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By Elaine Hightower Gagliardi*

§ 2.01 Introduction

Spousal portability of the applicable exclusion amount promises estate planning simplicity.[70] No longer will a married couple need to make lifetime transfers of assets to ensure that each spouse holds sufficient assets to fully use the unified credit of each regardless of the order of death.[71] A couple can also avoid the attendant costs of placing property in a credit shelter trust following the first death.[72] Portability achieves these purposes and at the same time aligns with testamentary goals of clients when all the children of the couple are from the marriage, neither spouse anticipates remarriage following the first death, and, on the last death, the couple plans to pass assets outright to children. It, however, does not provide the same ease of planning in a second marriage situation, or in the event of generation skipping transfer tax planning. Nor, as enacted, does it necessarily provide the promised simplicity.

A measure of complexity and uncertainty inherent in the concept as enacted makes portability an unreliable planning tool at best. The vagaries of the quest for a balanced budget prevent any certainty of its availability beyond 2012. While President Obama's budget proposals support making portability permanent,[73] given the track record of Congress, the possibility exists that, at least for some period of time, the amendments made by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Act")[74] will sunset and, even if any extender is made retroactive to January 1, 2013, that budget constraints will prevent permanent enactment of portability. Even were portability to be made permanent, concerns over possible abuse caused Congress to insert a very real element of uncertainty in the ability of the surviving spouse to use the ported applicable exclusion amount. The surviving spouse may only use the unused applicable exclusion amount of the "last" deceased spouse, resulting in the possibility of a loss of the ported amount in the event of remarriage. This "now you see it, now you don't" characteristic of portability makes it a less than optimal planning tool. Nevertheless, planners should carefully consider whether portability can be used to the advantage of clients given stated testamentary desires.

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[70] *Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Reform*, JCX-23-08 at 10 (April 2, 2008) ("[A]llowing for portability between spouses of unused exemption arguably would contribute to simplicity and facilitate compliance with the law, because it largely would eliminate the need for couples to employ the credit shelter trust strategy or to monitor and adjust the titling of assets.")

[71] *Id.*

[72] *Id.*

[73] See Department of Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, at 123, http://www.treasury.gov/resource-center/tax-policy/Documents/FinalGreenbookFeb2012.pdf .

[74] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub L No 111-312, 124 Stat 3296.

§ 2.02 Specifics of the Deceased Spousal Unused Exclusion Amount

Congress enacted the deceased spousal unused exclusion ("DSUE") amount as part of the 2010 Tax Act, and made portability applicable for purposes of both federal estate and gift tax during the years 2011 and 2012, with a sunset provision as of 2013.[75] Notably portability does not extend to the federal generation skipping transfer tax exemption.[76] The applicable exclusion amount beginning in 2011 consists of two elements: (1) the basic exclusion amount, and (2) the DSUE amount.[77] The basic exclusion amount of $5 million adjusts for inflation beginning in 2012, and currently equals $5,120,000.[78] The DSUE amount must be elected on the estate tax return of the predeceased spouse, and cannot exceed the basic exclusion amount available to and unused by the estate of the last deceased spouse.[79] Thus, the estate of a surviving spouse dying in 2012 will at most benefit from an applicable exclusion amount of $10,240,000, assuming the last deceased spouse also died in 2012. An apparent error in enactment of the limitation on the DSUE amount, however, further imbues its application with uncertainty.

A plain reading of the statute setting forth the DSUE amount indicates a mistake in the statute as enacted. The statute limits the DSUE amount to the lesser of (1) the basic exclusion amount or (2) the unused basic exclusion amount of the last deceased spouse. The first limit has no applicability.[80] In all events only the second limitation applies. Why include an inapplicable limit? The Joint Committee on Taxation acknowledges this error in an errata indicating: "A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent."[81] If enacted as had been anticipated, the first limitation would have had meaning and effect as the second limitation in a second marriage situation could have exceeded the basic exclusion amount.

This error in enactment causes further uncertainty in application of the DSUE amount because it raises a question as to whether a later gift by the surviving spouse uses up the basic applicable exclusion amount of the surviving spouse or the DSUE amount, as demonstrated by the following example.

Example:

Frank dies December 31, 2011, survived by his spouse Ellen, and Frank's executor makes the DSUE election by filing an estate tax return. Neither Frank nor Ellen made any taxable gifts prior to Frank's death. Frank's taxable estate totals $3 million, leaving a DSUE amount for Ellen's use of $2 million. Ellen, thus, has an applicable exclusion amount as of January 1,

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[75] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 §§ 302 - 304, Pub. L. No. 111-312, 124 Stat. 3296 *codified at* IRC §§ 2010(c)(4), (5);
[76] *Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate*, JCX-55-10 at 52, fn 56 (Dec 10, 2010).
[77] IRC § 2010(c)(2).
[78] IRC § 2010(c)(3)(B); Rev Proc 2011-52, 2011-45 IRB 701.
[79] IRC §§ 2010(c)(4); 2010(c)(5)(A).
[80] *Id*.
[81] *Errata "General Explanation of Tax Legislation Enacted in the 111th Congress,"* JCS-2-11 (March 2011).

2012 of $7,120,000 consisting of the aggregate of her 2012 basic exclusion amount of $5,120,000 and the DSUE amount from Frank's estate of $2,000,000. Ellen makes a taxable gift in 2012 of $3 million. Thereafter, she marries Sam, and dies on December 31, 2012 with a taxable estate of $1 million. As enacted, the statute raises the question whether following Ellen's death, the gift used up Ellen's basic exclusion or used up the DSUE amount she received on Frank's death. If it used up the DSUE amount from Frank's death, then the DSUE amount passing to Sam on Ellen's death will equal $4,120,000 because her basic exclusion amount essentially remains intact. If instead the gift used up Ellen's basic exclusion amount, then the DSUE amount passing to Sam on Ellen's death will equal $1,120,000. The statute does not provide an answer. If instead the statute had been enacted as intended, Sam's DSUE amount received from Ellen would equal $4,120,000 regardless.[82]

Noting this uncertainty, the American College of Trust and Estate Counsel in its comments filed with the Internal Revenue Service and dated October 28, 2011, urges Treasury to adopt regulations interpreting the statute as if it had been enacted as intended, and without the error. As of the writing of this article, Treasury has not issued regulations or other guidance addressing calculation of the DSUE amount.

Additional uncertainty in the specter of a clawback of estate tax exists. A second marriage may cause a claw back of gift tax in the event the second spouse predeceases leaving a smaller DSUE amount than was left on the death of the first spouse. The following example demonstrates the possibility of a claw back absent further guidance to the contrary by Treasury.

<u>Example:</u>

Peter dies on December 1, 2011, survived by his spouse Maria. His will passes his entire estate to Maria, and his estate files an estate tax return leaving a DSUE amount of $5 million available for Maria's use. Following Peter's death, Maria makes an outright taxable gift in the amount of $10,120,000 on January 5, 2012 that is fully sheltered by her available gift tax applicable exclusion amount of $10,120,000 consisting of her basic exclusion amount of $5,120,000 and the DSUE amount of $5,000,000 from Peter's estate.

Following Peter's death, Maria marries Stefan, who dies June 30, 2012, survived by Maria. Stefan's will passes his entire estate to his children. His executor files an estate tax return fully using Stefan's applicable exclusion amount. Maria dies shortly thereafter on December 31, 2012. As of her death, Maria's estate is limited to the DSUE amount of the last deceased spouse, or in other words, the DSUE amount, if any, from Stefan's estate tax return, in this case zero. Thus, applicable exclusion available to shelter assets on Maria's death equals the aggregate of Maria's basic exclusion amount of $5,120,000 and the DSUE amount from Stefan's estate of zero.

The calculation of federal estate tax on Maria's death will include as an adjusted taxable gift the $10,120,000 previously transferred by Maria and fully sheltered by her applicable exclusion amount at the time of the gift. As of her death, however, an applicable exclusion

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[82] See *General Explanation of Tax Legislation Enacted in the 111th Congress,"* JCS-2-11 at 555, example 3 (March 2011).

amount of only $5,120,000 will be available, and, as a consequence, absent further guidance to the contrary by Treasury, Maria's estate will owe estate tax on $5 million of assets previously transferred and at the time of the gift protected by the DSUE amount from Peter's estate that evaporated upon Stefan's death.

It was hoped that the 2011 federal estate tax return would interpret the statute so as to avoid this potential for a claw back of estate tax when a second marriage causes a reduction in applicable exclusion amount available at death, from that available during life. The 2011 federal estate tax return as issued unfortunately does not speak to the possibility of claw back.

§ 2.03 Mechanics of Electing the DSUE Amount

The availability of a DSUE amount hinges on a timely DSUE election by the estate of the last deceased spouse.[83] The statute specifically requires the DSUE election be made on a timely filed estate tax return of the predeceased spouse.[84] This requirement applies even where a return would otherwise not be required because the decedent's assets did not exceed the filing threshold. The election becomes irrevocable once made.[85]

Guidance clarifies DSUE election requirements. Notice 2011-82[86] makes explicit the following requirements for making the DSUE election:

- Estates of decedents dying prior to 2011 may not make the DSUE election.
- The estate of the predeceased spouse must file a "complete and properly prepared" estate tax return.
- The estate of the predeceased spouse must "timely" file the estate tax return, including extensions.
- Failure to timely file an estate tax return where one is not otherwise required to do so prevents the estate from making the DSUE election.
- Filing of a timely filed estate tax return automatically results in the making of the DSUE election, unless the return specifically indicates otherwise.
- Until otherwise required on the Form 706, the return need not compute the DSUE amount as required by statute.[87]

Treasury explains that it opted to make the election as simple as possible on the assumption that "married couples will want to ensure that the unused basic exclusion amount of the first spouse to die will be available to the surviving spouse and, thus, that the estates of most (if not all) married decedents dying after December 31, 2010, will want to make the portability election."[88] Despite its asserted simplicity, the requirements of the DSUE election cause an otherwise non-taxable estate to incur the additional cost of filing a "complete and properly prepared" Form 706 in order to preserve

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[83] IRC § 2010(c)(6).
[84] *Id.*
[85] *Id.*
[86] Notice 2011-82, 2011-2 CB 516.
[87] See IRC § 2010(c)(5)(A) (Notice 2011-82 temporarily waives the statutory requirement that the return of the predeceased spouse compute the DSUE amount.)
[88] Notice 2011-82, 2011-2 CB 516.

the DSUE election. Whether executors of non-taxable estates will in fact choose to incur this expense remains to be seen.

In apparent concern that estates of decedent's who died in the first half of 2011, prior to issuance of Notice 2011-82, did not have sufficient notice of the return filing requirement, Treasury announced in Notice 2012-21[89] that the estate of a decedent, who died prior to July 1, 2011, survived by a spouse and with a gross estate not exceeding $5 million, may timely request a six month extension to file the return no later than 15 months following the date of decedent's death. In other words, the qualifying decedent's estate may both request a six month extension to file and actually file the estate tax return on the date 15 months after the date of decedent's death and still meet the timely filing requirement of the DSUE election.[90]

Whether or not to make the DSUE election depends on the circumstances of the predeceased spouse's estate. If the estate chooses to make the election, the statute of limitations remains open for purposes of determining the correct DSUE amount.[91] Thus, on the later death of the surviving spouse, the Service may review the return of the predeceased spouse for purposes of confirming accurate calculation of the DSUE amount. An estate of a predeceased spouse may determine that it would prefer to avoid such reexamination, especially if the predeceased spouse made annual exclusion or other taxable gifts that could raise valuation issues, and the estate plan of the predeceased spouse uses a marital-credit shelter trust plan resulting in a zero estate tax on the first death. Should the executor of an estate required to file an estate tax return choose not to make the DSUE election, the executor must affirmatively elect not to make the DSUE election.[92] The executor may elect out by writing across the top of the first page of the return "No election under Section 2010(c)(5)."[93] Alternatively the executor may opt out of the election by attaching a statement so indicating to the estate tax return.[94] For estates of decedents not otherwise required to file a return, the executor should simply not file a return if the choice is made not to make the DSUE election.[95]

§ 2.04 Mechanics of Using the Election

The instructions to the 2011 federal estate tax return and to the 2011 federal gift tax return provide guidance on how to claim use of the DSUE amount by the surviving spouse. The DSUE amount translates to an increase in unified credit to offset the estate or gift tax owed by the surviving spouse. Thus, the unified credit claimed on the estate or gift tax return will reflect a credit attributable to the DSUE amount.

In order to claim a DSUE amount elected by the estate of the predeceased spouse on the estate tax return of the surviving spouse, the instructions to the federal estate tax return direct the executor indicate on the line specifying marital status of the surviving spouse the fact that the

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[89] Notice 2012-21, 2012-10 IRB 450.
[90] *Id*.
[91] IRC § 2010(c)(6).
[92] See Notice 2011-82, 2011-2 CB 516.
[93] Instructions for Form 706 at 1 (rev'd Aug. 2011).
[94] *Id*.
[95] See Notice 2011-82, 2011-2 CB 516.

decedent's predecease spouse made a DSUE election.[96] Instructions to the gift and estate tax returns also require attachment of the predeceased spouse's federal estate tax return.[97] In addition, instructions require the surviving spouse's gift and/or estate tax return provide a calculation of the DSUE amount based on the return of the predeceased spouse.

§ 2.05 Planning with Portability

After 2010, planners should consider implications of both the increased applicable exclusion amount and portability on estate planning choices. The combination of portability and a significantly increased applicable exclusion amount of $5 million, as indexed for inflation, makes transfer tax implications of little or no significance for most couples. Arguably, only those couples with aggregate assets nearing or exceeding the amount of the applicable exclusion need pay special attention to the impact of portability and wealth transfer taxes. The choice to include tax planning provisions as part of the estate plan depends on what clients see when they look into the proverbial crystal ball. Clients with assets significantly less than the current $5 million applicable exclusion amount may nevertheless choose to include tax planning provisions if they foresee a return in 2013 to the $1 million applicable exclusion amount, or even the $3.5 million threshold.

A tangential, but important consequence, of the combination of portability and the increase in applicable exclusion amount, is the impact on the estate planner's decision to represent both spouses in the creation and implementation of the estate plan. These changes may make it more difficult for the estate planner to represent both spouses. For many couples, the increased applicable exclusion amount and portability eliminates the need for trusts, and as a result opens the possibility of an outright gift to the surviving spouse on the first death. This in turn creates the possibility of a conflict as between the testamentary desires of each spouse especially where one spouse wishes to exert control from the grave. Whereas, absent portability and during a time of lower applicable exclusion amount, the joint desire to avoid taxes often led to the choice of a credit shelter trust and, thus, minimized the potential for conflict when one spouse wanted to exert more control. Planners should evaluate the possibility of conflicts in light of this new planning landscape before making the decision to proceed with a joint representation of spouses.

Design of the estate plan for a married couple depends on numerous factors. Factors key to the structure of the estate plan include the non-tax testamentary desires of the client, the aggregate wealth of the couple, relative wealth of each spouse, the relative income tax basis of the assets, the existence of a second marriage with children from a prior marriage, the likelihood of a second marriage following the first death, and the willingness of a client to incur ongoing costs of a trust as part of the overall plan. These factors play into the decision to recommend lifetime transfers, an outright gift to the surviving spouse, or use of a trust including a disclaimer trust, a credit shelter trust or a qualified terminable interest property (QTIP) trust for the benefit of the surviving spouse. In addition, these factors play into the decision to intentionally maximize use of each spouse's generation skipping transfer tax exemption.

With the advent of portability, income tax consequences become a critical factor in the choice of estate plan. Assuming an economy where more often than not assets appreciate in value,

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[96] Instructions for Form 706 at 13 (rev'd Aug 2011).
[97] Instructions for Form 706 at 13 (rev'd Aug 2011); 2011 Instructions for Form 709 at 15.

the choice between an outright gift to the surviving spouse or a gift in the form a QTIP trust and the use of the classic credit shelter trust depends on the income tax cost relative to the estate tax cost inherent in the planning choice. The following example demonstrates this trade-off.

Example:

Paul and Susan each own a $5.12 million apartment building in a prime location. Assume no gifts. Both buildings have been fully depreciated, and the clients believe that both buildings should continue to appreciate at a rate that outpaces inflation.

If in 2012 Paul predeceases and his estate plan transfers the apartment building to a credit shelter trust, the building will receive a basis step up on Paul's death to $5.12 million, no estate tax will be owed on his death if that is his only asset, appreciation in the apartment building will escape taxation on Susan's later death, but the building will not receive an additional step up in basis on Susan's death.

If instead, Paul's estate plan makes an outright gift to Susan and makes the DSUE election, the building gets a step up in basis at Paul's death and an additional step-up in basis at Susan's death. The DSUE election protects from estate tax $5.12 million in assets held by Susan at her death, but any appreciation following Paul's death will be subject to estate taxation assuming Susan dies with sufficient assets to fully use her basic exclusion amount.

Thus, the tax trade-off between the two plans is the difference between the income tax payable on the appreciation between deaths if the plan uses a credit shelter trust and the estate tax payable on the appreciation between deaths if the plan uses an outright marital bequest. If Paul, however, wishes to maximize use of his generation skipping transfer tax exemption, the credit shelter trust would trump the use of an outright gift if as discussed below a QTIP trust in fact is not an option because Paul's assets do not exceed the applicable exclusion amount available at his death.

Paul also needs to take into account the fact that an outright transfer to Susan allows her total control over the passage of his apartment building on her later death. Whether or not Paul could assert control by passing the apartment building to a QTIP trust (instead of making an outright gift) remains unclear where as here Paul's assets do not exceed the applicable exclusion amount, and thus do not trigger the need for a QTIP election, especially in light of Revenue Procedure 2001-38[98] allowing the taxpayer to apply for a ruling voiding the QTIP election where it was not necessary to avoid payment of estate tax. Until such time as this question is resolved, Paul should consider passing property to a QTIP trust. The QTIP trust, if allowed, would provide Paul control over the ultimate beneficiaries of the trust,[99] allow allocation of Paul's GST exemption through use of a reverse QTIP election,[100] and achieve a step up in basis on assets held in the trust on Susan's death.[101] If not allowed, the QTIP trust

[98] Rev Proc 2001-38, 2001-24 IRB 1335.
[99] IRC § 2056(b)(7).
[100] IRC § 2652(a)(3).
[101] IRC § 1014(b)(10).

would be treated in the same manner as a credit shelter trust, and Paul would still achieve control and the ability to ensure use of his GST exemption to the extent of his assets.

Where the married couple's assets do not exceed in the aggregate the applicable exclusion amount and it is unlikely that the assets will ever do so, tax planning will not contribute to the choice of estate plan. It is unlikely that a DSUE election would prove economically effective in this circumstance. However, where the assets of the married couple in the aggregate conceivably may at some point exceed the applicable exclusion amount, on the death of the first spouse consideration should be given to making the DSUE election. The decision to use a trust in this instance depends on the client's testamentary desires to control ultimate disposition of property on the death of the surviving spouse, and the client's willingness to incur ongoing costs of trust administration. Based on the example above, an outright gift to spouse in conjunction with the DSUE election would yield appropriate estate and income tax planning consequences assuming the DSUE amount remained available for use at the surviving spouse's death.

In the event that a couple's aggregate assets exceed the applicable exclusion amount, careful consideration should be given to the tax implications of the estate plan. Portability alleviates the necessity of making lifetime transfers to ensure full use of both spouse's applicable exclusion amounts regardless of order of death if the estate of the first spouse to die makes the DSUE election. To provide maximum flexibility in light of the uncertainty inherent in the DSUE election and in the ultimate applicable exclusion amount after 2013, consideration should be given to use of a disclaimer trust where the disclaimer trust is structured so as to allow the QTIP election if in fact one is allowed so that in conjunction with portability a step up in basis occurs at the surviving spouse's death for the assets held in trust. A disclaimer trust allows flexibility of waiting to make estate planning decisions until the first death. If the couple wishes to control ultimate disposition of assets on the death of the survivor in all events, the couple should instead consider use of a QTIP trust, or if appropriate in light of testamentary desires, use of a credit shelter-QTIP trust plan.

When a couple's assets exceed twice the applicable exclusion amount, the wealthy spouse can maximize tax benefits, control, and flexibility by using a QTIP trust in combination with a DSUE election. Portability allows the wealthy spouse to avoid any life time transfer to the less wealthy spouse in order to ensure full use of both spouse's applicable exclusion amounts. The estate of the less wealthy spouse would simply need to make a DSUE election. If the couple is uncertain about the ultimate availability of the DSUE amount, the couple may wish to make lifetime transfers sufficient to allow full use of the applicable exclusion of the less wealthy spouse without the need to rely on portability. Use of a lifetime QTIP trust to transfer assets from the wealthy to the less wealthy spouse or to the spouse expected to predecease can maximize estate planning and income tax benefits in conjunction with portability, especially if on the death of the recipient spouse the QTIP remainder assets pass through judicious exercise of special powers to the surviving spouse in the form of a defective grantor trust.[102] Alternatively QTIP trusts can be used in conjunction with portability at the first death to maximize tax benefits and control on the first death. If appropriate, a reverse QTIP election also can be made to fully allocate generation skipping transfer tax exemption.

[102] See PLRs 200944002; 200603040 (these private letter rulings rely on techniques approved in Rev Proc 2008-22, 2008-1 CB 658, and Rev Rul 2004-64, 2004-2 CB 7).

The discussion of planning alternatives makes evident the importance of a QTIP trust to achieving maximum flexibility to control ultimate disposition of assets and to make tax decisions using portability. The very wealthy can clearly use the QTIP trust to achieve the best of all possible worlds. It remains uncertain if couples whose assets do not exceed the applicable exclusion amount can take equal advantage of the benefits of a QTIP trust. In light of the continued uncertainty as to the ultimate applicable exclusion amount, tax rates, and the availability of the DSUE amount, it would be appropriate for Treasury, or if deemed necessary Congress, to consider clarifying that client's may make the QTIP election for purposes of portability planning regardless of whether the client dies with a taxable estate. Such a clarification would level the playing field for all taxpayers.