it will often be more efficient for the surviving spouse to use up inherited DSUE by lifetime gifts than for the first decedent to create a credit shelter trust that uses up the first decedent's applicable exclusion amount but triggers a state death tax. For example, a surviving spouse who is a beneficiary of QTIP might choose to remove assets from his taxable estate for state death tax purposes by triggering an artificial wealth transfer under Code section 2519.[28]

10. *Protection against market declines in non-marital share.* Tenth, during the period between the deaths of the two spouses, a couple might wish to have protection against possible market declines in the wealth protected against estate tax by the first decedent's applicable exclusion amount. If the first decedent uses up his or her applicable exclusion amount at death via a credit shelter trust, the applicable exclusion amount will not be restored if the credit shelter trust declines in value after the first decedent's death. By contrast, the DSUE amount is fixed. Thus,

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[25] *See id.*

[26] *See generally* Bramwell & Kanaga, *supra* note 23.

[27] An example is New Jersey's estate tax, which continues to have a "pickup" tax that is designed to be equal to the maximum amount of federal credit for state death taxes under Code section 2011. *See* N.J. STAT. ANN. § 54:38-1 et seq. That credit was essentially computed on the decedent's taxable estate and in many cases was not affected by the amount of the decedent's lifetime gifts. *See id.* Thus, a traditional pickup tax can be avoided by making lifetime gifts, even gifts made shortly before death. *See generally* Austin W. Bramwell & Vanessa L. Kanaga, *The Paradoxical Computation of New York Estate Tax*, 46 NYSBA TR. & EST. L. SEC. NEWSL. 4 (Winter 2013).

[28] *See* Austin W. Bramwell & Vanessa Kanaga, *Austin Bramwell and Vanessa Kanaga on PLR 201243004*, LISI EST. PLAN. NEWSL. #2040 (December 20, 2012).

portability in effect provides insurance against underutilization of the first decedent's exclusion amount as a result of market declines.

11. *Flexibility*. Finally, a couple might simply wish to preserve their options. Portability creates substantial post-mortem flexibility,[29] in that the surviving spouse can use up the first decedent's DSUE amount at any time during the surviving spouse's lifetime or at the surviving spouse's death.[30] Through a variety of techniques, such as making deemed taxable gifts under Code section 2519,[31] it is even possible for the surviving spouse to use up the first decedent's DSUE amount during lifetime *and* remove assets from the surviving spouse's gross estate in a manner similar to the creation of a credit shelter trust, yet *also* retain beneficial access to the first decedent's assets.

A full discussion of the advantages and disadvantages of portability is beyond the scope of this Article. It suffices to say that for many couples, the advantages of portability will be sufficiently compelling that many estates will end up making portability elections. In consequence, many surviving spouses will end up inheriting their deceased spouse's unused exclusion amounts.

IV. RISK OF DSUE FORFEITURE

Portability has at least one important downside for surviving spouses who remarry—the DSUE amount inherited from the first spouse may be lost if the second marriage ends by death rather than during the spouses' lifetimes, such as by divorce.[32] Forfeiture of the DSUE amount can occur under one of two technical portability rules. One such rule applies if an individual predeceases his or her second spouse, while the other can apply if the individual survives his or her second spouse.

The first rule that can cause forfeiture of DSUE is that the DSUE amount is defined as the lesser of two amounts.[33] Specifically, an

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[29] *See Portability or No*, *supra* note 10, at 243.

[30] A major caveat is that the surviving spouse will lose the DSUE amount by remarrying and surviving a second spouse prior to making taxable gifts up to the amount of the DSUE amount inherited from the first decedent. *See* Temp. Treas. Reg. § 20.2010-3T(a)(3).

[31] *See* I.R.C. § 2519.

[32] *See* Temp. Treas. Reg. § 20.2010-3T(a)(3). A second marriage in itself does not cause forfeiture of DSUE inherited from a prior spouse. *See id.* Nor does a marriage that terminates by reason other than death cause DSUE forfeiture. *See id.*

[33] *See* I.R.C. § 2010(c)(4).

individual's inherited DSUE amount (if any) is equal to the lesser of (1) the basic exclusion amount or (2) the applicable exclusion amount of the individual's last deceased spouse, reduced by the sum of the last deceased spouse's taxable estate and adjusted taxable gifts.[34] The first limitation—that DSUE amount cannot exceed the basic exclusion amount—will in some cases prevent a surviving spouse who remarries from making full use of the DSUE amount.

For example, suppose that the wife (in an opposite-sex couple) has $5,430,000 million of basic exclusion amount, plus $5 million of DSUE inherited from a previously deceased spouse, for a total of $10,430,000. The wife then remarries, dies, and leaves all of her assets in a QTIP trust for the benefit of her second husband. The DSUE amount that the second husband may inherit in that case is not the wife's full $10,430,000 of applicable exclusion amount. Rather, the second husband's DSUE amount is limited to the wife's basic exclusion amount of $5,430,000. The extra $5 million of applicable exclusion amount that the wife inherited from her first husband is lost, because it went unused.

The second rule that can cause loss of DSUE amount is the "last deceased spouse" rule.[35] This rule provides that a surviving spouse's applicable exclusion amount includes the DSUE amount inherited from the surviving spouse's last deceased spouse.[36] The modifier, last deceased, implies that an individual who has married and survived two or more spouses can only use the DSUE amount inherited from one of them, namely, the one who died most recently.[37] Thus, an individual who remarries and survives a second spouse will (without careful planning, as discussed later in this Article) lose the DSUE amount inherited from the first decedent.[38]

For example, suppose that the wife (in an opposite-sex couple) inherits $5 million of DSUE from her first husband. She then remarries and survives a second spouse, who dies and leaves his entire estate, which exceeds his applicable exclusion amount, to his children from a prior marriage. The wife cannot inherit any DSUE amount from her second husband, as his taxable estate will use up his entire applicable

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[34] *See id.*; I.R.C. § 2001(b).

[35] *See id.* § 2010(c)(4)(B)(i).

[36] *See id.* § 2010(c)(4)(i).

[37] *See Portability or No*, *supra* note 10, at 243.

[38] Only death can cause loss of DSUE. *See* Temp. Treas. Reg. § 20.2010-3T(a)(3). Mere remarriage does not cause such a loss, nor does a second marriage that ends in divorce. *See id.*

exclusion amount, thereby leaving no remaining unused exclusion to "port" to the wife.

Meanwhile, although the wife previously inherited DSUE from her first husband, the first husband is no longer the wife's last deceased spouse. That designation now belongs to the wife's second husband. Consequently, the $5 million of DSUE that the wife inherited from her first decedent is simply lost.[39] At a 40% federal estate tax rate, the potential tax cost to the wife of having failed to use the DSUE amount of her first husband is $2 million.

As the foregoing examples show, the technical portability rules may cause an otherwise avoidable estate tax to be imposed if a widow or widower who has inherited DSUE chooses to remarry. This problem is likely to become increasingly common. Indeed, whether taxpayers and their advisors realize it or not, the problem is no doubt common already. As noted, many married couples will, oftentimes for very good reasons, end up choosing to rely on portability. Thus, many surviving spouses will end up inheriting a DSUE amount from the first decedent. Of those surviving spouses, a substantial percentage will choose to remarry. However, when they do, they will be at risk of forfeiting their DSUE amounts entirely if their second marriages end by death. It is crucial, therefore, that advisors be able to plan to preserve inherited exclusion before it is lost.

V. BASIC STRATEGIES FOR PRESERVING INHERITED EXCLUSION

Fortunately, a surviving spouse who remarries can ensure that his or her DSUE amount from a prior spouse is preserved before it is lost at the death of either of the spouses in the second marriage. The discussion below describes the basic strategies that a surviving spouse may wish to consider. Later sections will examine several more specific techniques that are encompassed by those strategies. As will be seen, there are advantages and disadvantages to each technique.[40]

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[39] *See id.*, ex. (showing partial loss).

[40] The techniques for locking in DSUE are similar to those available in 2012-2013 for preserving estate and gift tax exclusion before it was set to expire under the Economic Growth and Tax Relief Reconciliation Act of 2001. *See* Pub. L. No. 107-16, 115 Stat. 38 § 901, as amended by Pub. L. No. 111-312, 124 Stat. 3296 §§ 101(a)(1) & 304. For example, making gifts-by-promise, and creating entities that are intentionally defective under Code section 2701, as discussed in sections VIII and IX of this Article, were both widely discussed by practitioners in 2012. *See generally* Steve R. Akers, *ACTEC 2012 Fall Meeting Musings*, available at https://www.actec.org/public/Akers_ACTEC_2012_

A. Credit Shelter Trust to Preserve DSUE

One partially effective way for a surviving spouse to preserve DSUE, even if he or she chooses to remarry, is to ensure that his or her taxable estate will be at least equal to the difference between his or her unused applicable exclusion amount and the basic exclusion amount. In other words, in his or her will or will substitute (such as a revocable trust), the surviving spouse should create a credit shelter trust (or make some other type of disposition that does not qualify for the marital or charitable deductions) that equals or exceeds the unused DSUE amount inherited from his or her first spouse. In this manner, a surviving spouse who remarries and predeceases a second spouse can effectively use up the DSUE amount inherited from the first deceased spouse, and at the same time preserve his or her basic exclusion amount for use by the surviving spouse.

For example, suppose that the wife (in an opposite-sex couple) inherits $5 million of DSUE from her first husband and later remarries. Thanks to the first limitation whereby the DSUE amount is calculated (that the DSUE amount cannot exceed the basic exclusion amount), if the wife predeceases the second husband, the second husband may at most inherit an amount of DSUE equal to the wife's basic exclusion amount.[41] The extra $5 million of applicable exclusion amount that the wife inherited from her first husband will go to waste if the wife chooses to leave all of her assets to the second husband in a form that qualifies for the marital deduction, thereby creating a taxable estate of $0.

To prevent that result, the wife should instead plan to have a taxable estate that is at least equal to the DSUE amount inherited from her first husband (reduced by any adjusted taxable gifts that used up the DSUE amount during the wife's lifetime). For example, she could bequeath $5 million to a credit shelter trust for her second husband. She could then leave him the balance in a form that qualifies for the estate tax marital deduction. Then, no estate tax will be due at the wife's death, as her $5 million taxable estate will be less than her applicable exclusion amount (the sum of her basic exclusion amount and the $5 million of DSUE

Fall_Meeting_Musings.asp. The applicability of the same techniques in order to lock in DSUE was recognized shortly after portability became permanent. *See Portability or No*, *supra* note 10, at n.240 (noting but declining to describe the "many techniques" for locking in DSUE).

[41] *See* I.R.C. § 2010(c)(4).

inherited from the first husband).[42] In addition, although the wife's taxable estate will not be large enough to use up the full amount of her applicable exclusion amount, her executors can make a portability election and thereby allow the second husband to inherit the unused portion of the wife's applicable exclusion amount. In other words, the wife can use the first husband's DSUE amount yet still pass on her basic exclusion amount to her second husband.

It should be noted that there may be good reasons for a remarried individual to create a credit shelter trust equal to his or her *full* applicable exclusion amount, and not just limit the credit shelter bequest to the remaining DSUE amount inherited from a prior spouse. For example, a remarried individual may wish to control where his property ultimately passes at the death of the second spouse, and not allow the second spouse to divert the property to a different set of beneficiaries (such as the second spouse's children by another marriage). In principle, a remarried individual can achieve that objective through a QTIP trust for the benefit of the second spouse. If a QTIP trust is used, however, it will normally bear the burden of a portion of the estate taxes due at the second spouse's death. Moreover, under Code section 2207A, the estate taxes payable by the QTIP trust are generally equal to the difference between the actual estate taxes due at the second spouse's death and the estate taxes that would have been due if the QTIP trust were not included in the second spouse's gross estate.[43] This rule essentially permits the second spouse to shift the burden of estate taxes from the beneficiaries of his own estate to the remainder beneficiaries of the QTIP trust.[44] To avoid that result, a spouse who inherits DSUE and remarries should, in many cases, use up his applicable exclusion amount in full and not rely on QTIP trusts to control the ultimate disposition of his assets.

Of course, a downside of attempting to use up DSUE amount inherited from a prior spouse (plus, if advisable, the basic exclusion amount) through a testamentary credit shelter trust is that a surviving spouse might not actually predecease his or her second spouse. Suppose, once again, that the wife inherits $5 million of DSUE from her first husband and later remarries. Her estate planning documents properly provide that in the event that she predeceases her second husband, a credit shelter trust at least equal to her remaining DSUE amount (if not

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[42] *See id.* § 2010.

[43] *See* I.R.C. § 2207A.

[44] *See Portability or No*, *supra* note 10, at 240.

her full applicable exclusion amount) will be created. If she survives her second husband, however, these provisions will become idle. Furthermore, under the last deceased spouse rule, the wife may lose the DSUE amount inherited from the first husband altogether. Thus, a credit shelter trust is only a partial solution to the risk of DSUE forfeiture. To preserve inherited exclusion in all cases, further planning is required.

B. Locking in DSUE via Lifetime Taxable Gifts

Generally, the only way for a remarried individual to ensure that an inherited exclusion amount will be preserved and not forfeited, even if he or she survives a second spouse, is to make lifetime taxable gifts. Code section 2010(c)(4), as discussed above, limits the DSUE amount to the unused exclusion of an individual's last deceased spouse.[45] Nevertheless, under a special rule in the portability regulations for calculating the applicable exclusion amount, any DSUE inherited from a prior deceased spouse can be preserved, even if an individual remarries and survives a second spouse.[46] The favorable calculation rule is only available if the remarried individual makes taxable gifts that use up the DSUE amount inherited from the first deceased spouse before he or she survives a second spouse.[47]

For example, suppose that the wife (in an opposite-sex couple) inherits $5 million of DSUE from her first husband. She then uses up this DSUE amount by making a $5 million taxable gift to her descendants. Later, she remarries and survives a second husband, who has a large taxable estate that uses up his entire applicable exclusion amount. As a result, the wife will not inherit any DSUE from the second husband. The second husband is also no longer the wife's last deceased spouse. Thus, under a literal application of the last deceased spouse rule, the DSUE amount inherited from the first decedent would be lost, despite the surviving spouse's $5 million lifetime taxable gift. At the same time, the gift would still be added to the amount with respect to which estate tax is calculated under Code section 2001(b) as an adjusted taxable gift. If the DSUE amount is lost, therefore, a tax on the $5 million lifetime gift would essentially be recaptured at death under the estate tax computation procedures of Code section 2001(b).

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45 *See* I.R.C. § 2010(c)(4).

46 *See* Temp. Treas. Reg. § 25-2505-2T(c).

47 *See id.*

Fortunately, this harsh result is avoided under a regulatory exception to the last deceased spouse rule. The exception provides that the DSUE amount of an individual who has survived multiple spouses equals the sum of both the DSUE amount of his or her last deceased spouse *plus* "[t]he DSUE amount of each other deceased spouse of the surviving spouse to the extent that such amount was applied to one or more previous taxable gifts of the surviving spouse."[48] The regulations further provide that the DSUE amount is automatically deemed to be applied prior to an individual's basic exclusion amount.[49] In other words, so long as a surviving spouse makes a taxable gift of the DSUE amount inherited from a deceased spouse, the DSUE amount is not lost, even if the surviving spouse remarries and survives a second spouse.[50]

Suppose that the wife (who, as stipulated above, inherited $5 million of DSUE from her first husband) dies in 2015 with a taxable estate of $5,430,000. Technically, under Code section 2001(b), her $5 million taxable gift is an "adjusted taxable gift" that is added to the amount with respect to which estate tax is computed.[51] That is, a gross estate tax equal to $4,117,800 will be computed on the amount of $10,430,000, which is the sum of the wife's taxable estate ($5,430,000) and adjusted taxable gifts ($5,000,000).

Nevertheless, thanks to the special calculation rule, no estate tax will be due. The reason is that the wife's estate will have an applicable credit amount equal to the amount of tax that would be calculated on the amount of $10,430,000, which is the sum of the wife's basic exclusion amount of $5,430,000 and the DSUE amount inherited from the first husband of $5 million. In other words, the wife's estate's applicable credit amount will be $4,117,800, which will entirely cancel out the tentative estate tax of the same amount.[52]

To understand the tax savings achieved, suppose that the wife had not made a $5 million taxable gift prior to surviving her second husband. In that case, although the wife would not have made any adjusted taxable gifts, the wife's taxable estate (assuming no appreciation) would be

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48 Temp. Treas. Reg. §§ 25.2505-2T(c); 20.2010-3T(b)(1).

49 *See* Temp. Treas. Reg. §§ 25.2505-2T(b); 20.2010-3T(b)(2), ex.

50 *See id.*

51 *See* I.R.C. § 2001(b).

52 Without the special calculation rule, the wife's applicable credit amount would be limited to the amount of tax computed on her basic exclusion amount. In essence, the tax on the wife's $5 million taxable gift, when added to the amount with respect to which estate tax is computed as an adjusted taxable gift, would be clawed back.

$10,430,000, as she would have retained and not made gifts of her assets. As before, a tentative tax of $4,117,800 would be computed on the amount of $10,430,000. However, this time the wife's applicable credit amount under Code section 2010 would be limited to the amount of tax computed on the wife's basic exclusion amount.[53] The DSUE amount inherited from her first husband would be lost, as the first husband is no longer the wife's last deceased spouse. Therefore, the estate tax due will be $2,000,000. By failing to lock in the DSUE amount before surviving her second husband, the wife causes approximately 19% of her wealth to be depleted by estate tax.

As this example shows, the key to effective planning with DSUE inherited from a deceased spouse, whenever the surviving spouse remarries, is to make taxable gifts of the DSUE amount. By doing so, the surviving spouse effectively locks in the DSUE amount, even if the second marriage ends by the death of one of the spouses. The tax savings will be as much as 40% of the DSUE amount that might otherwise be lost.

C. DSUE Lock-In of Relatively Small Amounts of DSUE

Locking in DSUE is, perhaps, easiest for surviving spouses whose inherited exclusion is small compared to their total wealth. Suppose, for example, that a surviving spouse, who has $100 million of personal wealth, has inherited $5 million of DSUE and wishes to remarry. Before potentially surviving the second spouse and losing the DSUE amount from the first spouse, he or she could make a $5 million taxable gift to or for the benefit of his or her descendants. Under the special calculation rule discussed above, the surviving spouse will thereby have successfully ensured that the DSUE amount inherited from the first deceased spouse will not be wasted, even if he survives the second spouse.

Similarly, a surviving spouse who is relatively less wealthy, but whose DSUE amount is small, may feel comfortable locking in DSUE by making gifts to or for the benefit of descendants, even if he does not retain any interest in the transferred property. For example, suppose that the first deceased spouse dies with a taxable estate (plus adjusted taxable gifts) that was $100,000 short of the applicable exclusion amount. In this scenario, if a timely portability election is made, the surviving spouse is able to inherit $100,000 of DSUE. In order to lock in the DSUE amount,

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[53] *See* I.R.C. § 2010.

the surviving spouse might wish to make an outright gift to descendants prior to remarrying (and potentially surviving) any second spouse.

For many reasons, it will often be advisable for gifts in these cases to be made in trust. Not only can trusts protect the transferred property from claims of creditors and provide other advantages, but a trust can be designed as a so-called "grantor trust" that is treated as owned by the donor for income tax purposes.[54] As a result, returns on trust property can be earned tax-free during the donor's lifetime, even as the donor's own estate is depleted. Despite the substantial wealth transfer that occurs, the donor's payment of the tax on taxable income generated by the trust property is not treated as a taxable gift.[55]

In addition, although the trust can pass outside of the donor's estate for estate tax purposes, so long as the donor does not retain any powers or interests described in one of the gross estate string sections of the Code,[56] the donor can still achieve an artificial form of a change in basis of trust assets under Code section 1014.[57] Specifically, the donor can, just before death, purchase low-basis assets from the trust in exchange for cash or high-basis assets. Such an exchange, if the trust is a wholly grantor trust, is ignored for income tax purposes and does not trigger gain or loss.[58] Nevertheless, the donor will thereafter die holding the low-basis assets, which will qualify for a step up in basis at death, even as the high-basis assets remain in the trust. Indeed, such deathbed substitution planning, in effect, permits a family to pick and choose which assets will obtain a change in basis at death. Code section 1014(a), by contrast, generally gives all assets inherited from a decedent a new basis, even those assets that have declined in value.[59]

D. Perceived Downsides of Making Taxable Gifts

Many surviving spouses who remarry, especially if their DSUE amounts are large, may be reluctant to make taxable gifts that lock in the DSUE amount. They may believe that, if they make such taxable gifts, they will lose control and access to the property transferred by gift. If the surviving spouse wishes the property transferred by gift to pass outside

[54] *See* I.R.C. §§ 671-77; 679.
[55] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.
[56] *See* I.R.C. §§ 2035-2040, 2042.
[57] *See id.* § 1014.
[58] *See* Rev. Rul. 85-13, 1985-1 C.B. 184.
[59] *See* I.R.C. § 1014(a).

of his or her gross estate at death, the surviving spouse's concerns are largely justified. For transferred property to escape gross estate inclusion at death, the donor must generally avoid retaining (or, in some cases, merely possessing at death) any of the rights or controls described in Code sections 2035 through 2039 and 2042.[60]

To be clear, it is possible to retain some measure of control and beneficial access without triggering the string sections of the Code. For example, suppose the donor transfers property to a trust created in a jurisdiction, such as Alaska, that generally allows even "self-settled" trusts to be protected against claims of creditors.[61] It seems that it is possible for the donor to retain the ability to receive distributions in the discretion of an independent trustee, yet not necessarily be considered to have retained the right to income, use, possession or other enjoyment within the meaning of Code section 2036(a)(1).[62] However, even in that case, if there was an understanding, express or implied, that the right to income, use, possession or enjoyment of the transferred property would later be conferred, such as on a rainy day, then the property can be pulled back into the donor's gross estate at death under Code section 2036(a)(1).[63] Cautious taxpayers who wish to avoid the application of that section will not wish to create a record, such as a history of distributions to the settlor, that could be used to support a finding that there was an implied understanding that trust assets would be made available to the donor. Therefore, as a practical matter, the donor's ability to receive distributions from a self-settled trust may be very limited if the donor wishes to avoid gross estate inclusion under Code section 2036(a)(1).[64]

Lack of access to transferred property is not the only reason that a donor might be hesitant to make a taxable gift of a DSUE amount in a manner that avoids gross estate inclusion at death. There is also a tax downside—it seems that if property inherited from a United States

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[60] *See id.* §§ 2035-2042.

[61] *See* ALASKA STAT. § 34.40.110 (2012).

[62] *See, e.g.*, Nat'l City Bank of Evansville v. Comm'r (*In re* Estate of Uhl), 241 F.2d 867, 870 (7th Cir. 1957); Estate of German v. United States, 7 Cl. Ct. 641, 643 (1985); Rev. Rul. 2004-64, 2004-2 C.B. 7; Rev. Rul. 76-103, 1976-1 C.B. 293; Priv. Ltr. Rul. 2009-44-002 (July 15, 2009).

[63] *See* Treas. Reg. § 20.2036-1(c)(1)(i); Rev. Rul. 2004-64, 2004-2 C.B. 7; Priv. Ltr. Rul. 2009-44-002 (July 15, 2009).

[64] *See* I.R.C. § 2036(a)(1).

citizen or resident is not included in his or her gross estate at death,[65] the property cannot generally qualify for a change in basis under Code section 1014.[66] Thus, if a surviving spouse who remarries makes a taxable gift of the DSUE amount and the property transferred by gift passes outside his or her gross estate, any estate tax savings may be offset by a loss of income tax savings from a change in basis under Code section 1014(a).[67]

E. Taxable Gifts Included in the Gross Estate

In many cases, a surviving spouse and his or her heirs will be better off from a tax perspective if the surviving spouse locks in DSUE by making taxable gifts in a manner that will cause the gifts to be pulled back into his or her gross estate at death. Suppose, for example, that the wife (in an opposite sex couple) survives the husband, inherits $5 million of DSUE from him, and has $6 million of her own assets. She later remarries and survives a second husband, but inherits $0 of DSUE from him. Prior to remarriage, however, she makes a taxable gift of the entire $5 million DSUE amount. Rather than make the gift in a manner that will pass outside her estate, she makes the gift to a lifetime grantor-retained income trust or "GRIT." That is, she makes a $5 million gift to an irrevocable trust in which she is entitled to all of the income for life. The balance of the trust property at her death is directed to be paid over to (or held in further trust for) her descendants.

The wife's retained income interest in that case is not a "qualified interest" within the meaning of Code section 2702(b).[68] As a result, it is valued at $0 for gift tax purposes under Code section 2702(a).[69] Here, the wife welcomes that result. Her goal, after all, is to use up the full $5

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[65] Property inherited from a nonresident alien decedent, however, need not be included in the decedent's gross estate for estate tax purposes in order for the property to qualify for a change of basis under Code section 1014(a). *See* Rev. Rul. 84-139, 1984-2 C.B. 168; Priv. Ltr. Rul. 2012-45-006 (July 19, 2012).

[66] *See* I.R.C. § 1014. It has been argued, however, that property passing from a trust that was a "grantor trust," with respect to the decedent, should qualify for a change in basis, even if the property is not included in the decedent's gross estate. *See* Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 154–55 (September 2002). *But see* IRS Chief Couns. Advice 200937028 (Sept. 11, 2009) (stating that the Internal Revenue Service "strongly disagree[s]" that a step up in basis occurs).

[67] *See* I.R.C. § 1014(a).

[68] *See* I.R.C. § 2702(b).

[69] *See id.*

million of DSUE. Thus, she does not actually want the gift tax value of her $5 million transfer to be reduced by the value of her retained interest. Code section 2702(a) permits the wife to retain substantial interest in transferred property, yet still be treated as making a taxable gift equal to the full value of the property transferred.[70]

Now suppose that at the time of the wife's death, she still has $1 million in her own name. The GRIT, meanwhile, has appreciated to $9 million, all of which is included in the wife's gross estate under Code section 2036(a)(1).[71] The wife's gross estate, therefore, is $10 million. Her taxable estate will exceed her basic exclusion amount of $5,430,000, assuming that she dies in 2015. Nevertheless, no estate tax will be due, as the wife's applicable exclusion amount will also include, thanks to the wife's $5 million GRIT, the $5 million DSUE amount inherited from the first husband.

To be sure, the gift that used up the DSUE amount is included in the wife's gross estate under Code section 2036(a)(1).[72] But the exclusion inherited from the first decedent is not thereby forfeited. On the contrary, the special calculation rule that permits the DSUE amount of a *prior* deceased spouse to be preserved applies to *all* taxable gifts that use up DSUE, not just gifts (generally known as adjusted taxable gifts) that pass outside of the gross estate.[73] Thus, the wife's applicable exclusion amount will be equal to the sum of her basic exclusion amount of $5,430,000 and the $5 million of DSUE inherited from the first decedent. The $10,430,000 total applicable exclusion amount generates enough credit to cancel out the gross estate tax on the wife's taxable estate. If the taxable estate is $10 million and the wife dies in 2015, the GRIT saves approximately $1.8 million of estate tax.

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[70] *See id.* § 2702(a).

[71] *See id.* § 2036(a)(1). Code section 2036(a)(1) provides, *inter alia*, that the gross estate of a decedent includes the value of any property of which the decedent made a transfer (other than in a bona fide sale for full and adequate consideration in money or money's worth) and retained the right to income for life. *See id.*

[72] *See id.*

[73] *See* Temp. Treas. Reg. § 20.2010-3T(b)(1); *see also* T.D. 9593, 2012-28 I.R.B. 17, 22 ("[T]he temporary regulations . . . compute the DSUE amount available to such a surviving spouse or to his estate, respectively, as including both: (i) the DSUE amount of the surviving spouse's last deceased spouse, and (ii) any DSUE amount actually applied to *taxable gifts* pursuant to the rule in § 25.2505-2T(b) to the extent the DSUE amount so applied was from a decedent who no longer is the last deceased spouse for purposes of § 2010(c)(4)(B)(i).") (emphasis added).

In addition, the GRIT property qualifies for a step up in basis under Code section 1014(a).[74] Suppose that the GRIT property had a basis of $5 million just before the wife's death and that the effective capital gains tax rate, after taking into account federal income tax, net investment income tax under Code section 1411,[75] and state and local income taxes, is 30%. The step up in basis from $5 million to $9 million and the avoidance of a 30% capital gains tax on $4 million of gain when the GRIT property is sold, saves $1.2 million of inherent income tax liability. Had the wife locked in DSUE by making a gift to descendants that passed outside of her gross estate, those income tax savings would likely have been lost. By instead making the taxable gift via a GRIT, the wife achieves two benefits at once: she locks in the DSUE amount from her first husband, saving approximately $1.8 million of estate tax, and she achieves a step up in basis at death, saving an additional $1.2 million of income tax.

In addition, the wife did not even have to give up the income from the property transferred by gift. As noted, few surviving spouses may be willing to make gifts of DSUE inherited from a deceased spouse if doing so means giving up access to and control over the transferred property. In the foregoing example, the DSUE amount of $5 million represented five-sixths of the wife's total personal wealth. An individual in that position will almost surely not wish to lose the income from $5 million of assets. Fortunately, he or she does not have to—not only does a gift that deliberately triggers gross estate inclusion still lock in DSUE, but, quite often, especially for the less wealthy, doing so will be more tax efficient.

VI. THE VIRTUALLY REVOCABLE TRUST

A GRIT exploits the draconian special valuation rules of Chapter 14 of the Code—that is, even though the donor retains a significant interest in the transferred property, the retained interest is ignored for gift tax valuation purposes, provided that the non-retained transfer is made to or for the benefit of members of the transferor's family.[76] Under Code section 2702, the donor can make a gift of the full DSUE amount, notwithstanding a retained interest.[77] By the same logic, a surviving

[74] *See* I.R.C. § 1014(b)(3).

[75] *See id.* § 1411.

[76] *See id.* § 2702(a).

[77] *See id.* It does not seem that the Service may, on its own initiative, disregard the mandatory special valuation rule of Code section 2702. *See id.*; *see generally* Austin Bramwell, Brad Dillon & Lisi Mullen, *Relax, Rev. Proc. 2001-38 Cannot Be Used*

spouse can retain more than just an income interest, yet still successfully lock in the DSUE amount. So long as at least some portion of the gift is made to members of the donor's family and the gift of that portion is complete for gift tax purposes,[78] all of the retained interests of the donor will be valued at zero.[79] Thus, the donor can retain virtually all rights and controls over property transferred in trust, yet still successfully lock in DSUE amount, provided that at least some portion of the transfer is completed for gift tax purposes.[80]

Suppose, for example, that the wife inherits $5 million of DSUE from a deceased husband and later chooses to remarry. To preserve the DSUE amount, she creates a trust that, for a period of six months, is held exclusively for the benefit of her descendants. The wife has no power to revoke the trust during that six-month period. As a result, the wife's gift of the trust property for that six-month period is a completed gift for gift tax purposes.[81] After six months have elapsed, however, she becomes the sole beneficiary of the trust property and has the power to revoke the trust at any time. She also is appointed as sole trustee and is given sole power over distribution decisions. Economically, except for the initial six-month period, the wife has retained all control and rights with respect to the trust (hereinafter, the "virtually revocable trust"). Indeed, after the initial six-month period, the trust can function like a conventional revocable trust. Although it might seem that the wife has made only a small taxable gift, under Code section 2702,[82] she is, in fact, deemed to have made a very substantial taxable gift. Specifically, the value of the wife's

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Against Taxpayers, or Why QTIP Planning Is Safer Than Some Might Think, LISI EST. PLAN. NEWSL. May 20, 2013 (arguing that the Service may not disregard a QTIP election, as some had previously contended).

[78] *See* I.R.C. § 2702(a)(3)(A)(i); Treas. Reg. § 25.2511-2.

[79] The general rule for valuing a gift made in trust is that the value of any retained interest is subtracted from the total value of the property transferred, so long as the retained interest is subject to measurement. *See* Robinette v. Helvering, 318 U.S. 184, 188 (1943); Treas. Reg. § 25.2511-1(e). However, under Code section 2702, if the other beneficiaries of the trust are members of the transferor's family, the retained interest is valued at zero (with some exceptions). *See* I.R.C. § 2702. For purposes of Code section 2702, members of the transferor's family means, with respect to any individual, his spouse, any ancestor or lineal descendant of such individual or of such individual's spouse (and any spouse of any such individual) and any brother or sister of the individual (and any spouse of any such individual). *See* I.R.C. §§ 2702(e); 2704(c)(2).

[80] Code section 2702 does not apply to wholly incomplete gifts. *See* I.R.C. § 2702(a)(3)(A)(i); Treas. Reg. § 25.2702-1(c)(1).

[81] *See* Treas. Reg. § 25.2511-2(b).

[82] I.R.C. § 2702.

retained remainder interest is equal to $0. Thus, her taxable gift is equal to 100% of the property transferred, or $5 million.

At the wife's death, the full value of the trust will be included in her gross estate under Code sections 2036[83] and 2038.[84] Therefore, the $5 million gift is not an adjusted taxable gift within the meaning of Code section 2001(b)[85] and will not be added to the amount with respect to which estate tax is calculated. Note, however, that the wife should not revoke the trust during her lifetime. If she does so, the property that was previously held in the virtually revocable trust may, at least arguably, be converted into an adjusted taxable gift.[86]

Once again, that does not prevent the DSUE amount inherited from the first deceased spouse from being added to the applicable exclusion amount, even if the first deceased spouse is no longer the last deceased spouse. Instead, the DSUE amount is equal to the sum of the DSUE amount inherited from the last deceased spouse, plus the DSUE amount of "each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse."[87] Thus, the DSUE amount inherited from prior spouses is added to the applicable exclusion amount whenever it is applied against a taxable gift, regardless of whether the taxable gift is later included in the gross estate or not.[88] A transfer to a virtually revocable trust is a taxable gift and, therefore, qualifies for the special calculation rule that preserves DSUE amount from a prior deceased spouse.

Finally, just as with a GRIT, property held as part of a virtually revocable trust will qualify for a change in basis under Code section 1014(a).[89] It seems that, under Code section 1014(b)(2),[90] a decedent's

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[83] *Id.* § 2036.

[84] *Id.* § 2038.

[85] *Id.* § 2001(b).

[86] *But see* Rev. Rul. 84-25, 1984-1 C.B. 191 (holding that property transferred by gift that is included in a decedent's gross estate under Code section 2033 may avoid classification as an adjusted taxable gift, even though the gift is not pulled back into the gross estate under one of the string sections of the Code).

[87] Temp. Treas. Reg. § 20.2010-3T(b)(1)(ii).

[88] Indeed, other favorable rules in the portability regulations are only available for adjusted taxable gifts. *See* Temp. Treas. Reg. § 20.2010-2T(c)(1)(ii)(B)(2); Temp. Treas. Reg. § 20.2010-2T(c)(5) ex. 2 (highlighting that the special rule permitting DSUE amount to be preserved is available for all taxable gifts and not just adjusted taxable gifts).

[89] *See* I.R.C. § 1014(a).

[90] *Id.* § 1014(b)(2).

power of revocation, combined with the right to income from a virtually revocable trust, should cause the property to be deemed to be inherited from a decedent within the meaning of Code section 1014(a).[91] Thus, just like a surviving spouse who uses up inherited exclusion with a GRIT, a surviving spouse who uses up inherited exclusion with a virtually revocable trust achieves a double tax benefit—he or she not only preserves the DSUE amount, even if he survives a second spouse, but also obtains a potential step up in basis at his or her death.

VII. TRIGGERING SECTION 2519

As the authors previously argued, Code section 2519 creates an attractive way for a beneficiary of a QTIP trust to make taxable gifts without necessarily losing access to the property deemed to have been transferred.[92] One unique advantage of this type of planning is that, if the QTIP trust is a so-called reverse QTIP trust, to which the settlor allocated generation-skipping transfer (GST) exemption, the original settlor remains the transferor of the QTIP property for GST tax purposes, even though the beneficiary spouse is deemed to have made a transfer of the trust property. The benefits of Code section 2519 planning are now more widely acknowledged.[93]

In brief, Code section 2519 provides that a disposition of a "qualifying income interest for life" in QTIP property causes the beneficiary to be deemed to have made a transfer of all interests in the property *other than* the qualifying income interest.[94] For example, suppose that the wife (in an opposite-sex couple) is the surviving spouse. She inherits $5 million of DSUE amount from the husband, and is the beneficiary of a $5 million QTIP trust created under the husband's will. The trust provides that the wife is entitled to all income of the trust and that the wife may also receive principal in the discretion of the trustee. Suppose further, that the

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[91] *See id.* § 1014(a). Perhaps, on the other hand, the property of a virtually revocable trust does not meet the requirement of Code section 1014(b)(2) that the power of revocation be held "at all times" before death. *See id.* § 1014(b)(2). Even if Code section 1014(b)(2) fails to trigger a change of basis, it seems clear that a change of basis will occur under Code section 1014(b)(9). *See id.* § 1014(b)(9).

[92] *See* Austin W. Bramwell, *Using 2519 to Enhance Estate Planning with QTIPs*, 38 EST. PLAN. 15, 18–21 (2011); Bramwell & Kanaga, *supra* note 10, at 15.

[93] *See*, *e.g.*, Bramwell, *supra* note 92, at 18–21; Bramwell & Kanaga, *supra* note 10, at 15; Richard S. Franklin & George D. Karibjanian, *Portability and Second Marriages – Worth a Second Look*, 39 EST., GIFTS & TR. J. 179, 189 (2014).

[94] *See* I.R.C. § 2519(a).

husband's executors made an election under Code section 2652(a)(3) to treat the husband as the transferor of the QTIP trust for GST tax purposes and to allocate the husband's GST exemption to the QTIP trust to make it effectively exempt from GST tax.[95]

The wife then chooses to remarry. In order to preserve the DSUE amount inherited from the first decedent, she makes a taxable gift by irrevocably assigning her income interest in the QTIP trust to her descendants or to a trust for their benefit.[96] Alternatively, it may be advisable for her to assign merely a fraction of the income interest, such as 5%, and retain the right to the remaining 95%. The irrevocable assignment of the income interest will be treated as a taxable gift under normal gift tax provisions.[97] In addition, under Code section 2519, the wife will be *deemed* to have made a taxable gift of principal.[98] Thus, the wife is treated, technically, as making two gifts: a gift of the income interest under ordinary gift tax principles and a deemed gift of principal under Code section 2519.[99] The sum of the two gifts should equal the entire value of the QTIP trust, or $5 million. The entire $5 million DSUE amount, therefore, is effectively preserved by the gift of the income interest.

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[95] *See id.* § 2652(a)(3).

[96] Often, a trust will include a "spendthrift" clause that prohibits assignments of beneficial interests. Similar spendthrift protection may also be afforded by default under local law. *See, e.g.*, N.Y. ESTATES, POWERS & TRUSTS LAW § 7-1.6 (McKinney 1993). A QTIP trust can be drafted, however, to permit assignments of the income interest to descendants (other than creditors). It seems that such a clause will not impair the creditor protection benefits of a more standard spendthrift clause. Other practitioners, however, advocate relying on nonqualified disclaimers or renunciations of QTIP income interests. *See* Franklin & Karibjanian, *supra* note 93, at 189.

[97] *See* Monroe v. United States, 301 F. Supp. 762, 768 (E.D. Wash. 1969); Hrobon v. Comm'r, 41 T.C. 476, 497 (1964) (holding that the sale of an income interest in exchange for payments equal to 60% of future distributions was a gift equal to 40% of the income interest); *see also* Treas. Reg. § 25.2512-5(d)(2).

[98] *See* I.R.C. § 2519; Treas. Reg. § 25.2519-1(a).

[99] *See* I.R.C. § 2519. The fact that the wife may continue to be the discretionary beneficiary of principal does not prevent a completed gift from occurring. *See* Priv. Ltr. Rul. 2012-43-004 (Oct. 26, 2012); *see also* Herzog v. Comm'r, 116 F.2d 591, 595 (2d Cir. 1941); Treas. Reg. § 25.2519-1(g) ex. 5 (stating that the valuation rules of section 2702, which only apply to complete gifts, apply to the deemed transfer under Code section 2519, even though the spouse continued to be a discretionary beneficiary of principal); Priv. Ltr. Rul. 2009-44-002 (Oct. 30, 2009). However, the transfer will, it seems, be deemed to be incomplete if the beneficiary of a QTIP trust has a testamentary power of appointment, although there is no direct authority on point. *See* Priv. Ltr. Rul. 2012-43-004 (Oct. 26, 2012).

Meanwhile, although the wife has assigned the income interest to her descendants, she continues to be a discretionary beneficiary of principal.[100] Thus, even following the actual gift of the income interest and the deemed gift of principal, the wife can continue to receive distributions of the very principal that is deemed, under Code section 2519, to have been transferred.[101] In other words, just as in the case of a GRIT or a virtually revocable trust, the wife can preserve DSUE amount by making substantial taxable gifts, yet retain beneficial access to the transferred property.

A deemed gift under Code section 2519 also preserves the GST exemption that was allocated to the QTIP trust by the first husband.[102] Although the wife is deemed to make a taxable gift of principal for gift tax purposes and for GST tax purposes, due to the reverse QTIP election, the husband is still deemed to be the transferor.[103] Thus, the husband's GST exemption continues to cause the trust property to be effectively exempt from GST tax. In other words, the QTIP principal can ultimately pass free of GST tax to grandchildren and more remote descendants.[104] The wife's GST exemption does not need to be allocated (indeed, it cannot be allocated, as the wife is not the transferor of the QTIP)[105] to the QTIP trust in order to preserve the GST exemption but can instead be allocated to other property.

A. Section 2519 Transfers: Triggering Gross Estate Inclusion

Normally, QTIP property is included in the beneficiary spouse's gross estate under Code section 2044.[106] However, that section does not apply if, during the lifetime of the beneficiary spouse, there was a

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[100] *See id.*

[101] *See* I.R.C. § 2519; Treas. Reg. § 2519-1(b)(5).

[102] *See* I.R.C. §§ 2519; 2631(a).

[103] *See* Treas. Reg. § 26.2652-1(a)(3).

[104] In addition, it seems that, even if the income interest is assigned to or for the benefit of "skip persons," the husband's GST exemption will continue to shield even the income of the trust from GST tax. *See generally* Austin W. Bramwell & Sean Weissbart, *The Dueling Transferors Problem in Generation-Skipping Transfer Taxation*, ACTEC L. J. (forthcoming 2015); *see also* Treas. Reg. § 26.2652-1(a)(5) ex. 5 (providing that the original transferor remains the transferor of trust property following a gift of an income interest). *But see Portability or No*, *supra* note 10, at 246 (stating, without explanation, that the first decedent's GST exemption "probably would not" continue to shield the income of the trust from GST tax).

[105] *See* I.R.C. § 2631(a).

[106] *See id.* § 2044.

disposition of the qualifying income interest under Code section 2519.[107] Thus, Code section 2044 will not cause the property of a QTIP, following an assignment by the beneficiary spouse of the income interest, to be included in the wife's gross estate.[108]

Nevertheless, it may still be advisable for the QTIP to be included in the gross estate of the beneficiary spouse. In particular, the spouse may not have sufficient assets of his or her own that when combined with the QTIP trust will cause an estate tax to be due after taking the DSUE amount into account. The spouse's family may, in that case, be better off having the QTIP property included in his or her gross estate, provided that doing so will cause the property to qualify for a change in basis under Code section 1014.[109]

As it turns out, even without the help of Code section 2044,[110] it is possible to lock in DSUE with a deemed gift of principal yet still cause the QTIP property to be included in the spouse's gross estate. Specifically, the property can be included in the spouse's gross estate under Code section 2036(a)(1).[111] Suppose, once again, that the wife inherits $5 million of DSUE amount from her deceased husband and is the beneficiary of a $5 million QTIP trust created under the husband's will. The trust provides that the wife is entitled to all income of the trust and that the wife may also receive principal in the discretion of the trustee. The wife then chooses to remarry. This time, to preserve the $5 million of DSUE amount, the wife assigns only a small fraction of the income interest, such as 5%. As before, the assignment of the 5% income interest is a taxable gift under normal gift tax rules. In addition, she will be treated under Code section 2519 as transferring all interests in the trust other than the income interest.[112] Thus, the wife is deemed to have made a taxable gift of the entire principal of the trust.

In addition, for purposes of determining the value of the wife's gift under Code section 2519,[113] the value of the wife's retained interest in 95% of the income is ignored under Code section 2702.[114] The value of

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[107] *See id.* §§ 2044(b)(2); 2519.
[108] *See id.* § 2044.
[109] *See id.* § 1014.
[110] *See id.* § 2044.
[111] *See id.* § 2036(a)(1).
[112] *See id.* § 2519.
[113] *See id.*
[114] *See id.* § 2702; Treas. Reg. § 25.2702-2(b).

the wife's deemed gift of principal under Code section 2519 is increased by the value of her retained 95% income interest.[115] The sum of the wife's actual gift of a 5% income interest and her deemed gift under Code section 2519[116] is equal to the entire value of the QTIP property. In short, just by assigning a small portion of the income interest in a QTIP trust, a surviving spouse can make a taxable gift of the entire trust and lock in DSUE to the extent of the entire value of the QTIP property.

Furthermore, at the wife's death, 95% of the QTIP property will be included in the wife's gross estate under Code section 2036(a)(1).[117] It is at least arguable that, as a result, the property included in wife's gross estate qualifies for a change in basis under Code section 1014(a).[118] That section provides that the basis of property "in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is generally equal to its fair market value at the decedent's death (or alternate value if an alternate valuation election was made).[119] Code section 1014(b) provides a list of categories of property that are considered "to have been acquired from or to have passed from the decedent."[120] Code section 1014(b)(9) is a catch-all provision that generally causes property included in the decedent's gross estate to be considered to have been acquired from or to have passed from the decedent.[121] Thus, it seems that property that is included in a decedent's gross estate by virtue of a deemed transfer under Code section 2519,[122] combined with a retained income interest under Code section 2036(a)(1),[123] should qualify for a step up in basis.

Unfortunately, however, Code section 1014(b)(9) contains a separately stated requirement that the property be "acquired from the decedent by reason of death, form of ownership, or other conditions."[124] It is unclear that property that was deemed to have been transferred by

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[115] *See* Treas. Reg. § 25.2519-2(g) ex. 4.

[116] *See* I.R.C. § 2519.

[117] *See id.* § 2036(a)(1); Treas. Reg. § 25.2519-2(g) ex. 4; *see also* Treas. Reg. §§ 25.2036-1(c)(1); (c)(ii) ex. 4.

[118] *See* I.R.C. § 1014(a).

[119] *See id.*

[120] *See id.* § 1014(b).

[121] *See id.* § 1014(b)(9).

[122] *See id.* § 2519.

[123] *See id.* § 2036(a)(1).

[124] *See id.* § 1014(b)(9).

the decedent under Code section 2519[125] satisfies this requirement. After all, the deemed transfer is purely notional—no actual transfer of principal occurs. It is the original settlor of the QTIP trust, rather than the deceased spouse beneficiary, from whom the property actually passes.[126] Meanwhile, the transfer under Code section 2519 is only deemed to occur for estate and gift tax purposes but not necessarily for income tax purposes.[127] There is no provision of the Code that states that the property is also deemed to have been transferred by the decedent for purposes of Code section 1014.[128]

By contrast, where property is included in the spouse's gross estate under Code section 2044,[129] a change in basis would clearly be available under Code section 1014(b)(10), which provides that such property is considered to have passed from the spouse.[130] The Code fails, however, to provide a similar rule for property that is included in a spouse's gross estate as a result of a deemed transfer under Code section 2519.[131] As a matter of policy, it is difficult to see why different income tax results occur, depending on whether QTIP property is included in a spouse's gross estate under Code section 2044[132] or a result of a deemed transfer (combined with a retained interest) under Code section 2519.[133]

Nevertheless, it is not clear whether property included in a spouse's gross estate as a result of Code section 2519[134] does qualify for a change in basis.[135] If a beneficiary of a QTIP trust wishes to lock in DSUE amount and be assured of a step up in basis, it may be preferable for the principal of the QTIP trust to be distributed to the spouse. The spouse can thereafter create a GRIT or virtually revocable trust whose property

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[125] *See id.* § 1014.
[126] *See id.* § 1014(b).
[127] *See id.* § 2519.
[128] *See id.* § 1014.
[129] *See id.* § 2044.
[130] *See id.* § 1014(b)(10); Treas. Reg. § 20.2044-1(b).
[131] *See* I.R.C. § 2519.
[132] *See id.* § 2044.
[133] *See id.* § 2519.
[134] *See id.*
[135] For a more optimistic view, see Franklin & Karibjanian, *supra* note 93, at 185 (arguing that a step up in basis does occur).

will clearly qualify for a change in basis at death.[136] However, surviving spouses who prefer to keep the QTIP trust (for example, for creditor protection reasons) and are willing to accept uncertainty as to the income tax consequences at death, should consider a partial disposition of qualifying income interest in order to preserve DSUE amount from the deceased spouse.

B. Section 2519 Transfers that Escape Gross Estate Inclusion

In other cases, such as where the QTIP property is expected to appreciate in value and, if included in the beneficiary spouse's gross estate, will trigger an estate tax, it may be preferable for property deemed transferred under Code section 2519 *not* to be included in the spouse's gross estate at death. It seems that this result can be achieved so long as the beneficiary spouse, as the deemed transferor of the principal, does not retain any rights described in one of the string sections of the Code. For example, if the spouse is not a beneficiary of QTIP principal and has no power to control its disposition, the principal should pass outside of the spouse's gross estate upon his death.

The principal of the QTIP trust should likewise pass outside of the spouse's gross estate, even if, following a deemed transfer under Code section 2519,[137] the spouse remains eligible to receive principal in the discretion of an independent trustee. It is well established that a decedent's mere eligibility to receive distributions from an independent trustee, and nothing more, does not cause property transferred during lifetime to be included in his gross estate under Code section 2036(a)(1).[138] Granted, if the transferred property was subject to claims of the decedent's creditors, then the decedent is considered to have retained the beneficial enjoyment of the property within the meaning of Code section 2036(a)(1).[139] However, a transfer under Code section 2519 is a deemed transfer purely for tax purposes; it is not a transfer at all for

[136] *But see* Estate of Kite v. Comm'r, 105 T.C.M. (CCH) 1277 (2013) (holding that a distribution of principal from a QTIP trust, followed by a sale of the property distributed, triggered Code section 2519).

[137] *See* I.R.C. § 2519.

[138] *See* Nat'l City Bank of Evansville v. Comm'r (*In re* Uhl), 241 F.2d 867, 869 (7th Cir. 1957); German v. United States, 7 Cl. Ct. 641, 643 (1985); Rev. Rul. 2004-64, 2004-2 C.B. 7; Rev. Rul. 76-103, 1976-1 C.B. 293; Priv. Ltr. Rul. 2009-44-002 (July 15, 2009).

[139] *Cf. In re Uhl*, 241 F.2d at 869; *German*, 7 Cl. Ct. at 642; Rev. Rul. 2004-64; Rev. Rul. 76-103; Priv. Ltr. Rul. 2009-44-002.

state law purposes, or a transfer in trust that might otherwise be void as against creditors.[140] On the contrary, after a surviving spouse beneficiary of a QTIP trust assigns the right to income but retains a discretionary interest in principal, the *deceased* spouse remains the settlor of the trust for state law purposes.

In other words, for tax purposes, although the beneficiary spouse is deemed to have transferred principal for her own benefit, the trust is not a self-settled trust for state law purposes and, therefore, cannot be void as against the creditors of the beneficiary spouse. Consequently, the beneficiary spouse may trigger a deemed transfer of principal under Code section 2519,[141] continue to hold a discretionary interest in principal, and have the principal protected against claims of the beneficiary's creditors under standard spendthrift provisions (or as discretionary interest).[142] Creditors' rights doctrine, therefore, does not cause the principal of the trust in that case to be included in the spouse's gross estate under Code section 2036(a)(1).[143]

Code section 2036(a)(1)[144] can also apply where there was an agreement, express or implied, that the decedent would retain the right to income or the beneficial enjoyment from the transferred property.[145] Thus, courts have found an implied understanding to exist and pulled transferred property back into a decedent's gross estate at death, where the decedent, although he or she did not retain any legal right to the property, was in actual possession or was actually enjoying the transferred property.[146] For a number of reasons, however, it seems that in the case of a deemed transfer under Code section 2519,[147] it would be difficult for the IRS to establish that there was an implied understanding

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[140] *See* I.R.C. § 2519. Under the law of most states, the settlor's creditors may reach the assets of a trust that the settlor creates for his own benefit, to the extent that the settlor may receive distributions. *See*, *e.g.*, N.Y. ESTATES, POWERS & TRUSTS LAW § 7-3.1 (McKinney Supp. 2015).

[141] I.R.C. § 2519.

[142] *See* RESTATEMENT (SECOND) OF TRUSTS § 155 (1959).

[143] *See* I.R.C. § 2036(a).

[144] *Id.* § 2036(a)(1).

[145] *See* Treas. Reg. § 20.2036-1(c)(1)(i).

[146] *See, e.g.*, Estate of Maxwell v. Comm'r, 3 F.3d 591, 593–95 (2d Cir. 1993); Guynn v. United States, 437 F.2d 1148, 1150 (4th Cir. 1971); Estate of Reichardt v. Comm'r, 114 T.C. 144, 150–53 (2000); Estate of Paxton v. Comm'r, 86 T.C. 785, 813–14 (1986); Estate of Kerdolff v. Comm'r, 57 T.C. 643, 647–48 (1972); Estate of Linderme v. Comm'r, 52 T.C. 305, 307 (1969).

[147] *See* I.R.C. § 2519.

that the trustee would thereafter make discretionary principal distributions. For one thing, the transfer of principal under Code section 2519 is purely notional.[148] There is no actual transfer of property with respect to which an understanding, express or implied, regarding distributions could even arise. Indeed, the spouse may trigger a deemed transfer under Code section 2519 without even communicating with the trustee.[149] The deemed transfer could even occur at a time before the trustee of the trust was appointed. Thus, with proper planning, it seems that the risk of gross estate inclusion under Code section 2036[150] following a deemed transfer under Code section 2519[151] is minimal. Possibly, the spouse could receive even liberal distributions of principal without causing the QTIP trust property to be included in the spouse's gross estate at death.

C. Fine-Tuning the QTIP Gift

In some cases, a spouse may wish to make a deemed taxable gift under Code section 2519 of only a portion of the QTIP trust property.[152] Suppose, for example, that the surviving spouse has inherited $5 million of DSUE and is the beneficiary of a QTIP trust worth $15 million. In that case, the surviving spouse may wish to use up the DSUE amount by triggering a deemed transfer of principal under Code section 2519.[153] However, even if the surviving spouse assigns only a small fraction of the income interest, he or she will still be deemed to have transferred all of the other interests in the QTIP trust.[154] As a result, the surviving spouse will be deemed to have made a taxable gift of the full $15 million. The surviving spouse may not wish to make such a large taxable gift or to pay the ensuing gift tax.

For surviving spouses who are the beneficiaries of large QTIP trusts, it may be possible, despite the general rules of Code section 2519[155] and regulations promulgated thereunder, to fine-tune the amount of the deemed transfer. Specifically, it may be possible first to divide the QTIP trust into two or more trusts. For example, if the surviving spouse is the

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148 *See id.*
149 *See id.*
150 *Id.* § 2036.
151 *Id.* § 2519.
152 *See id.*
153 *See id.* § 2519.
154 *See* Treas. Reg. § 25.2519-1(a).
155 I.R.C. § 2519.

beneficiary of a $15 million QTIP trust, the trustee could, if permitted under the terms of the governing instrument or local law, divide the trust into two trusts, one of which is funded with $5 million and the other with $10 million. The surviving spouse could then assign all or a portion of the right to income with respect to the $5 million QTIP trust. Potentially, in that case, the surviving spouse will only be deemed to have made a transfer under Code section 2519 with respect to the $5 million QTIP trust and not also the $10 million QTIP trust.[156]

The technique of severing a QTIP trust and then triggering Code section 2519[157] with respect to only one of the resulting trusts has been blessed by several non-precedential private rulings.[158] At this point, some practitioners may be comfortable using the technique without a private ruling. On the other hand, the Code states that if a disposition is made of a qualifying income interest in "any property" for which QTIP marital deduction was allowed, then the spouse is deemed to have transferred all interests in that property.[159] This language could be interpreted to mean that even if a QTIP trust is divided into separate trusts, a disposition of the income interest in one of the trusts will trigger a deemed transfer under Code section 2519 of the property of *both* trusts (since both trusts qualified for the marital deduction as QTIP trusts).[160] Thus, cautious practitioners may wish to obtain a private letter ruling before proceeding.

VIII. GIFT BY PROMISE

Another way to lock in the DSUE amount inherited from a surviving spouse is to make a gift by promise. The gift by promise is one of the most time-honored strategies in estate and gift tax planning.[161] It is well established that, for gift tax purposes, an individual makes a taxable gift

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[156] *See id.*; *cf.* Treas. Reg. § 25.2519-1(c)(5) (treating trusts that were severed to reflect a partial QTIP election as separate trusts for purposes of Code section 2519).

[157] I.R.C. § 2519.

[158] *See* Priv. Ltr. Rul. 2014-26-016 (June 27, 2014); Priv. Ltr. Rul. 2012-43-004 (Oct. 26, 2012); Priv. Ltr. Rul. 2011-19-004 (May 13, 2011); Priv. Ltr. Rul. 2011-18-007 (May 6, 2011); Priv. Ltr. Rul. 2005-30-014 (July 29, 2005); Priv. Ltr. Rul. 2003-28-015 (July 11, 2003); Priv. Ltr. Rul. 2003-19-002 (May 9, 2003).

[159] *See* I.R.C. § 2519(a); Treas. Reg. § 25.2519-1(a).

[160] *See* I.R.C. § 2519.

[161] In *Commissioner v. Copley's Estate*, the taxpayer was held to have made a taxable gift when he entered into a binding obligation to pay money to the donee but not when the obligation was ultimately discharged. *See* 194 F.2d 364, 365 (7th Cir. 1952). As the obligation was incurred before the gift tax was effective, the gift-by-promise effectively avoided gift tax. *See id.* at 369.

at the time that he or she enters into a binding obligation, for less than full and adequate consideration in money or money's worth, to make a future transfer of money or property.[162] Conversely, an individual does not make a gift when that obligation is ultimately discharged.[163] If an individual dies at a time when the obligation is outstanding, the taxable gift made when the obligation became binding is not treated as an adjusted taxable gift and is not added to the amount with respect to which estate tax is computed.[164] Thus, there is no double estate taxation at death—the property that will be used by the decedent's estate to discharge the obligation is included in the decedent's gross estate under Code section 2033,[165] just as if the decedent had not entered into the obligation, while the gift made as a result of the obligation is not added in the computation of estate tax.[166]

These principles make it possible to lock in DSUE through a gift by promise. Suppose, for example, that the wife inherits $5 million of DSUE from her deceased husband and later chooses to remarry. To preserve the DSUE amount inherited from her husband, she promises her children that, at her death, she will pay them $5 million in the future, plus interest at the applicable federal rate. Assume that the promise is made in such a way that it is binding under local law. The wife will be treated as making a taxable gift of the full $5 million obligation.[167]

Now, suppose that the wife survives her second spouse but does not inherit any DSUE amount from him. She dies in 2015 with a taxable estate of $10,430,000, having made no taxable gifts other than the $5 million gift by promise. The $5 million gift by promise is not added to

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[162] *See id.* at 367; Harris v. Comm'r, 178 F.2d 861, 864 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950); Rev. Rul. 79-384, 179-2 C.B. 344; Rev. Rul. 84-25, 1984-1 C.B. 191. Curiously, despite the strong authority that a gift-by-promise is indeed a gift, a recent article has argued that such gifts are merely faux gifts that should be ignored. *See* Jeffrey N. Pennell & Jeffrey A. Baskies, *Does the Gift by Promise Plan Work?*, LISI EST. PLAN. NEWSL. #2022, Nov. 6, 2012. *But see* Austin W. Bramwell, *The Gift-by-Promise Plan Works as Advertised*, LISI EST. PLAN. NEWSL. #2033, Dec. 3, 2012.

[163] *See Copley's Estate*, 194 F.2d at 368.

[164] *See* Rev. Rul. 84-25 1984-1 C.B. 191.

[165] *See* I.R.C. § 2033.

[166] For more on why a gift-by-promise should not be treated as an adjusted taxable gift, see Bramwell, *supra* note 162.

[167] The value of a promissory note is presumed to be the face amount of the note, plus accrued interest, unless the donor establishes a lower value. *See* Treas. Reg. § 25.2512-4.

the amount with respect to which estate tax is computed.[168] Thus, estate tax is computed solely on the $10,430,000 taxable estate, without any addition for adjusted taxable gifts. The wife's basic exclusion amount in 2015 is $5,430,000, which is $5 million less than her taxable estate. Nevertheless, her estate is allowed a $5 million DSUE exclusion thanks to the $5 million gift by promise, for a total applicable exclusion amount of $10,430,000. No estate tax will be due and the wife's entire estate can pass to her descendants free of estate tax. In addition, all of the property of the wife's estate (other than IRD) should qualify for a change in basis under Code section 1014(b)(1).[169]

Note that during the wife's lifetime, she did not have to make any transfer of cash or property to lock in the DSUE amount inherited from the first husband. Rather, all she had to do was promise to transfer cash or other property in the future, generally at death. So long as the promise is binding, it is treated as a taxable gift. The gift by promise is, perhaps, the most painless method of locking in DSUE amount while preserving a change in basis, as it permits a surviving spouse to retain complete ownership over his own property subject to a future obligation.[170]

For the gift-by-promise plan to succeed, it is crucial that the obligation be binding under local law. Otherwise, a taxable gift will not occur.[171] Generally speaking, purely donative promises that are made for no consideration are not legally binding under traditional principles of contract.[172] However, that rule was modified under the Uniform Written Obligations Act.[173] In a state, such as Pennsylvania, that has enacted a form of the Act, a person has the option of making a promise binding, even if it is made for no consideration, so long as the obligation is in

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[168] *See* Rev. Rul. 84-25, 1984-1 C.B. 191.

[169] *See* I.R.C. § 1014(b)(1).

[170] It seems that the donee of a gift-by-promise will typically not have gross income when the promise is made or when it is discharged, as the gift in most cases should be excluded from gross income under Code section 102(a). *See generally* Austin Bramwell & Elizabeth Madden Mullen, *Donative Promise Can Use Up Gift Tax Exemption*, LISI Est. Plan. Newsl. #2033, Aug. 23, 2012.

[171] *See* Alexander v. United States, 640 F.2d 1250, 1252 (Ct. Cl. 1981); Rev. Rul. 67-396, 1967-2 C.B. 351.

[172] *See generally* E. Allan Farnsworth, *Promises to Make Gifts*, 43 AM. J. COMP. L. 359 (1995) (discussing making a gift by promise). On the other hand, an obligation may in some cases be considered binding on a theory of promissory estoppel. *See* RESTATEMENT (SECOND) OF CONTRACTS § 90 (1981).

[173] *See, e.g.*, 33 PA. CONS. STAT. § 6.

writing and the obligor expresses an intent to be legally bound.[174] Thus, it seems that a surviving spouse can make a taxable gift and thereby preserve DSUE amount, by delivering a promissory note to the donees promising to pay over a sum of money in the future to them (such as at death) and expressing an intent to be legally bound. If Pennsylvania law governs the enforceability of the note, then it should be legally binding and trigger a taxable gift. To ensure that Pennsylvania law will apply, the note could, in addition to containing a choice of law provision selecting Pennsylvania as the governing law, be physically delivered in the state of Pennsylvania.[175] In this manner, a surviving spouse can make a taxable gift of his DSUE amount yet still retain ownership and control of his property.

Alternatively, the surviving spouse could enter into a binding obligation by extracting some form of legally sufficient consideration from the donees.[176] So long as the consideration, while legally sufficient as a matter of contract law, is not adequate and full consideration in money or money's worth, the difference in value between the donor's promise and the consideration received will be considered a taxable gift.[177] Advocates of extracting consideration point out that many individuals would be glad to obtain some kind of consideration from the intended recipients. By making gifts by promise, surviving spouses can lock in DSUE and have fun doing it as well.

IX. INTENTIONALLY NON-2701-COMPLIANT PREFERRED PARTNERSHIP

A final technique that can be used to lock in DSUE amount is to make a gift of an interest in a partnership (or corporation) in a manner that deliberately runs afoul of the special valuation rules of Code section 2701.[178] Suppose, for example, that the wife (in an opposite-sex couple) survives the husband, inherits $5 million of DSUE from him, and chooses to remarry. To preserve the DSUE amount inherited from her husband, she transfers $5 million of assets to a limited liability company (LLC). The governing documents of the LLC provide that there are two classes of membership interests, class A and class B. The class A

[174] *See id.*

[175] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

[176] A full discussion of consideration is beyond the scope of this Article. *See generally* Bramwell & Mullen, *supra* note 170.

[177] *See* Treas. Reg. § 25.2512-8.

[178] *See* I.R.C. § 2701.

interests are the only interests that are entitled to receive distributions from the LLC so long as it is in existence. (The distribution right is noncumulative.) The class B members, by contrast, are entitled to all of the net proceeds upon dissolution of the LLC.

The wife then makes a gift in trust for her descendants of the class B membership interests. She retains the class A membership units for herself. Under Code section 2701,[179] the value of the wife's retained distribution rights with respect to the class A shares is ignored for purposes of computing the value of the wife's gift.[180] Consequently, under the subtraction method that is used to determine the value of a gift to which Code section 2701 applies,[181] the value of the wife's taxable gift is equal to the entire value of the LLC or $5 million. The $5 million taxable gift, for the reasons discussed previously, preserves the entire DSUE amount inherited from the first husband. Meanwhile, the wife, through the class A interests, retains the ability to receive distributions from the LLC. As with a GRIT or a virtually revocable trust, the intentionally noncompliant LLC permits the wife artificially to increase the value of her taxable gift while retaining access to the transferred property.

Now suppose that the wife dies at a time when the LLC's net assets are worth $10 million. Suppose, further, that the wife's class A membership interests are the only assets included in her gross estate. Technically, her $5 million taxable gift of the class B interests is an adjusted taxable gift that must be added to the amount with respect to which estate tax is computed. However, Treasury Regulation 25.2701-5(a)(3) provides that the amount of the adjusted taxable gift is reduced by the amount by which the wife's taxable gift was increased under Code section 2701.[182] Consequently, only a fraction of the wife's total applicable exclusion amount is added to the amount with respect to which estate tax is computed.

For example, suppose that the fair market value of the class A interests at the time of the gift (determined under normal valuation principles without application of Code section 2701)[183] was equal to 95% of the entire net value of the LLC. Of the wife's total $5 million taxable gift in the case, $4,750,000 is attributable to a deemed increase in the

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[179] *Id.*

[180] *See id.*

[181] *See id.*; Treas. Reg. § 25.2701-3.

[182] *See id.*; I.R.C. § 2701.

[183] I.R.C. § 2701.

amount of the gift under Code section 2701.[184] As a result, the adjusted taxable gift that is added to the amount with respect to which estate tax is computed is only $250,000. The value of the wife's gross estate is $9.5 million (the value of the class A membership interests at the wife's death), to which is added an adjusted taxable gift of $250,000, for a total amount subject to tax of $9,750,000. The sum of the wife's basic exclusion amount and DSUE amount should be large enough to avoid any estate tax liability.[185]

An advantage of a gift of common interests in a non-2701-compliant entity is that the gift can be made to a trust to which GST exemption can be allocated.[186] By contrast, under the estate tax inclusion period or "ETIP" rule of Code section 2642(f), GST exemption cannot generally be allocated as of the date of the gift to a GRIT or a virtually revocable trust.[187] Moreover, even if GST exemption could be allocated as of the date of inception, the allocation would likely not be efficient.[188] It should be possible, on the other hand, to allocate GST exemption to a gift by promise, if the promise is made in trust.[189] A gift that uses up DSUE amount by triggering Code section 2701[190] rather than Code section 2702,[191] permits a surviving spouse not only to lock in the DSUE amount while retaining access to the transferred property, but also to put his GST exemption to work.

Finally, the surviving spouse's retained interests in a non-2702-compliant preferred partnership will be included in his estate and should qualify for a change in basis in Code section 1014(b)(1).[192] Thus, if an

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[184] *See id.*

[185] The mitigation rule of Treasury Regulation § 25.2701-5(a)(3) applies only to the computation of adjusted taxable gifts. *See* Treas. Reg. § 25.2701-5(a)(3). It does not appear to apply for purposes of computing the amount of DSUE, which should be tied to the amount of the taxable gift, even where Code section 2701 applies. *See* I.R.C. § 2701.

[186] *See* N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT—A Way Around the ETIP Issue?*, 35 ACTEC JOURNAL 289, 289 (2009).

[187] *See* I.R.C. § 2642.

[188] *See generally* Austin Bramwell, *Generation-Skipping Transfer Tax Consequences of GRATs: Finding the Answers*, 5 J. TAX'N, 114, (2011) (explaining how an allocation of GST exemption to a grantor-retained trust is possible but why it is almost always undesirable).

[189] *See* Austin Bramwell, *Donative Promise Can Lock In 2012 Gift Tax Exemption*, 39 EST. PLAN. J. 3, 10 (2012).

[190] I.R.C. § 2701.

[191] *Id.* § 2702.

[192] *See id.* § 1014(b)(1).

election is made under Code section 754 to increase the surviving spouse's share of the inside basis of partnership assets, the partnership can sell assets after the spouse's death and the capital gain realized by the partners will be minimized.[193] Therefore, the strategy potentially permits a triple tax benefit—DSUE lock-in for estate tax purposes, GST exemption allocation, and a step up in basis at death.

X. CONCLUSION

It is hard to resist the cliché that portability is a game changer. Even that term, however, understates the impact of portability on estate planning. Portability does not just force planners to reconsider how they draft for married couples. It has also created a whole new area of planning—DSUE preservation planning—that did not previously exist.

[193] *See id.* § 754.