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Portability – The Game Changer

The Estate and Gift Tax Committee of the Income and Transfer Tax Planning Group of the Real Property Trust & Estate Law Section of the American Bar Association prepared this paper on estate planning with portability as enacted in the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010. The members of the Income and Transfer Tax Planning Group responsible for this paper are: Richard S. Franklin (Co-Chair, Estate & Gift Tax Committee, Washington, DC, rfranklin@mcarthurlaw.com), Lester B. Law (Co-Chair, Estate & Gift Committee, Naples, FL, lester.law@ustrust.com); and George D. Karibjanian, (Chair of the Portability Subcommittee of the Estate & Gift Taxes Committee of the ABA Tax Section, Boca Raton, FL, gkaribjanian@proskauer.com). If you have any questions or comments on this paper, please send them to any of the authors.

This white paper is a follow-up to the white paper titled *Portability – Part One*, which was written by the authors of this paper and other members of the Estate and Gift Tax Committee in January 2011.

This paper has many hyperlinks (colored in blue) to other materials. An electronic version of this paper, with working hyperlinks, will be posted on the Estate and Gift Tax Committee's webpage.

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Portability

The Game Changer

This paper addresses why portability will change how we think about estate planning for our clients – it is a "game changer", if you will. *Portability - Part One* covered the background of portability (including its history and enactment), reasons to learn about portability, a critical analysis of the law, an analysis of the examples provided by the Joint Committee on Taxation, a summary of the comments provided to the Treasury pursuant to Notice 2011-82, suggestions for regulatory and statutory changes, and some suggested changes to other related rules. In June 2012, Treasury issued the new temporary and proposed regulations, *Portability – The Regulations* summarizes and analyzes the new regulations, which changed the law and made portability even more taxpayer friendly.

I. Introduction

Even before its permanency, we believed that portability was going to be a "game changer" in how to approach estate planning for many of our clients. This is contrary to the perception of some that portability is a "back stop" or primarily useful as a "post mortem" planning tool - akin to using disclaimers in planning. In this paper, we explain how portability can be creatively used as a primary (and not secondary) tool in estate planning.

Importantly, whether each spouse should use his or her applicable exclusion amount by gift while both are living is not the focus of this paper. The fact is that frequently upon the first spouse's death, that spouse will have exclusion available. Even among the uber wealthy, for one reason or another, many do not all use their applicable exclusion amounts by gift. The focus of this paper is on whether the traditional approach of using that remaining exclusion in a by-pass trust is more advantageous than portability planning.

A. Terms Used

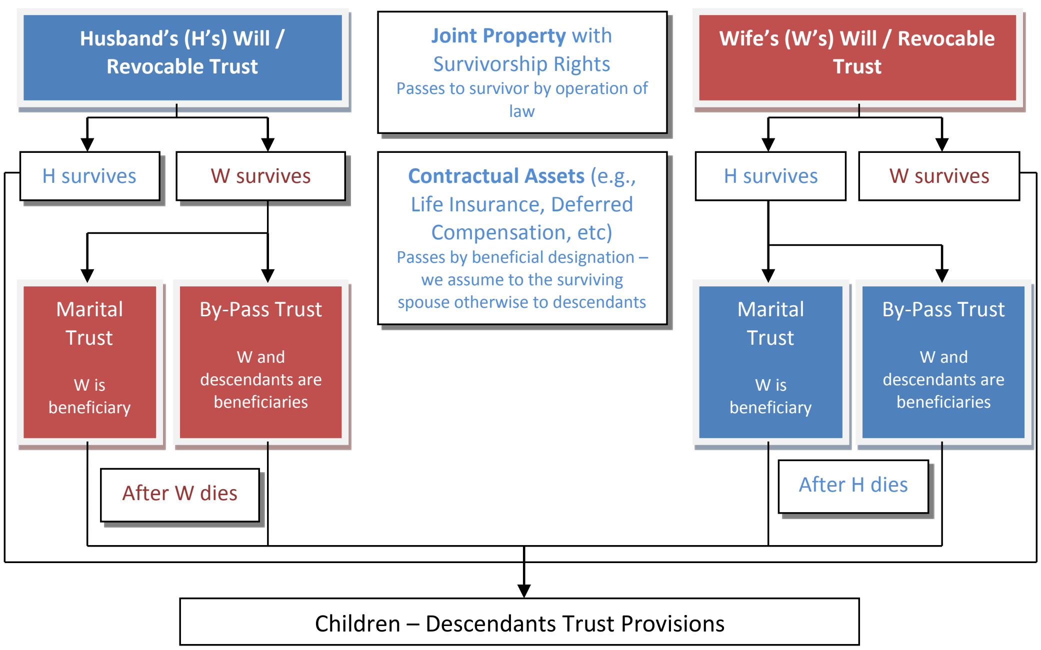
We use a number of defined terms in this paper (which we also used in *Portability - Part One* and *Portability – The Regulations*). Our only departure from one of the previously defined terms in *Portability - Part One* is that we will not use the term "inherited exclusion amount", rather we now use the "DSUE amount" (i.e., the term now used by the in the regulations, on the Form 706 and the instructions to the tax return). The following terms are used throughout this paper and defined at Appendix I:

- Applicable Credit Amount
- Applicable Exclusion Amount
- Basic Exclusion Amount
- By-Pass Trust
- Deceased Spouse
- Deceased Spousal Unused Exclusion Amount ("DSUE amount")
- Gift Tax Credit
- Last Deceased Spouse
- Internal Revenue Code
- Regulations
- "section"

B. Traditional Planning – By-Pass Trust Planning

Traditional planning generally would encompass a by-pass trust and a marital trust (or trusts, if GST planning is desired) as depicted in Illustration #1.

Illustration #1: Traditional Plan (By-Pass Trust and Marital Trust(s))



Under the traditional plan in Illustration #1, the by-pass trust is designed to be funded with an amount equal to the deceased spouse's remaining applicable credit amount and avoid estate tax in the surviving spouse's estate. The marital trust receives the balance of the deceased spouse's estate and is subject to estate tax upon the surviving spouse's death. The by-pass trust will not receive an adjusted basis upon the surviving spouse's death. The marital trust's assets, by virtue of being included in the surviving spouse's estate, would receive a basis adjustment to the fair market value at the time of the surviving spouse's death. The deceased spouse's GST exemption is typically allocated first to the by-pass trust to reach a zero inclusion ratio, with any remaining GST exemption allocated to the marital trust. If there is insufficient GST exemption for the marital trust to have a zero inclusion ratio, then the marital trust is typically split into exempt and nonexempt parts.

C. Benefits of Traditional By-Pass Trust Planning

A commonly held view is that a by-pass trust continues to have advantages over planning to use portability. The reasons most frequently cited to justify continuing to use a by-pass trust plan, include to provide:

(i) asset management;
(ii) asset protection via spendthrift trust protection;
(iii) disposition control by the decedent spouse (i.e., preventing the surviving spouse from diverting the assets); and
(iv) use of the deceased spouse's GST exemption (because there is no GST exemption portability).

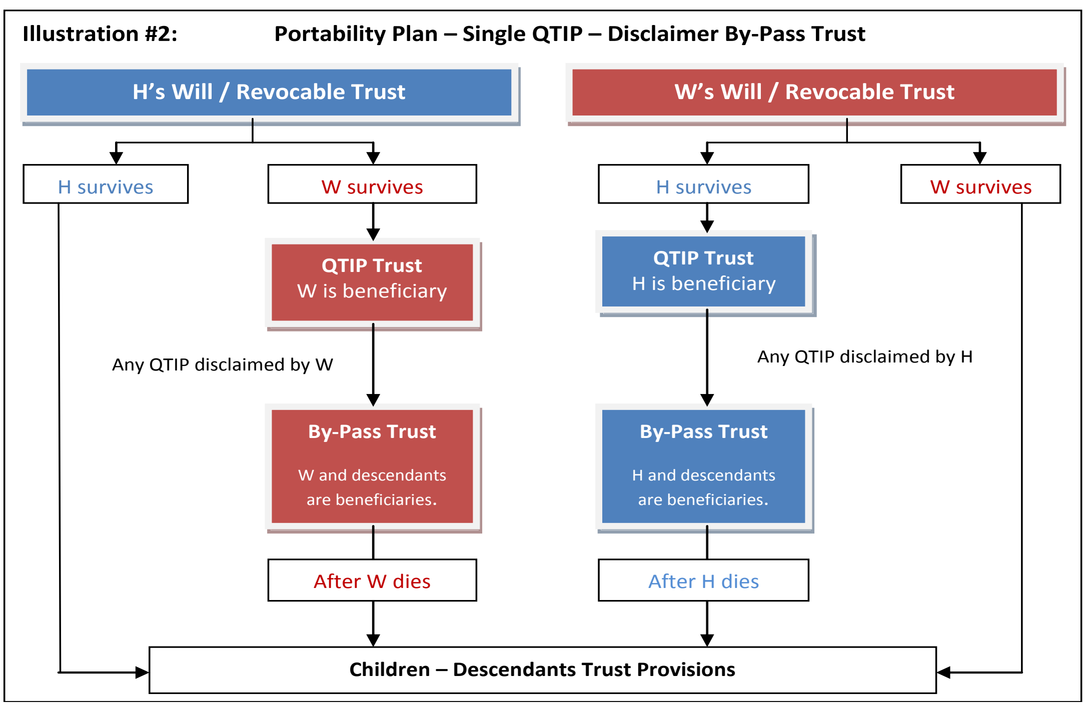
In this paper, we will refer to these concerns as the "1st tier concerns."

A number of strategic considerations influence the analysis of whether to continue using a traditional by-pass trust. The main concern in this category is the desire to protect any accretions in value in assets protected by the deceased spouse's applicable exclusion amount from estate tax upon the surviving spouse's death (the "estate tax advantage of by-pass trusts"), while simultaneously addressing the 1st tier concerns.

This paper will primarily focus on the 1st tier concerns and the estate tax advantage of by-pass trusts, which are at the core of the debate relating to portability's relative usefulness. A future paper will address other strategic reasons that may or may not be important in any given situation, such as the desire to protect the surviving spouse from losing the DSUE amount by remarriage, concerns with second marriages and blended families, and limiting disclosure of the deceased spouse's estate tax return to the surviving spouse (i.e., a desire for privacy).[1]

D. QTIP Trusts Can Address 1st Tier Concerns

Suppose that upon the deceased spouse's death, all of the deceased spouse's assets that would otherwise pass to a by-pass trust instead pass to a QTIP trust and the personal representative makes the QTIP election, the reverse QTIP election and portability election.[2] The QTIP Trust can provide for asset management and be a spendthrift trust that provides asset protection from the claims of creditors both as to the surviving spouse and subsequent beneficiaries. With the reverse QTIP election, the QTIP trust can virtually port the GST exemption. And, of course, the deceased spouse can control the disposition of the assets upon the surviving spouse's death. Therefore, using a QTIP trust is one alternative for addressing the 1st tier concerns while planning to use portability. Such a QTIP trust plan is shown in Illustration #2.



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[1] As to limiting disclosure, under the new regulations, making the portability election means the surviving spouse has a right to obtain the estate tax information for the deceased spouse pursuant to Code § 6103(e). Some clients are obsessed with privacy. Presumably if the portability election is not made the spouse would not automatically have this right. This is a very niche reason to consider in deciding whether to make the portability election.

[2] As a caveat, see Rev. Proc. 2001-38, which is discussed below.

Under this portability plan, there are many planning options available upon the deceased spouse's death. First, the deceased spouse's personal representative could make the full QTIP election. Second, the personal representative could make a partial QTIP election. Third, the surviving spouse could disclaim assets into the disclaimer by-pass trust. Fourth, any combination of the prior three could be done. One reason for using any of the alternatives might be to utilize the deceased spouse's state death tax exemption.

One of the benefits of a QTIP plan is that it allows a basis adjustment at the time of the survivor's death for assets passing to the QTIP Trust to which a QTIP election is made.[3]

E. Comparing Benefits of Traditional and Portability Planning

Portability has the potential of offering both income and transfer tax advantages over traditional by-pass trust planning. These advantages are explained below, as well as how your clients can construct plans that avail themselves of these advantages while simultaneously addressing the 1st tier concerns.

One of the benefits of traditional by-pass trust plans is that assets funded into the by-pass trust avoid (or by-pass) any future estate tax. In light of the increased basic exclusion amount to $5.25 million (in 2013) for an individual and $10.5 million for a couple, the estate tax advantage of by-pass trusts is of less concern for "smaller" estates (i.e., those that will not trigger the federal estate tax).

Quite often portability planning is thought of as "simple planning," often equated with "I love you" Wills or holding assets jointly with rights of survivorship. That type of planning is too simplistic and not the best approach for many clients. Portability planning could be as sophisticated as traditional planning was before the advent of portability. Illustration #2 demonstrates that a portability-driven plan could resemble a traditional plan (i.e., it is structured with continuing trusts after the deceased spouse's death), and it could address the 1st tier concerns associated with traditional planning. [4]

F. Common Flaw in Comparing Portability with Traditional Planning

It is a fallacy to compare portability planning as inferior to traditional by-pass planning. The comparison is usually based on a few inaccurate premises: (i) that portability-driven plans are simple plans; (ii) that the surviving spouse will not use the DSUE amount until the surviving spouse's death;[5] (iii) the scant consideration given to the income tax benefits of a portability driven plan.[6]

One of the most often presented analyses compares the estate tax advantage of a traditional by-pass trust to a simple portability plan where assets pass outright to the surviving spouse. In that analysis, the benefit of an increased income tax basis that occurs in the portability plan is compared with the estate tax savings of using a by-pass trust (where the appreciation on asset values escapes estate tax). On balance, the traditional plan wins, especially if there was a significant increase in value. As discussed above, that analysis uses the flawed assumption that the surviving spouse will use his or her DSUE

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[3] A basis adjustment results because the assets are included in the surviving spouse's estate. If the asset values are greater than the assets basis before death, there is a step-up, if they are less, there is a step-down. We generally think of a "basis step-up" at death, but a step-down is possible too. For this paper, we will generally assume that the asset values are increasing, thus we will often refer to the basis adjustment as a step-up, unless the context states otherwise.

[4] The legal and administrative costs of a traditional by-pass trust might be considered expensive in comparison to a simple portability planning, such as holding all assets in tenancy by the entirety. However, the portability planning suggested below is not simple planning. It will be at least as complex as traditional planning, and perhaps more complex. Thus, the costs of planning with portability would likely be roughly the same as traditional planning.

[5] It is clear under the Portability Regulations that the surviving spouse could use the DSUE amount immediately after the deceased spouse's death.

[6] As discussed in more detail below, a portability driven plan can be structured so that the surviving spouse could use the DSUE amount immediately after death to create an irrevocable grantor trust, and thus have those asset grow income-tax free to the beneficiaries.

amount at death. If instead, the surviving spouse uses the DSUE amount immediately after death of the deceased spouse, then the traditional by-pass plan offers no estate tax advantage because the assets transferred by the surviving spouse avoid estate tax inclusion in the same manner as the assets in the traditional by-pass trust. Thus, the real disadvantage is that the traditional by-pass is not entitled to receive the step-up in basis.

As can be seen, one must be careful when comparing the analysis of by-pass trusts to simple portability plans. We suggest that one should do a better "apples-to-apples" comparison.

G. Gift Tax Planning with Portability

As you review the ideas below, keep in mind two provisions of the Regulations that favorably affect the use of the DSUE amount through gifts. First, a new ordering rule addresses the use of the DSUE amount when the surviving spouse makes a gift. Treas. Reg. § 20.2505-2T(b) provides that when a surviving spouse makes a taxable gift, such spouse first uses the DSUE amount of the person who was the "last deceased spouse" at the time of the gift, before the surviving spouse is required to use his or her own basic exclusion amount. Second, the Regulations now eliminate the concern about recapture.[7] Absent the Regulations, if the surviving spouse remarried, it would be possible that the surviving spouse's DSUE amount from such surviving spouse's first deceased spouse could disappear if the new spouse died before the surviving spouse. The Regulations eliminate this possibility by providing that if the surviving spouse had multiple spouses and made taxable gifts relying on a predeceased spouse's DSUE amount, the surviving spouse always gets credit to use that DSUE amount. This is the case even if the DSUE amount is from a person who would not qualify as the "last deceased spouse" at the time of the surviving spouse's death.[8] Essentially, the surviving spouse's applicable exclusion amount upon death includes both (i) the DSUE amount of the "last deceased spouse", and (ii) if the surviving spouse made taxable gifts, an amount equal to the applied DSUE amount from a prior spouse who was at the time of such taxable gift the "last deceased spouse."

H. Crunching the Numbers

When posed with the question as to what is the primary advantage of the traditional by-pass trust, the easy answer is the "transfer tax free appreciation." With the advent of portability, it may be possible, in certain situations, that by analyzing all taxes – income and transfer – the net property passing to beneficiaries may actually be greater by "by-passing" the traditional by-pass trust.

The best way to illustrate this concept is to provide certain examples that "crunch the numbers." For each of the examples, the following assumptions are made:

Principal growth	5%
Ordinary Income rate of return	1.5%
Dividend rate	1.5%
Ordinary Income Tax Rate for Surviving Spouse	35%
Ordinary income tax rate for continuing trust	39.6%
Ordinary income tax rate for children	31%
Qualified dividend / capital gain rate for surviving spouse	20%
Qualified dividend / capital gain rate for trust	20%
Qualified dividend / capital gain rate for children	15%

[7] This is discussed in detail in *Portability – The Regulations*.

[8] Temp. Treas. Reg. § 20.2505-2T(c) (with respect to gift taxes), and Temp. Treas. Reg. § 20.2010-3T(b) (with respect to estate taxes).

> Example 1: H and W are U.S. citizens and have only been married to each other. H owns $5 million and W owns $5 million. H dies in 2011. W dies 10 years later (in 2021). Assume that the tax laws remain the same for the next ten years. Also assume that the basic exclusion amount grows by 2.5% per year (the approximate COLA adjustment). H and W live in a state with no state estate tax and no state income tax. W will use $300,000 for her lifestyle (which will grow at a COLA rate of 2.5% per year). W's tax basis in her assets is 80% of the value of her assets at the time of H's death. Assume that the assets have a 20% turnover rate (to maintain the asset allocation) and upon W's death the children receive all of the assets and subsequently convert such assets into cash (i.e., triggering any income tax at that time).

If H and W have a traditional estate plan, under which H's $5 million passes to a by-pass trust that provides W with a mandatory income interest, then, upon W's death, the assets remaining for the children would be approximately $13,570,000. Alternatively, assume that H leaves his estate in a QTIP trust (and a QTIP election[9] and reverse QTIP election are made), which requires (as it must) that W receive the annual net income. At W's death, the children would receive approximately $13,030,000 from the QTIP plan. The traditional plan yields a better result by approximately $540,000. This expected result is because the simple QTIP plan will suffer estate taxes in excess of the increased income tax associated with the traditional family trust.

As shown below, however, the tax advantage falls in favor of portability-driven plans in many situations, including this one if additional planning steps are taken.

> Example 2: Assume the same facts as in Example 1, except that H and W only have $2.5 million each (i.e., an aggregate of $5 million). In this case, the net assets passing to the children would be as follows:
> Portability Plan – approx. $4,680,000
> Traditional Plan – approx. $4,540,000

In this case, the portability plan is better by $140,000. The reasons for this are two-fold. First, in this situation, the surviving spouse's gross estate is less than the surviving spouse's applicable exclusion amount; [10] thus, there will be no estate tax. In Example 1, there is an estate tax. Second, upon the surviving spouse's death, the basis of the assets in the QTIP trust receive a basis adjustment. By comparison, the basis of the assets in the traditional family trust is not adjusted. Thus, the income tax differential favors the portability plan; therefore, in cases where there will be no estate tax, the portability yields the better result.

> Example 3: Assume the same facts as Example 1, except that H and W have $3.75 million each (i.e., an aggregate of $7.5 million). In this case, the net assets passing to the children would be as follows:
>
> Portability Plan – approx. $9,260,000
> Traditional Plan – approx. $9,050,000.

In this case, the portability plan is better by approximately $210,000. The reasons for the result are the same reasons in Example 2; however, the benefit is amplified because the dollars are larger.

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[9] A caveat to this election is the potential resistance by the Service pursuant to Rev. Proc. 2001-38, discussed in Article VII below.

[10] Recall that the surviving spouse's applicable exclusion amount would be such spouse's basic exclusion amount (as it would have appreciated over time for the COLA adjustment) and the deceased spouse's DSUEA of $5 million).

Example 4: Assume the same facts as Example 1, except that after H's death the traditional plan has a by-pass trust that pays all income to the children. Further assume that under the portability plan, H's assets pass into a QTIP trust for W's benefit and concurrently W makes a gift equal in value to the DSUE amount she received from H (i.e., $5 million) and places it into an irrevocable grantor trust for the children. Assume the W is confident that the remaining $5 million in the QTIP Trust is sufficient for her needs.

Under either plan, the children will receive the income from a trust funded with $5 million in assets. As discussed in Article V below, the alternative portability plan allows H's exclusion amount to be used in a grantor trust (as to W), which creates the opportunity for savings beyond that available in a by-pass trust. In this case, net assets passing to the children are as follows:

Traditional Plan – approx. $13,715,000
Portability Plan – approx. - $13,850,000

The portability plan is better by roughly $135,000. In this case, the reason for the success is that the assets of the irrevocable grantor trust are not subject to estate tax (because it was a gift that used H's DSUE amount soon after H's death, so it grows estate tax free in the same manner as a by-pass trust). Under the traditional plan, assets in the by-pass trust do not receive a basis adjustment upon W's death. Under the portability-driven plan, W can virtually step-up the basis of the assets inside the irrevocable grantor trust by swapping cash or higher basis assets for appreciated trust assets.

Example 5: Assume the same facts as Example 4, except that H and W each have $10 million (an aggregate of $20 million). The net assets passing to the children are as follows:

Traditional Plan – approx. $29,130,000
Portability Plan – approx. - $30,515,000

The portability plan is better by roughly $1,385,000.

What we see in Examples 4 and 5 is that when one uses a portability plan, where the plan fully uses the deceased spouse's DSUE amount soon after death, it eliminates the primary benefit of the traditional by-pass trust plan, i.e., the avoidance of estate taxes on the surviving spouse's death. Furthermore, Examples 4 and 5 do not consider the additional estate planning value the irrevocable grantor trust could provide, such as enabling leveraging through the "sale to a defective grantor trust" technique (see Article V.A below) or that state death taxes could be permanently avoided (see Article VI below).

The discussion below explains in greater detail how to create portability driven plans that address both the 1st tier concern and obtain total tax savings beyond the estate tax advantage of a traditional by-pass trust.

II. Portability Is a Game Changer

Portability is a sweeping game changer. Portability was sold as simplifying planning, but that is not the story we are telling. Our version of portability planning comes with a healthy dose of planning, yielding greater benefits!

Keep in mind that under a traditional by-pass trust/marital deduction plan, a spouse's estate tax exclusion amount had to be fully utilized during that spouse's lifetime or at the time of that spouse's death. With portability, that is no longer so. Now, with portability and reunification of the gift and estate tax exclusion amounts, both spouses' estate tax exclusions can be used anytime through the time of the surviving spouse's death. This flexibility creates opportunities.

III. Pre-Estate Tax Dollars

A. Income Taxes Play A Bigger Role in Portability Planning

Income taxes play a bigger role in portability planning than in traditional planning. With portability, there is a step-up in basis[11] upon the surviving spouse's death, whereas there is no step-up for assets that fund a by-pass trust.[12] Generally, much discussion of portability centers on this basis adjustment; however, when comparing a traditional plan to a portability plan, one should also consider the use of "pre-estate tax" and "post-estate tax" dollars to pay debts, expenses and income taxes.

B. Portability Permits Trust Tax Liabilities to be paid with Pre-Estate Tax Dollars

In planning, clients are often encouraged to create irrevocable *inter vivos* trusts for their descendants. The reason for the irrevocability is to make sure that the trusts are "out of the estate" (i.e., assets in such trusts will no longer have to incur an estate tax). In addition to the irrevocable feature, the trusts are often also structured as grantor trusts for federal income tax purposes. The rationale behind creating these irrevocable *inter vivos* trusts as grantor trusts is to have the grantor pay the taxes. One benefit is that the payment, although an obligation of the grantor, it is an indirect gift to the beneficiaries of the trust. Another benefit is that every time the grantor pays the income tax liability, he spends money that would otherwise one day have been included in the grantor's estate, subject to estate tax- they are "pre-estate tax dollars." Conversely, the payment of the trust's income tax liability with the dollars in the irrevocable grantor trusts are often viewed as a "no-no," because those trust dollars will no longer be subject to estate tax and payment with those dollars is viewed as payment with "post-estate tax dollars." This concept has been with us for quite some time, as the evolution toward grantor trusts has occurred in recent decades.

The planner generally looks for opportunities to use pre-estate tax dollars to pay expenses, or make transfers to the beneficiaries. Portability enables a new construct whereby pre-estate tax dollars are used to pay the income tax liability on <u>all assets included in their portability-driven estate plans</u> (the "New Construct").[13]

By comparison to portability plans one of the less obvious downsides of using a by-pass trust is that any income tax imposed on the trust[14] during the surviving spouse's lifetime will be paid with post-estate tax dollars, and not pre-estate tax dollars. If the income taxes on these items of income are paid with pre-estate tax dollars the income taxes are essentially deducted against future estate taxes.

It should be noted that if the total aggregate estate is such that the spouses' estate tax exclusions will eliminate all Federal estate taxes, this planning idea is of no consequence for federal tax planning, but it still may have importance in lowering total taxes considering state estate taxes.

Using a traditional by-pass trust approach is inconsistent with the New Construct – paying all income taxes before the second spouse's death by using pre-estate tax dollars. Income taxes paid from the by-pass trust during the surviving spouse's lifetime are by definition paid with post-estate tax dollars as the by-pass trust has been subjected to estate tax upon the first spouse's death.

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11 *See*, Note 3, *infra*.

12 *Id.*

13 A more refined statement of the New Construct would be that all income taxes for assets remaining in the aggregate taxable estate of the deceased spouse and surviving spouse should be paid with pre-estate tax dollars. This goes to the core of what planning is most beneficial at the time of the deceased spouse's death. This analysis is not attempting to address the separate planning decision of the advisability of making gifts (e.g., to irrevocable grantor trusts, GRATs, insurance trusts, etc.) while both spouses are alive.

14 This is distinct from the income tax imposed on beneficiaries (which generally occurs when distributions are made from the trust carrying out distributable net income). The income tax imposed on trusts generally occurs when there are capital gains, phantom income and undistributed net income inside the trust.

C. Traditional Plans - Income Taxes (from Capital Gains)

Assets held in a traditional by-pass trust will escape estate taxes upon the surviving spouse's death. However, the basis of those assets will not be stepped-up at the time of such death.[15] Rather, the basis is carried over to the successor beneficiaries. If sold, such sale will trigger an income tax which will be paid with post-estate tax dollars.

> Example 6: Suppose that a couple has $5 million in assets (no IRD items), has a traditional by-pass trust plan, and has followed the traditional approach of splitting their assets between them, $2.5 million in each of their respective names or revocable trusts. Suppose further that the husband dies in 2013, and that during the wife's subsequent lifetime all of the assets double in value.

If a traditional by-pass trust is funded with the husband's $2.5 million of assets and the trust assets have appreciated to $5 million upon the surviving spouse's death, the by-pass trust assets have a potential capital gain of $2.5 million. At a 23.8% rate of taxation, the potential capital gain will cost $595,000. If state income taxes are applicable, the costs are higher.

In this example, if the husband's assets all passed to a QTIP trust (the plan depicted in Illustration #2), and the personal representative made the QTIP election, reverse QTIP election and portability election, there would be no federal estate tax and no potential capital gain upon the wife's death. The wife's gross estate for federal estate tax purposes would be $10 million (i.e., the wife's $5 million and the QTIP trust of $5 million). The wife's applicable exclusion amount would be at least $10.5 million, plus later years' inflation adjustments to the wife's basic exclusion amount.

Consistent with the New Construct, all income taxes will be paid with pre-estate tax dollars. The QTIP trust is by definition untaxed for federal estate tax purposes until the surviving spouse's death. The surviving spouse will pay the income tax on any ordinary items of income distributed to her (i.e., from funds before application of the estate tax in her estate). As to any capital gains taxed to the QTIP trust, those too are paid from the QTIP trust before estate taxes are imposed in the surviving spouse's estate.

The QTIP structure does not provide an advantage in this fact situation for federal estate tax purposes because no federal estate tax is owed at the surviving spouse's death. However, it would result in savings for state estate tax purposes.

D. Deconstructing the By-Pass Trusts – Constructing the Portability Trust Plan

As noted above, there is the lack of step-up in basis for the traditional by-pass trust. Reconstructing the plan to use portability eliminates the potential capital gain in the by-pass trust. This can be accomplished while protecting against the 1st tier concerns. The estate tax advantage of a by-pass trust is not implicated in this example as the couples' aggregate estate tax exclusions are in excess of the expected accretions in value.[16]

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15 *See*, Note 3, *infra.*

16 Note that in the traditional by-pass trust arrangement, the trustee might be granted the discretion to make distributions to any of the surviving spouse or descendants, whereas in the QTIP trust only distribution to the surviving spouse are permitted during her lifetime. This fact is of little consequence if the surviving spouse has her own assets with which to make gifts. Also, if the QTIP trust has a flexible power in an independent trustee to make distributions to the surviving spouse for any purpose, distributions could be made to the surviving spouse with which she could make gifts. The gifts by the surviving spouse over the annual exclusion would use a portion of the surviving spouse's applicable credit amount, but that would occur upon the surviving spouse's death anyway (or upon funding the by-pass trust), so that is a neutral point.

Example 7: Suppose that a couple has $20 million in assets (no IRD items), has a traditional by-pass trust/QTIP trust plan, and have followed the traditional approach of splitting their assets between them, $10 million in each of their respective names or revocable trusts. Suppose further that the husband dies in 2013, that during the wife's subsequent lifetime all assets increase by 50% in value, and that $1 million of capital gains are realized and recognized by the by-pass trust. Assume that all items of ordinary income from the by-pass trust are paid to the surviving spouse.

The point of this example is to illustrate the effect of the traditional by-pass trust, funded with $5.25 million of the husband's assets, paying income taxes on its $1 million of realized and recognized capital gains. Assuming a 23.8% rate of taxation applied to the gains, the income taxes would be $238,000, which are paid with post-estate tax dollars. If these income taxes had been paid with pre-estate tax dollars, it would save 40% of the $238,000 or $92,500 in federal estate taxes. In a state with a state death tax, the savings from paying these taxes with pre-estate tax dollars would be even higher.

All other income taxes in this example are paid with pre-estate tax dollars, consistent with the New Construct. This includes the income taxes paid in respect to the surviving spouse's assets, the marital disposition for the husband's assets in excess of the $5.25 million transferred to the by-pass trust, as well as the ordinary items of income paid out the surviving spouse from the by-pass trust.

The plan in Example 7 could be reconstructed consistent with the New Construct by having all of husband's assets pass to a QTIP trust (the plan depicted in Illustration #2), with the personal representative making the QTIP election, the reverse QTIP election (and splitting this trust into exempt and nonexempt trusts), and the portability election. Immediately after the husband's death, the wife could give $5.25 million to an irrevocable GST trust for the descendants, which trust would be structured as a "grantor" trust for income tax purposes. Since the wife funds the irrevocable GST trust immediately after the husband's death, estate taxes are avoided on the future appreciation, which neutralizes the estate tax advantage of by-pass trusts. However, since the irrevocable GST trust is a grantor trust for income tax purposes as to the surviving spouse, she is paying all the trust's income taxes with pre-estate tax dollars, thereby saving $92,500. For more on grantor trusts, see Article V of this paper.

As in Example 6 and consistent with the New Construct, all income taxes in the reconstructed plan would be paid with pre-estate tax dollars. However, unlike in Example 6, the reconstructed plan in Example 7 is advantageous in saving federal estate taxes because the estates in Example 7 are of sufficient size to result in a federal estate tax liability upon the surviving spouse's death. Additional savings would be applicable if the couple resides in a state with a state estate tax. The reconstructed plan also achieves these savings while protecting against the 1st tier concerns.[17]

IV. Accretions in Value - Varied Permutations

In Example 6 each spouse has $2.5 million of assets. Think of the ups and downs that might occur with the asset values between the deaths of the two spouses, contrasting for this purpose the traditional by-pass trust plan to the reconstructed plan as suggested for Example 6 using a QTIP trust for all of the husband's property and using portability.

[17] Note that in the traditional by-pass trust arrangement the trustee could make distributions to any of the surviving spouse or descendants and under the reconstructed plan the surviving spouse could not be a beneficiary of the irrevocable GST Trust (i.e., without application of Code § 2036). The question of whether the surviving spouse needs access to the $5.25 million passing to the irrevocable GST trust is important. In some situations it will be of consequence and not in others. The discussion in sections C and D below build further on the utility of the surviving spouse making gifts to use the DSUE amount.

The following chart demonstrates the varied permutations of how asset values could increase (or accrete in value) or decrease. The net estate could increase, while certain trusts decrease in value and other increase.

	Husband Current Value at Husband's Death 2,500,000			Wife Current Value at Husband's Death 2,500,000			Total Estate at Wife's Death	Appreciation protected from Capital gains taxes by using portability
Both Up	Future Value	50%	3,750,000	Future Value	50%	3,750,000	7,500,000	2,500,000
	Future Value	100%	5,000,000	Future Value	100%	5,000,000	10,000,000	5,000,000
Both Down	Future Value	-25%	1,875,000	Future Value	-25%	1,875,000	3,750,000	-
	Future Value	-50%	1,250,000	Future Value	-50%	1,250,000	2,500,000	-
One Up, One Down	Future Value	200%	7,500,000	Future Value	-25%	1,875,000	9,375,000	5,000,000
	Future Value	-25%	1,875,000	Future Value	200%	7,500,000	9,375,000	5,000,000
One Flat, One Up	Future Value	0%	2,500,000	Future Value	200%	7,500,000	10,000,000	5,000,000
	Future Value	200%	7,500,000	Future Value	0%	2,500,000	10,000,000	5,000,000

A. **All Assets Increase in Value**

If both pools of assets go up in value, portability enables up to about $5 million of appreciation to be protected from income taxes. The idea is that the assets in which this $5 million of appreciation exist will be included in the gross estate of the surviving spouse upon the surviving spouse's death and thereby receive a full step-up in basis, but without an increase in estate taxes because of the DSUE amount passing to the surviving spouse.

B. **All Assets Decrease in Value**

If both pools of assets go down, portability would preserve applicable exclusion that would otherwise be lost when a by-pass trust is less valuable upon the surviving spouse's death than upon the deceased spouse's death. In the facts of Example 6, this is of no consequence if both pools of assets decline in value because there is much more exclusion available than assets includible in the taxable estate. However, if the surviving spouse had remarried, there would be less exclusion available to pass to the new spouse because of being wasted on a depreciated by-pass trust.

C. **Some Up – Some Down**

If one pool of assets goes up and one pool of assets goes down, portability could be important. Using a by-pass trust is helpful only in one direction – i.e., protecting accretions in value from estate taxes upon the surviving spouse's death. The surviving spouse's applicable exclusion amount, including the DSUE amount, can be used efficiently on either pool of assets to protect the value from estate taxes (since both pools are included in the gross estate of the surviving spouse). For example, if the husband's pool of assets declines to $1,875,000 at the time of the surviving spouse's death, only this amount of applicable exclusion amount is needed to protect this pool of assets from estate taxes upon the surviving spouse's death. That preserves $625,000 more exclusion for the surviving spouse to use in protecting her assets from estate taxes in case they appreciate dramatically.

D. **Mixed Results**

Likewise, if one pool of assets stays flat and the other pool goes up in value, portability could be important.

The $5 million of appreciation, which could be protected from estate taxes in this example, could come in any combination between the pools of assets. Using portability provides more flexibility to protect it from estate taxes and achieve a basis increase. The example is good "food for thought" but it is limited and does not tell us everything we need to know about the subject.

E. **Static Asset Values**

Another point to consider is that the aggregate asset value of a traditional by-pass trust might remain approximately the same upon the surviving spouse's death, a situation in which there is no estate tax advantage of the by-pass trust. In these overall flat situations, portability planning might again be advantageous.

Suppose the by-pass trust has individual assets that appreciate in value and others that depreciate. Using portability planning could achieve a step-up in basis for the appreciated assets upon the surviving spouse's death. Triggering losses to offset gains is not always possible. For example, suppose the deceased spouse owned publicly traded stocks that at the time of the deceased spouse's death were valued at $2.5 million and upon the surviving spouse's death are valued at $3.5 million. Suppose further that the deceased spouse's other asset is a $2.5 million interest in a private family company that depreciates in value upon the surviving spouse's death to $1.5 million and that for any number of reasons the loss cannot be realized or recognized.

An overriding consideration to keep in mind is that now it is possible to pass $10.5 million of wealth from a husband and wife (perhaps soon from a same sex couple too) to their children with no federal estate taxation and with a full basis for income tax purposes (of course, there are exceptions to the step-up in basis rules, such as items of IRD – e.g., IRAs). It is not hard to imagine that failing to achieve this result might subject the planner to criticism.

V. Portability and Grantor Trusts

In this section, we explain how surviving spouses can use irrevocable grantor trusts to neutralize the estate tax advantage of by-pass trusts, and portability's role in enabling such trusts.[18] For purposes of this section of the paper, the term "irrevocable grantor trust" means an irrevocable trust into which the donor transfers assets that will be a completed gift for gift tax purposes, a grantor trust for income tax purposes (as to the donor) and excluded from the donor's estate for estate tax purposes.

A. **Benefits of Grantor Trusts**

Remember that a traditional by-pass trust is a non-grantor trust funded with the applicable exclusion amount of the deceased spouse. Wouldn't it be better to use any amount of estate tax exclusion that the deceased spouse has remaining in a trust that is a grantor trust as to the surviving spouse? The benefits generally ascribed to grantor trust status are:

- Payment of Income Taxes is NOT a Gift for Gift Tax Purposes. The surviving spouse's payment of the income tax on the trust's income is not a gift for gift tax purposes. Rev. Rul. 2004-64. This allows the trust property to grow free from the burden of income tax.

  > Example: The irrevocable grantor trust has a $5 million securities portfolio that produces combined taxable ordinary income and capital gains of $500,000. Assume that the surviving spouse must pay $150,000 in income taxes on this income. If the income generated and the tax rates remain constant over a 10 year period, the surviving spouse's income tax payments would enhance the trust value by $1,500,000 without gift tax implication.

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[18] This idea was first discussed by two of our authors, Franklin and Law in the article entitled *Portability's Role in the Evolution Away from Traditional By-Pass Trusts to Grantor Trusts*, Vol. 37, No. 2 of BNA/Tax Management's Estates, Gifts and Trusts Journal (March-April 2012).

- Purchase Assets from or Sell Assets to Irrevocable Grantor Trust without Income Tax Recognition. The irrevocable grantor trust could purchase assets from the surviving spouse without the purchase being treated as a sale for income tax purposes, so that there would be no gain to report (i.e., the so-called sale to a defective grantor trust). Rev. Rul. 85-13. For example, the irrevocable grantor trust could purchase an asset from the surviving spouse having a value of about 10 times the current net equity value of the irrevocable grantor trust and pay for the asset by giving the surviving spouse a promissory note paying annual interest at a rate equal to the IRS mid-term applicable federal rate (0.87% for January 2013), with principal due in 9 years. If the asset purchased appreciates at a rate in excess of the interest rate on the note, the excess appreciation escapes estate taxes on the surviving spouse's death.

  The surviving spouse could also reacquire appreciated trust assets in exchange for higher basis assets, and the surviving spouse could do this income and transfer tax-free. The ability to reacquire assets and substitute assets without triggering gain has many benefits. For example, assume that an asset of the irrevocable grantor trust appreciates in value. Assume the asset has a value of $1 million and a basis of $500,000, having unrealized gains of $500,000. The surviving spouse could swap $1 million in cash or high basis assets, such as bonds, for the assets of the irrevocable grantor trust without the swap being treated as an exchange for income tax purposes. If the surviving spouse dies with the appreciated asset as part of his/her estate, the income tax basis of the asset will be increased to fair market value upon the surviving spouse's death, and the potential capital gain is avoided.[19]

- Interest on Loans between the Irrevocable Grantor Trust and the Surviving Spouse is Ignored for Income Tax Purposes. The interest paid on a loan between the surviving spouse and the irrevocable grantor trust is ignored for income tax purposes. The interest payments are not included in the lender's income and are not deductible by the borrower. Notwithstanding this income tax non-recognition of interest, interest should be paid on any promissory notes to avoid gift tax implications.

- Irrevocable Grantor Trust can Own S Corporation Stock. The irrevocable grantor trust would be qualified to own stock in an S Corporation. The surviving spouse would report on his/her income tax return any tax attributes of the S stock owned by the irrevocable grantor trust. A typical by-pass trust that is taxed as a separate taxpayer would have to qualify as a QSST or ESBT to own S stock, which is more complicated and, perhaps, less tax efficient.

- No Separate Income Tax Return. As a grantor trust, the irrevocable grantor trust can use the surviving spouse's social security number for tax reporting purposes, and no separate income tax return is needed for the irrevocable grantor trust.

Portability enables the creation of an estate plan in which the deceased spouse's applicable exclusion amount is used by the surviving spouse to fund an irrevocable trust that is a grantor trust as to the surviving spouse.

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[19] To accomplish this virtual basis step-up, the trustee should have the power to sell any of the trust's assets, and perhaps there would be a specific power to swap assets of equivalent value in the grantor (*a la* Code § 675(4)(C)). Accordingly, the trustee could swap appreciated trust assets for cash or higher basis assets of the surviving spouse/grantor, therefore effectively stepping up the basis of the trust assets. This requires the surviving spouse (or her agents) to be diligent in monitoring both the value and basis of the trust's investments and continuously implementing the swapping of assets for other higher basis assets over time.

B. Portability and Irrevocable Grantor Trusts in Planning

Estate plans can be reconstructed using combinations of irrevocable grantor trusts and QTIPs to achieve the goals of a traditional by-pass trust (i.e., the 1st tier concerns) and obtain the benefits of grantor trust treatment. Among other benefits, the grantor trust feature would allow the basis of the trust's assets to be increased during the grantor's lifetime and therefore virtually enable the step-up in basis upon the surviving spouse's death (i.e., the principal tax benefit of ascribed to plans featuring portability).

> Example 8: H and W have always resided in Florida (a common law state with no state estate tax). H is 73 years old; W is 68 years old. They are receptive to any form of asset ownership and are willing to shift ownership, provided there are no adverse income tax consequences.[20] Their descendants will survive both H and W. They wish to provide for each other and upon the surviving spouse's death to pass the net assets in trusts to the descendants. H and W make no lifetime taxable gifts. The estate, gift and GST tax laws, as they exist today (January 2013), will continue through surviving spouse's year of death. The couple's combined net worth is $14 million, each having $7 million in their individual names. W is expected to be the surviving spouse.

Illustration #2 above depicts a simple plan that H and W could implement.[21] By each of H's and W's Wills, the deceased spouse leaves all of his or her assets in a testamentary QTIP trust for the surviving spouse.[22] For example, if H predeceases W, the plan is to make a QTIP election for all of the assets,[23] and upon W's death, the QTIP trust assets pass to continuing lifetime trusts for the children and their descendants. H's executor would file a timely estate tax return electing portability.[24]

<u>Discussion – If H Dies First</u>: If H dies first, as expected, his applicable exclusion amount is inherited by W via the portability election. H's GST exemption could be used by making the reverse QTIP election with respect to testamentary QTIP trust (for the benefit of W) created under his Will.

W would have some options following H's death for use of their combined applicable exclusion amounts:

- Option 1 – Immediately following H's death, W could create and fund an irrevocable grantor trust for descendants with some portion of her assets. Recall, at H's death, W's applicable exclusion amount included not only her $5.25 million basic exclusion amount, but also H's $5.25 million DSUE amount, giving W a total applicable exclusion amount of $10.5 million. Thus, following H's death, W could fund a irrevocable grantor trust with an amount roughly equal to H's $5.25 million basic exclusion amount – i.e., the amount that H could have transferred to a traditional by-pass trust. W would begin to rely on her remaining $1.75 million and the QTIP trust created by H for her support.[25]
- Option 2 – If W believes that she may need access to some of the amounts she would transfer to the irrevocable grantor trust, for all or a portion of the gift she could instead establish the same type of irrevocable grantor trust except established it in one of the domestic asset

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[20] Code § 1041 provides that asset ownership can be shifted from one spouse to the other without tax consequence for most assets. The major exceptions are IRAs and other forms of deferred compensation.

[21] The examples used in this paper are to illustrate the ideas. The suggested plans are simply possible approaches to addressing the hypothetical. The goal of these examples is to illustrate the idea and premise that applicable exclusion amounts can and should be used in grantor trusts, rather than traditional non-grantor by-pass trusts, and the important role that portability plays in making this possible.

[22] Of course, a revocable trust could be used to create such plans, but for simplicity purposes this article just refers to Wills.

[23] A disclaimer by-pass trust is illustrated as a failsafe – e.g., to enable funding a more traditional by-pass trust, and to cover the possibilities that portability could be eliminated in the future or if the couple moves to a decoupled state.

[24] Cf. Rev. Proc. 2001-38 and the discussion at Article VII below.

[25] The proposed regulations provide an ordering rule that makes clear the DSUE from H is used first.

protection states and include herself as a discretionary beneficiary. This type of trust is described in PLR 200944002.[26]

In either case, the trust would be a grantor trust as to W, whereas a traditional by-pass trust would be a non-grantor trust. The grantor trust feature would help W to reduce the value of her taxable estate during her lifetime. As discussed in Section A above, this structure would enable all income taxes to be paid with pre-estate tax dollars. In planning, the QTIP trust (created by H's Will for W's benefit) should be flexible enough to allow principal distribution to W to pay income taxes on the irrevocable grantor trust (thereby depleting the QTIP trust's value), and perhaps to allowing W to fund the irrevocable grantor trust to a higher amount.[27]

Some argue that a traditional by-pass trust is superior to utilizing portability because the traditional by-pass trust's growth escapes estate tax upon the second spouse's death, whereas any DSUE amount is not even indexed for inflation and thus it is inferior. This argument would be correct if the surviving spouse could only use the DSUE amount at the time of the second spouse's death. However, as discussed above, portability allows the use of both exclusions "at any time before the second spouse dies." If the surviving spouse used the deceased spouse's DSUE amount immediately following the deceased spouse's death by creating an irrevocable grantor trust, the future appreciation is protected from estate tax just like the traditional by-pass trust.[28] Thus, the irrevocable grantor trust yields the same estate tax benefit, while having the added benefit of being a grantor trust as to the surviving spouse.

1. Portability and the Ultra-Wealthy Client.

Yet another oft-heard shortcoming of portability is its lack of utility for the ultra wealthy client. In certain circumstances, however, even the ultra-wealthy can use portability to his or her advantage, and can do so on a tax efficient basis.

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[26] See, Rothschild, Blattmachr, Gans, IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate, 37 Est. Plan (Jan. 2010).

[27] Such distributions should be made from the non-GST part of the QTIP trust created by H's Will.

[28] It is important to note that an irrevocable grantor trust is more flexible than a traditional by-pass trust from a funding and investment standpoint, too. As discussed above, W could fund the irrevocable grantor trust **immediately upon** H's death. In fact, W need not fund the trust immediately; she can wait if it makes sense. If, for instance, H's entire estate were comprised of marketable securities and W was uncomfortable with the direction and volatility of the market, yet she understood the importance of staying invested in the market, W could either wait a while and then fund the irrevocable grantor trust, or she could create the irrevocable grantor trust immediately, and the trustee could swap assets in and out of the irrevocable grantor trust, depending upon market conditions. Importantly, if she opts to create and fund the trust immediately, and if she uses the strategy of swapping assets, she could do so without any potential capital gain recognition issues (since the irrevocable grantor trust is a grantor trust). Thus, the irrevocable grantor trust also provides the additional layer of funding and investment flexibility.

Example 9: H and W, U.S. citizens, have always resided in the District of Columbia (a common law jurisdiction with a separate estate tax). H is 65 years old; W is 58 years old. The couple's combined net worth is $240 million; H and W own a portfolio of marketable securities and private equity investments of $140 million in their joint individual names as tenancy by the entirety. H has $100 million in private operating companies. Before 2010, both H and W had used their entire $1 million gift tax exclusion amounts. Each of H and W plan to fund irrevocable grantor trusts to use their additional $4.25 million of applicable exclusion amounts by making taxable gifts.[29] Because their assets are so extensive, neither H nor W feels he or she needs access to the gift funds. Before making the gifts, they plan to fund a family limited partnership with private equity interests, so their children have exposure to these investments (i.e., through the irrevocable grantor trust). Upon death, each of H and W leave his or her entire estate in a QTIP trust for the benefit of the survivor and upon the survivor's death 25% is given to the family foundation and the balance to trusts for the children (and their descendants). Assume the estate, gift and GST tax laws, as they exist today, will continue through surviving spouse's year of death. Assume H dies tragically in 2013 before the gifts are made.

Discussion: Since H died in 2013 before he had a chance to use his additional $4.25 basic exclusion amount, H's personal representative would have three options. The first two options contemplate using H's $4.25 million unused applicable exclusion amount at H's death, and the third option contemplates electing portability. The personal representative could make a partial QTIP election to use H's remaining applicable exclusion, effectively creating a traditional by-pass trust. Alternatively, W could disclaim enough of the QTIP trust to use H's remaining applicable exclusion, effectively passing those assets onto trusts for the children (and grandchildren). The other option is that the personal representative could make a full QTIP election and elect portability (thereby H's $4.25 unused exclusion amount would port to W).

If H's personal representative makes a partial QTIP election to use H's $4.25 million exclusion amount, since H and W lived in the District of Colombia, a DC estate tax of roughly $307,600 would be triggered.[30] This DC estate tax result would apply equally to the disclaimer option. However, if portability is elected, there would be no DC estate tax. By relying on portability, following H's death, W could then immediately make gifts to a irrevocable grantor trust to use her applicable exclusion which would include not only her remaining basic exclusion amount of $4.25 million, but also the DSUE amount of $4.25 million from H (totaling $8.5 million), which would be consistent with their plan prior to H's death. Thus, electing portability has the benefit of saving the DC estate tax of roughly $307,500 that would have been assessed on H's estate.[31]

If partial QTIP or disclaimer is chosen, the resulting trusts will not be grantor trusts (i.e., similar to a traditional by-pass trust). However, if portability is selected and W makes the gifts of $8.5 million to a irrevocable grantor trust, as suggested above, the entire irrevocable grantor trust would be a grantor trust for Federal income tax purposes as to W.

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[29] H and W represent the ultra-wealthy couple (i.e., a couple with over $100 million in net asset value) who can afford to and are planning to give the additional $4.25 million of applicable exclusion. Many of these ultra-wealthy clients have used their $1 million exclusion before 2010 and some have also paid gift taxes. The existing Wills/revocable trust plans for such persons frequently devise the balance of their property to a testamentary QTIP trust upon the deceased spouse's death (perhaps some devise to charity is also made). A traditional by-pass trust may not be provided in these situations since the expectation is that no estate exclusion would exist.

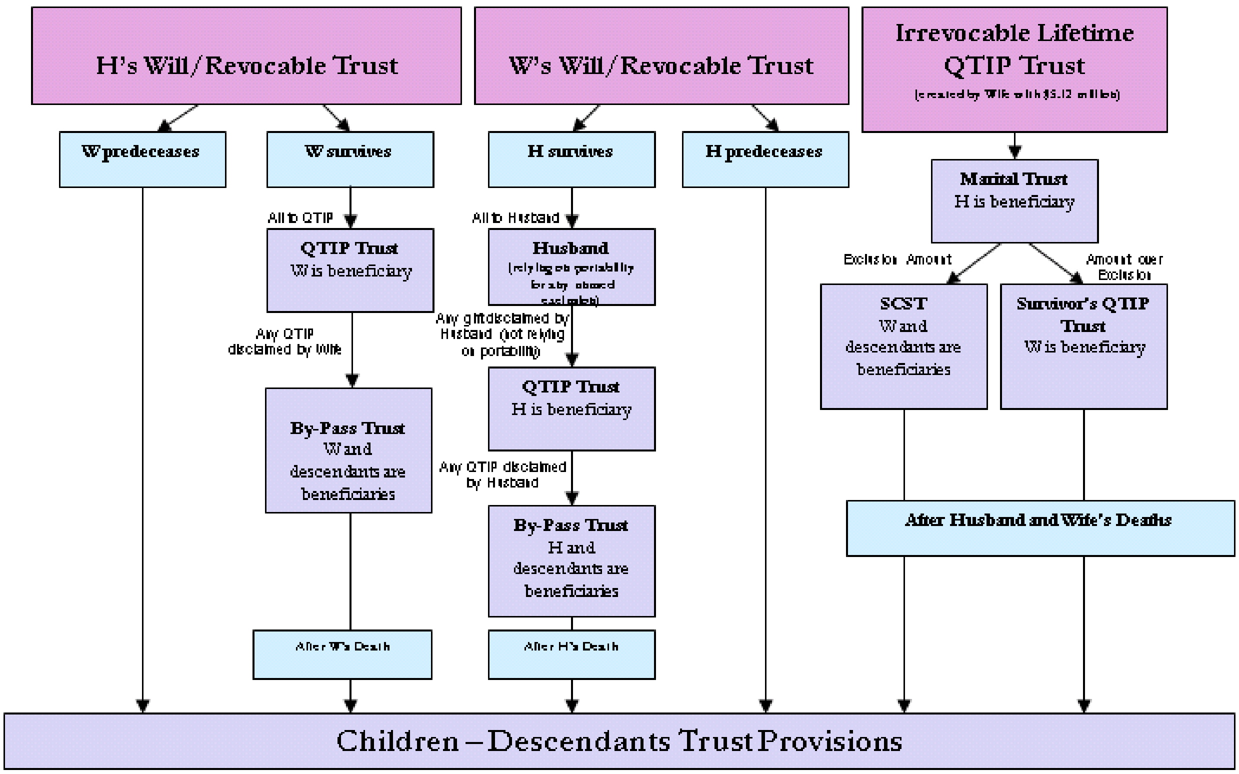
[30] Since DC has no gift tax, no DC gift was imposed on the $1 million of gifts made by H.

[31] DC does not impose a gift tax.

Regardless of which option is selected, H's personal representative can make a reverse QTIP election on the QTIP trust that remains, thereby virtually porting the GST exemption. The QTIP trust would provide asset protection under any of the options, as well as providing disposition control. Thus, all of the 1st tier concerns are addressed.

2. Portability and Inter Vivos QTIPs:

The next illustration, below, depicts a more sophisticated plan that H and W from Example 8 could implement to utilize their estate and gift tax applicable exclusion and GST exemption amounts.[32]



By H's Will, H leaves all of his assets in a testamentary QTIP trust. If H predeceases W, the plan is to make a QTIP election for all of the assets, and upon W's death, the QTIP trust assets pass to continuing lifetime trusts for the children and their descendants.

W establishes an *inter vivos* QTIP with $5.25 million[33] of her assets and keeps $1.75 million[34] of her assets.[35] She makes the gift tax QTIP election on a timely filed gift tax return. The goal is to use H's applicable exclusion amount upon H's death if H dies first. Since the value of the *inter vivos* QTIP trust during H's lifetime will fluctuate up and down, W will need to monitor its value and perhaps make

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[32] The proposed plan is just one possible approach and is used to illustrate the ideas discussed herein.

[33] This is the basic exclusion amount for 2013. If the amount increases due to inflation, additional funds could be given to the *inter vivos* QTIP trust to match the inflation adjustment.

[34] Recall that W had $7 million, thus, after forming the $5.12 million *inter vivos* QTIP trust, the balance of her assets would be $1.88 million.

[35] This *inter vivos* QTIP could be established currently or at any time prior to H's death. W could establish the arrangement under a revocable trust as to W and plan to release her interests in the revocable trust when it appears that H's death is imminent, thereby triggering the irrevocable gift to the *inter vivos* QTIP.

subsequent additions to keep the QTIP trust's value near H's applicable exclusion amount (and with each addition, W would make the gift tax QTIP election).[36]

The *inter vivos* QTIP trust provides H with beneficial interests sufficient to qualify for QTIP treatment. Upon H's death, the language of the trust instrument would provide that the portion of this trust that is equal to H's remaining applicable exclusion amount is distributed to a separate trust, the "SCST"[37] and

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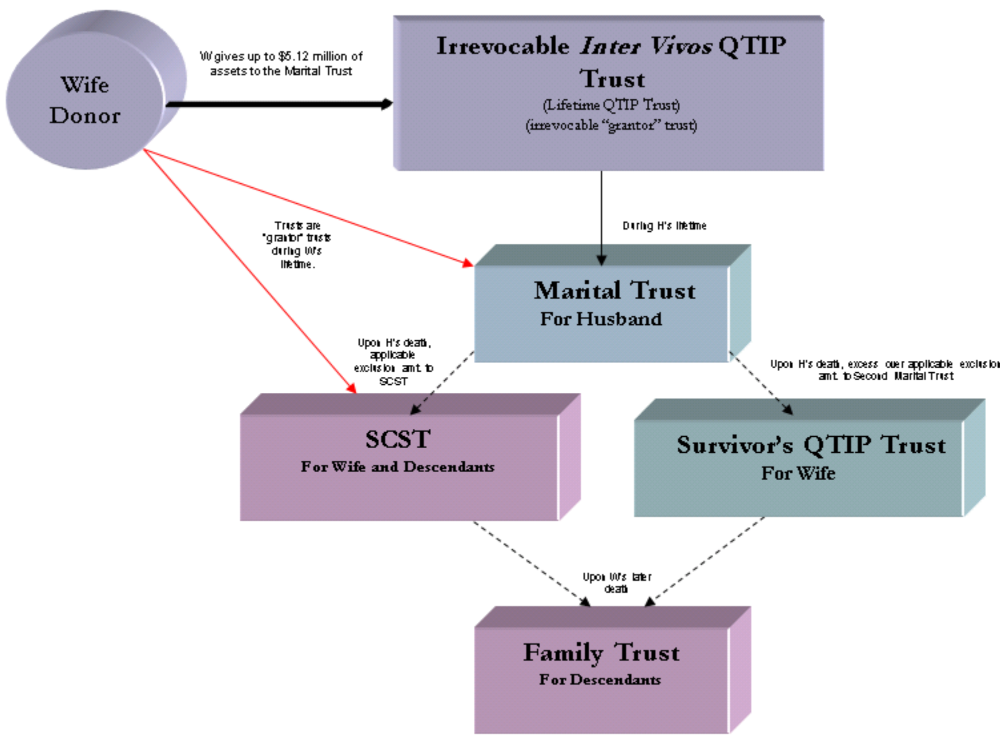
[36] We assume that the GST exemption would likely be tied to the gift tax exemption; accordingly, W would likely make a reverse QTIP election for GST purposes, too.

[37] *See* Jonathan Blattmachr, Mitchell Gans and Dianna Zeydel, "*Supercharged Credit Shelter Trust*[SM], 21 Prob. & Prop. 52 (July/Aug. 2007). This article described using the estate tax applicable exclusion amount of the deceased spouse for a trust that would be a grantor trust as to the surviving spouse (herein referred to as the "*SCST*"). By example, W establishes an *inter vivos* QTIP trust for H's benefit and transfers $5.12 million of assets to the trust. W elects QTIP treatment to qualify the trust for the Federal gift tax marital deduction on a timely filed gift tax return reporting her gift. Because the QTIP election is made, W's gift to the *inter vivos* QTIP trust would not cause any federal gift tax liability at the time of the trust funding and the value of the trust would be included in H's estate for Federal estate tax purposes at the time of his death pursuant to Code § 2044. Additionally, W could make a reverse QTIP election under Code § 2652(a)(3) so that the trust is exempt for generation-skipping transfer (GST) tax purposes. The SCST is illustrated below.



The primary reason for establishing the *inter vivos* QTIP trust is to set the stage for creating the SCST in the event that W survives H. W must put the plan into effect while H is living – think of it as staging before the important and critical second act. During the first act, while H is alive, he would be the sole beneficiary of the *inter vivos* QTIP. Therefore, during this period of time, the assets are just for H's benefit.

Upon H's death, if W is then living, an amount of the *inter vivos* QTIP trust's assets equal to H's applicable exclusion amount could be distributed to the SCST for W's benefit and the balance (if any) could be held in a Survivor's QTIP Trust for W's benefit. A QTIP election would be made for the Survivor's QTIP trust on H's estate tax return.

The SCST would provide for W and any of W and H's descendants (i.e., similar to a by-pass trust). The creation of this SCST is the key to this plan. Because the trust was included in H's estate under Code § 2044 the SCST will not be included in W's estate pursuant to Code §§ 2036 or 2038. Treas. Reg. § 25.2523(f)-1(f), Examples 10 and 11. Careful attention must also be given to avoid inclusion in W's estate pursuant to Code § 2041 (e.g., based on application of the rule against self-settled spendthrift trusts thereby enabling W's creditors to reach her interests in the trust). Generally, this means that to accomplish the balance to the Survivor's QTIP Trust for W. Importantly, the SCST is a grantor trust as to W and provides benefits to her and the descendants.[38] This is the key advantage of this trust over the traditional by-pass trust!

W also implements a Will that leaves the balance of her assets[39] to H, or if H predeceases W, to continuing lifetime trusts for the children and their descendants. And, if H predeceases W, when W dies, the remaining assets under the *inter vivos* QTIP trust pass to continuing lifetime trusts for the children and their descendants.

Discussion – If H Dies First: If H dies first, as expected, his applicable exclusion amount is used through the *inter vivos* QTIP established by W.[40] The SCST and Survivor's QTIP Trust created under the *inter vivos* QTIP for W are grantor trusts as to W, which provide the desired advantage of grantor trust status that a traditional by-pass trust cannot provide. A significant advantage of the SCST is that W's interest in the SCST is not subject to attack under Code § 2036.[41] On the other hand, W would have risks associated with Code § 2036 if an irrevocable grantor trust is created following H's death in proposed plan #1 as a domestic asset protection trust (e.g., if the Internal Revenue Service ("Service") could prove a pre-existing understanding that distributions would be made to W).[42]

H's GST exemption would be used by making the reverse QTIP election with respect to the testamentary QTIP trust (for the benefit of W) created under his Will. While H's GST exemption could also be allocated to the *inter vivos* QTIP created by W when included in his estate under Code § 2044, this would be unnecessary as W will likely allocate her GST exemption to the *inter vivos* QTIP at the time she creates it by making the reverse QTIP election. W will make the reverse QTIP election at the time of the gift for two reasons: (i) if W unexpectedly dies before H, the allocation of her GST exemption to the *inter vivos* QTIP preserves the use of her GST exemption, and (ii) W's allocation to the *inter vivos* QTIP potentially leverages the use of her GST exemption during the period from establishing the trust to the death of H.

Discussion – If W Dies First: If W unexpectedly dies before H, W's leaves (by Will) her remaining estate (i.e., the $1.75 million) outright to H. W's executor would file a timely estate tax return electing portability. W's unused applicable exclusion amount (i.e., $5.25 million (as it may increase for inflation)) would port to H. Portability prevents the waste of W's applicable exclusion amount (for estate and gift tax purposes). While the GST exemption is not portable, as mentioned above, W would have allocated her GST exemption to the *inter vivos* QTIP Trust, and because she made a reverse QTIP election, her GST exemption has virtually ported to H and is not wasted.

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the tax objectives, it is preferable to "situs" or locate the trust in a state such as Alaska, Nevada or Delaware and use their laws to govern the administration of the trust. Carefully giving attention to this feature makes the trust protected from the claims of the beneficiaries' creditors, including W's creditors. This should eliminate any concerns with including of the SCST in W's estate for estate tax purposes under authority of Code § 2041. Some Non-DAPT states have enacted statues to abrogate the self-settled spendthrift trust rule in this circumstance. *See e.g.,* Fla. Stat. § 736.0505(3); VA Code § 55-545.05, B.3.
For GST purposes, if W made a reverse QTIP election, W will be deemed to be the transferor, and as such the assets in both the SCST and the Survivor's QTIP Trust would be GST exempt.
For income tax purposes, W is still the grantor of any continuing trust for her benefit. This allows W to have the benefits of grantor trust status as to the SCST and to be a beneficiary of the trust. This combination of benefits makes the SCST special. A traditional by-pass trust, is not a grantor trust – and thus, not as special.

[38] The Survivor's QTIP trust is also a grantor trust as to W. This trust is less important and could for example be terminated by an independent trustee with unlimited discretion back to W.

[39] Recall that she would have roughly $1.75 million after implementing the *inter vivos* QTIP trust.

[40] H's executor or personal representative would not make a QTIP election for the SCST trust; however, a QTIP election would be made for the Survivor's QTIP Trust.

[41] *See, supra* note 12.

[42] *See*, *supra* note 26.

Immediately after W's death, H could create and fund a irrevocable grantor trust with some part of his now $8.75 million of assets. Recall, at W's death, H's applicable exclusion amount included not only his $5.25 million basic exclusion amount, but also the DSUE amount from W, which was an additional $5.25 million. Accordingly, H's applicable exclusion amount would total $10.5 million. Thus, after W's death, H could fund a irrevocable grantor trust with an amount roughly equal to his $5.25 million basic exclusion amount, and he would begin to rely on his remaining $3.5 million of assets (i.e., $1.75 million of his own assets and $1.75 million from his wife) for his lifestyle. The *inter vivos* QTIP Trust created by W is also available to H, however, recall that it is GST exempt.[43] If H believes that he may need access to some of the amounts he would transfer to the irrevocable grantor trust, he could establish as a domestic asset protection trust and include himself as a discretionary beneficiary (i.e., immediately upon W's death).

As an alternative, H can create two irrevocable grantor trusts, one of which could also be domestic asset protection trust with H as a discretionary beneficiary; this allows him to receive distributions from one of the trusts if necessary and it allows the other irrevocable grantor trust to grow for the benefit of his descendants. Suffice to say, the options could vary based upon client circumstances.

In either case, the irrevocable grantor trust would be a grantor trust as to H, whereas a traditional by-pass trust would not. This grantor trust feature will help enable H to reduce the value of his taxable estate during his lifetime. The *inter vivos* QTIP trust created by W should be flexible enough to allow principal distributions to H to pay income taxes on the irrevocable grantor trust (thereby depleting the QTIP trust's value).[44]

3. Is the Irrevocable Grantor Trust Planning More Complicated Plan?

One complaint that may be leveled against this planning is that it is complicated. This is especially so given that many planners have devolved into using one "standard" formula traditional by-pass trust plan.[45] It is important to remember thirty years ago, when traditional by-pass trust planning developed, the credit equivalent amount was $175,625.[46] Now each spouse's exclusion is $5.25 million, planning with such larger amounts *is* more complicated and should be done thoughtfully. The value of the surviving spouse having grantor trust status as to the trust created with the applicable exclusion amount of the deceased spouse is much more valuable by comparison to simply relying upon traditional non-grantor by-pass trust planning.

4. Grantor Trust Conclusion.

Portability enables greater use of trusts funded with applicable exclusion amounts to be grantor trusts as to the surviving spouse.[47] That's a game changer! Portability planning furthers the evolution that

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43 From an investment standpoint, H would likely invest the $3.76 million to generate more income and the trustee of the *inter vivos* QTIP Trust to generate less income and more growth. This would likely maximize the overall estate and GST tax potential.

44 Such distributions should be made from the non-GST part of the QTIP trust created by H's Will.

45 Portability was designed to simplify the planning. *See*, *General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals* (a.k.a., the "2012 Greenbook"), p 123, Department of the Treasury. A copy of the 2012 Greenbook is available at: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf. The administration has continued to advocate the continuation of portability in its most recent publication of the *General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals (a.k.a., the 2013 Greenbook)*, p. 76, Department of the Treasury, a copy of the 2013 Greenbook may be obtained at: http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

46 *See* Jacobson, Raub and Johnson, *The Estate Tax: Ninety Years and Counting*, a copy of which is available at: http://www.irs.gov/pub/irs-soi/ninetyestate.pdf Under ERTA, recall that the estate and gift tax credit was originally $47,000 (which translated to a credit equivalent amount of $175,625, in 1982) and which was to be phased in over six years to increase the credit to $192,800 (and the credit equivalent amount to $600,000).

47 Note that the *2013 Greenbook* includes a new provision at page 83 designed to eliminate the benefits of grantor trusts

had already begun away from traditional by-pass trusts. In this approach to planning, portability offers the same or better estate tax benefits,[48] GST exemption of both spouses is utilized, creditor protection is preserved, and state death taxes and administrative costs are potentially lower.

VI. Portability Role in Saving State Estate Taxes

Portability can provide flexibility in planning for state death taxes in decoupled states.[49] In a state that imposes a state death tax and has an exemption limit under $5.25 million, a married couple will have to pay a greater amount in state estate taxes if they wish to take advantage of the full federal applicable exclusion amount upon the first spouse's death in funding a traditional by-pass trust.

> Example 10: The District of Columbia, which has an estate tax, provides an estate tax exemption amount of $1 million. For a married District of Columbia couple, funding a by-pass trust with the $5.25 million federal applicable exclusion upon the first spouse's death would require a payment of $420,800 in state death taxes if the state death tax is charged to the by-pass trust (i.e., resulting in a net funding of $4,829,200). Alternatively, it would be possible to fund the by-pass trust with a net of $5.25 million. To do this, the taxable estate would need to be $5,728,181, whereupon the state death tax would be $478,182. The federal estate tax would still be zero (since the Code § 2058 deduction would reduce the taxable estate to $5,250,000), but state death taxes would increase by $57,382 ($478,182 - $420,800). It also makes a difference if the state estate tax is deductible in the calculation of the state death tax. In DC it is not so.

A. Portability as Alternative to Paying State Estate Tax on First Spouse's Death

On the death of the first spouse to die, a traditional by-pass trust could be funded with an amount equal to the state estate tax exemption (*e.g.*, for a D.C. resident, $1 million).[50] The balance of the estate of the first spouse could pass to the surviving spouse in an outright transfer, QTIP trust or GPOA marital trust or by joint property. The portability election could be made on the estate tax return of the first spouse to die, and the surviving spouse would then make full use of the first spouse's remaining applicable exclusion amount, either by means of lifetime gifts, or transfers upon death, if the surviving spouse's estate is large enough to make full use of both spouses' remaining applicable exclusion amounts.

B. Cost of Not Using Lower Brackets of State Death Tax Table

There is a cost to choosing at the death of the first spouse not to make use of the lower brackets under the state death tax table between the first $1 million and $5.25 million. The rates from $1 million to $5.25 million are 5.6% to 12%. By funding the by-pass trust on the first spouse's death only with the state exemption amount and relying on the surviving spouse's use of portability for the remainder of the first spouse's applicable exclusion amount, an extra $4.25 million could end up in the estate of the surviving spouse to be taxed at higher rates under the state death tax table, (although this extra amount included in the surviving spouse's estate is deductible against a 40% federal estate tax). The

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for gift and estate tax purposes. At this point, it is just a proposal and a signal of potential governmental concern (*a la* proposals to eliminate valuation discounts). It is not cause to change planning solutions. Even under this proposal, it appears that pre-effective date grantor trusts will be unaffected, except to the extent of contributions after the effective date.

48 The estate tax savings are potentially better than the traditional by-pass trust because of the benefits associated with the types of exclusion trusts discussed herein being grantor trusts.

49 *See* Franklin and Walls, *State Death Tax Planning*, Vol. 150, *Trusts & Estates*, p.28 (September 2011).

50 We are not necessarily suggesting that funding a traditional by-pass trust with the state death tax exclusion amount is the most efficient plan. The value of having grantor trust treatment for that amount through an irrevocable grantor trust as suggested in Article V above may be more valuable. Additionally, there is the costs to consider of maintaining a separate taxable trust for just $1 million (or the applicable state death tax exclusion amount).

examples below illustrate that not making use of the lower brackets of the state death tax table may increase the aggregate tax paid by both spouse's estates.

$10.5 Million Estate - Married Couple	Pay State Estate on Each Spouse's Death	Pay State Estate on 2nd Spouse's Death	
1st Spouse's Death			
Gross Estate Value	5,250,000	5,250,000	
Marital Deduction	-	(4,250,000)	
Taxable Estate	5,250,000	1,000,000	
Maryland Estate Tax	420,800	-	
Federal Estate Tax	-	-	
Total Estate Tax	420,800	-	
2nd Spouse's Death			
Gross Estate Value	5,250,000	5,250,000	
Additional Marital from 1st Spouse	-	4,250,000	
Taxable Estate	5,250,000	9,500,000	
Maryland Estate Tax	420,800	991,600	
Federal Estate Tax	-	-	*
Total Estate Tax	420,800	991,600	
Total Estate Tax for both Spouses	841,600	991,600	
Increase(decrease)		150,000	

*Assumes portability of $4.25 million of exclusion from 1st Spouse to die.

$100 Million Estate - Married Couple	Pay State Estate on Each Spouse's Death	Pay State Estate on 2nd Spouse's Death	
1st Spouse's Death			
Gross Estate Value	50,000,000	50,000,000	
Marital Deduction	(44,750,000)	(49,000,000)	
Taxable Estate	5,250,000	1,000,000	
Maryland Estate Tax	420,800	-	
Federal Estate Tax	-	-	
Total Estate Tax	420,800	-	
2nd Spouse's Death			
Gross Estate Value	50,000,000	50,000,000	
Additional Marital from 1st Spouse	44,750,000	49,000,000	
Taxable Estate	94,750,000	99,000,000	
Maryland Estate Tax	14,626,800	15,306,800	
Federal Estate Tax	29,780,960	29,677,280	*
Total Estate Tax	44,407,760	44,984,080	
Total Estate Tax for both Spouses	44,828,560	44,984,080	
Increase(decrease)		155,520	

*Assumes portability of $4.25 million of exclusion from 1st Spouse to die.

C. **Use Portability and Lifetime Gifts to Permanently Save Estate Taxes.**

The increased state estate taxes incurred by the surviving spouse's use of portability at his or her later death can be mitigated if the surviving spouse makes lifetime gifts of the DSUE amount. For example, the surviving spouse could make a gift of the amount by which the deceased spouse's applicable exclusion amount exceeded the state death tax exemption amount that was disposed of under the deceased spouse's will.[51] State death taxes on the portion given would be completely avoided in most cases, since most states do not have a separate gift tax. This is preferable to taking advantage of the bracket run in both estates under the state death tax table. Since the DSUE amount applies to both federal estate and gift taxes, there would be no federal gift tax on this portion either.

As discussed above, the surviving spouse could make the gifts to an irrevocable grantor trust to mitigate the concerns with the gifts having a carry-over basis for income tax purposes. The irrevocable grantor trust could be structured as a domestic asset protection trust if the surviving spouse is concerned with having to part permanently with the property.

One fairly clear example of the utility of using portability and making gifts in the context of saving state death taxes involves a frequently occurring disclaimer situation. For example, suppose that the deceased spouse and surviving spouse owned all of their property in tenants-by-the-entirety. Suppose

[51] In the context of a gift, it is not clear whether the inherited exclusion amount or the surviving spouse's applicable exclusion is used first, or if both are used pro rata. The Joint Committee on Taxation issued an ERRATA on March 23, 2011, wherein they proposed replacing the reference to basic exclusion amount of the last deceased spouse in Code § 2010(c)(4)(B)(i) with applicable exclusion amount of the last deceased spouse. With this change there would no need for an ordering rule. Unless this change occurs, however, if the surviving spouse has not used his or her applicable exemption amount previously, it may be that the surviving spouse has to make a gift sufficiently large to exhaust his or her applicable exclusion amount before the inherited exclusion amount is used or sufficiently large to use an amount of the surviving spouse's applicable exclusion amount equal to the inherited exclusion amount.

further that upon the deceased spouse's death, if the surviving spouse disclaimed any of the survivorship interests in the joint property, the interest would pass outright to the couple's children. If the surviving spouse implements the disclaimer to fully use the deceased spouse's $5.25 million federal applicable exclusion amount, then state death taxes of approximately $470,000 will be payable. Alternatively, the surviving spouse would rely upon portability and then make a gift of $5.25 million to consume all of the DSUE amount and avoid the state death tax on this amount entirely and permanently. If the surviving spouse would be willing to implement the disclaimer planning, wherein the surviving spouse would not continue to benefit from the disclaimed property, there is no reason not to pursue the alternative portability/gift strategy wherein the state death taxes are saved. This probably is simpler than the disclaimer planning anyway and would allow perhaps greater control over the asset selection for transfer.

Finally, in regard to making gifts to save state estate taxes, there is no absolute need to make the gifts immediately after the deceased spouse's death and in some cases "death bed" gifts for this purpose may be preferred.[52] Gifts made in contemplation of death are subject to the imposition of federal estate tax.[53] However, most states do not tax gifts made in contemplation of death, so even "death bed" gifts can escape state death taxation in most states.[54] Therefore, end-of-life gifts using the DSUE amount may make sense for some clients in order to reduce state death taxes. This strategy would protect against the surviving spouse's need for the assets during his or her lifetime. The estate planning attorney should also be sure that any death bed gifts are tax neutral for federal tax purposes, to avoid any adverse income tax consequences. Finally, since any property given will have a carryover basis, it is advisable that the property given before death be cash or high basis property. One strategy to consider is to borrow funds to enable the gifts in cash. Upon death, the decedent's liability from the borrowing will provide a deduction that reduces the taxable estate value. Yet, the decedent's assets will receive a step-up in basis and can thereafter be sold without capital gains exposure to satisfy the liability.

VII. Rev. Proc. 2001-38 and QTIP Elections

Revenue Procedure 2001-38[55] is important to understand in the context of portability planning. Initially, consider this procedure in its context prior to the advent of portability. The Service issued the revenue procedure in response to numerous requests for relief in situations in which the estate made an unnecessary QTIP election. For example, the procedure is designed to provide relief if a QTIP election is made for an estate having a value less than the applicable exclusion amount under Code § 2010. In such as case, the election is unnecessary because no estate tax would be imposed without the election. The procedure notes that in some cases QTIP elections were mistakenly made for by-pass trusts.[56] Remember, a QTIP election once made is irrevocable and it carries tax implications for the surviving spouse: (i) a QTIP election causes the trust to be included in the surviving spouse's estate under Code § 2044, (ii) in the event the surviving spouse disposes of any part of the income interest during his or her lifetime, a Code § 2519 transfer would occur, and (iii) the surviving spouse becomes the transferor of the QTIP property for GST purposes, unless the reverse QTIP election is made.

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52 You might wonder about the 3-year rule of Code § 2035 and the often stated principle that lifetime gifts are typically less expensive than transfers upon death, because lifetime gifts are tax-exclusive (after the 3-year period passes), while gifts at death are tax-inclusive. Even so, the gifts contemplated by the discussion in the associated text above relates to using DSUE and are suggested for the sole purpose of saving state estate taxes.

53 Code § 2001(b) provides that taxable gifts form part of the unified tax base for calculating federal estate tax, and, pursuant to Code § 2035(c), gift taxes paid within 3 years of death are includible in the gross estate.

54 The following states do tax certain transfers as gifts made in contemplation of death: Indiana, Iowa, Kentucky, Maryland, Massachusetts, Nebraska, New Jersey, Ohio, Pennsylvania and Tennessee.

55 Rev. Proc. 2001-38, 2001-1 C.B. 1335 (06/11/2001).

56 *See* PLR 2011120001 (3/25/2011)(erroneous QTIP election for by-pass trust ruled void).

The procedure applies to QTIP elections under Code § 2056(b)(7) where the election was not necessary to reduce the estate tax liability to zero, based on final estate tax values. Rev. Proc. 2001-38 specifically does not apply to protective elections; or where a partial QTIP election was needed to reduce estate tax liability to zero and the executor made the election with respect to more property than was necessary; or to elections that are stated in terms of a formula designed to reduce the estate tax to zero. For example, if the executor made 50% QTIP election, when a 35% election would have zeroed out estate taxes, the procedure offers no relief.

If the QTIP election is within the scope of the procedure the election will be ignored for federal estate, gift and GST tax purposes, and the property will not be subject to transfer tax in the surviving spouse's estate. The ruling makes a blanket statement that "In the case of a QTIP election within the scope of this revenue procedure, the Service will disregard the election and treat it as null and void for purposes of sections 2044(a), 2056(b)(7), 2519(a), and 2652." Then the Service sets forth a procedure to follow in establishing whether an election is within the scope of the revenue procedure:

> *To establish that an election is within the scope of this revenue procedure, the taxpayer must produce sufficient evidence to that effect. For example, the taxpayer may produce a copy of the estate tax return filed by the predeceased spouse's estate establishing that the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. Such information, including an explanation of why the election should be treated as void under this revenue procedure, should be submitted either with the Form 706 filed for the surviving spouse's estate, or with a request for a private letter ruling submitted at any time prior to filing that Form 706.*

Rev. Proc. 2001-38 does not state whether the Service could an ignore election within the scope of the procedure on its own accord or whether this procedure's relief is solely within the control of the taxpayer. This is the crux of the issue as concerns portability.

Example 11: Suppose H1 dies leaving his entire $4 million estate to a QTIP trust for W. H1 has made no taxable gifts. H1's BEA is $5 million. The QTIP election is made and the portability election is made. Therefore, the QTIP trust is within the scope of Rev. Proc. 2001-38. The question is whether H1's entire $5 million exclusion is ported.

If the QTIP trust in the example appreciates to $5 million before the surviving spouse dies, then the surviving spouse's estate may wish to provide the information to show the QTIP election was within the scope of the procedure – i.e., voiding the QTIP election – and have the effect of a by-pass trust. In this permutation, $1 million of DSUE is preserved as compared to having a $5 million dollar inclusion under Code § 2044 with $5 million of DSUE.[57] It seems that this permutation is within the scope of the relief the Service sought to provide by the procedure. The fact that $1 million of DSUE is ported is a natural result flowing from having used less than all of the $5 million BEA upon H1's death.

On the other hand, if the QTIP trust in the example goes down in value to $3 million before the surviving spouse dies, then keeping the QTIP election in play and relying on portability may be better. In this permutation, surviving spouse would have $5 million of DSUE and only $3 million in the QTIP trust to be included under Code § 2044, thereby preserving $2 million of DSUE as compared to just having $1 million of DSUE if the QTIP election is void – i.e., the QTIP trust is in effect treated as a by-pass trust. This is the permutation that arguably the Service did not agree to accept by the relief

[57] If the QTIP election is void, the $1 million of appreciation would not be eliminated by the step-up in basis rule as a result of inclusion in the surviving spouse's estate under Code § 2044.

granted under the procedure. It is unlikely the Service could have foreseen this benefit to keeping a QTIP election within the scope of the procedure in effect. Therefore, the concern is that Service would declare the QTIP election is void on its own accord.

For portability planning purposes one alternative would be to focus on QTIP elections that are outside the scope of the revenue procedure. For example, the ruling only applies to estate tax QTIP elections. Gift tax QTIP elections are beyond the scope of the ruling. Also, for example, a testamentary QTIP trust having a size in excess of the deceased spouse's applicable exclusion amount would be outside the scope of the procedure, since without the QTIP election an estate tax would result.

Furthermore, note that the ABA-RPTE Portability Regulation Comments,[58] asked Treasury to re-evaluate Rev. Proc. 2011-38 in light of portability, "where one may now want to intentionally make a QTIP election in estates having less value than the deceased spouse's available applicable exclusion amount."[59] Most likely any concern with Rev. Proc. 2011-38 will be resolved by Treasury, and pending that if you are concerned that this ruling limits potential planning, carefully structure plans such as those depicted above with the possibility that a disclaimer by-pass trust could be created.

VIII. Conclusion

Some authorities have relegated portability to preventing waste if the applicable exclusion amount is not fully utilized at the death of the deceased spouse. Of course that is true, portability can prevent waste, but it can do more. The reality is that portability is a game changing new tool that can be used to produce superior benefits to the traditional estate planning that has been used to over the past 30 years (i.e., since the inception of the unlimited marital deduction and the unified credit (now called the "applicable credit amount")).

58 *See*, pages 13 -16 of the ABA-RPTE Portability Regulation Comments.

59 *Id*.

Appendix I.

I. Terms Used in this Paper

A. Applicable Credit Amount

The applicable credit amount[60] is the amount of tentative tax equal to the applicable exclusion amount (defined below).[61] Thus, when the applicable exclusion amount is equal to $5 million, the applicable credit amount is $1,730,800. If the applicable exclusion amount is $5.12 million (i.e., because the inflation adjusted basic exclusion amount increased to that amount)[62] the applicable credit amount is $1,772,800, which is 35% of the adjustment amount for inflation.[63] For 2013, the applicable exclusion amount increased to $5.25 million and the applicable credit amount is $2,045,800.[64]

B. Applicable Exclusion Amount

As of January 1, 2011, the applicable exclusion amount[65] is the sum of the basic exclusion amount (defined below) and the Deceased Spousal Unused Exclusion Amount.[66] For brevity, we will sometimes use the acronym "AEA" to mean the applicable exclusion amount.

C. Basic Exclusion Amount

For 2011, the basic exclusion amount was $5 million.[67] For 2012, this amount, indexed for inflation (rounded to the nearest multiple of $10,000),[68] was $5.12 million.[69] For 2013, the basic exclusion amount is $5.25 million. For brevity, we will sometimes use the acronym "BEA".

D. By-Pass Trust

We use the term "by-pass trust" interchangeably with the term "credit shelter trust," in each case to refer to a trust that is generally created upon the first spouse's death, which is not subject to federal estate tax by virtue of the deceased spouse's applicable exclusion amount and which benefits the surviving spouse (and perhaps others, such as descendants) but is not subject to federal estate tax in the surviving spouse's estate.

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60 Code § 2010(c)(1); Temp. Reg. § 20.2010-1T(d)(2).

61 Code § 2505(a) refers to the applicable credit amount under Code § 2010(c) to define the credit allowed against the gift tax. As discussed below, for 2010 the applicable credit amount for gift tax purposes is limited to the tax on an applicable exclusion amount of $1 million. For 2010, Code § 2631(c) refers to the applicable exclusion amount under Code § 2010(c) to define the GST exemption amount. For 2011 and thereafter it refers to the basic exclusion amount to eliminate the portability feature for GST exemption purposes that is built into the term applicable exclusion amount starting in 2011. Temp. Reg. § 25.2505-1T(a).

62 Rev. Proc. 2011-52, §3.29. The website link is: http://www.irs.gov/pub/irs-drop/rp-11-52.pdf

63 For a list of the applicable credit amounts (or the unified credit as it was called in earlier versions of the law), from 1977 to date, see IRS Publication 950 at: http://www.irs.gov/publications/p950/ar02.html

64 We calculated this based on the new tables in Code § 101(c) of ATRA 2012, as follows:
(((($5.25 million - $1 million) x 40%) + $345,800) = $2,045,000).

65 Code § 2010(c)(2); Temp. Reg. § 20.2010-1T(d)(2).

66 The "deceased spousal unused exemption amount" is referred to by many as "DSUEA", in *Portability – Part One*, we referred to is as the "inherited exclusion amount"; however, since the Portability Regulations use the term "DSUE amount", we have opted to go to that term for this paper.

67 Code § 2010(c)(3)(A); Temp. Reg. § 20.2010-1T(d)(3)(i).

68 Code § 2010(c)(3)(B) provides that the basic exclusion amount will be adjusted for any inflation increases. It should be noted that if there is deflation, such amount is not adjusted downwards. Temp. Reg. § 20.2010-1T(d)(3)(ii).

69 Rev. Proc. 2011-52, §3.29. The website link is: http://www.irs.gov/pub/irs-drop/rp-11-52.pdf

E. **Deceased Spouse**

We use the term "deceased spouse" to mean the first spouse to die, unless the context indicates otherwise.

F. **Deceased Spousal Unused Exclusion Amount ("DSUE amount")**

With respect to the surviving spouse of a deceased spouse dying after December 31, 2010, the term deceased spousal unused exclusion amount[70] (the "DSUE amount") is defined differently in the Code by comparison to the Portability Regulations. The Code defines the DSUE amount as <u>the lesser</u> of (A) the basic exclusion amount of the surviving spouse at his or her death, or (B) the excess of (i) the applicable exclusion amount of the last deceased spouse of the such surviving spouse,[71] over (ii) the amount with respect to which the tentative tax is determined under Code § 2001(b)(1) on the estate of such deceased spouse.[72]

The Portability Regulations define the DSUE amount as "generally, the unused portion of a decedent's applicable exclusion amount to the extent this amount does not exceed the basic exclusion amount in effect in the year of the decedent's death." Then, in defining such amount it directs the reader to go to Temp. Reg. §§ 2010-2T(c) and -3T(b) to determine how to compute the amount.[73]

To compute the DSUE amount, the Portability Regulations provide that subject to the provisions of Temp. Reg. § 20.2010-2T(c)(2) through (4), the DSUE amount of a decedent with a surviving spouse is <u>the lesser</u> of the following amounts — (i) the basic exclusion amount in effect in the year of the death of the decedent; or (ii) the excess of— (A) the decedent's applicable exclusion amount; over (B) the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under Code § 2001(b)(1).[74] Temp. Reg. § 20.2010-3T(b) has special rules when the decedent dies having had multiple predeceased spouses and "previously-applied" DSUE amounts

G. **Gift Tax Credit**

Code § 2505 is titled "unified credit against gift tax"; we will use the term "gift tax credit" to mean such credit.

H. **Last Deceased Spouse**

Under the Code, the phrase "Last Deceased Spouse" to refer to the person who predeceased the decedent and at the time of such person's death was married to the decedent.[75] The term defined in Temp. Reg. § 20.2010-1T(d)(5) is similar.[76] However, the Portability Regulations go further to refine the definition depending upon the particular circumstances when attempting to determine the applicable exclusion amount of the surviving spouse during life[77] and at death.[78] We discuss the nuances of the difference below. The following example generally explains the concept of the "last deceased spouse".

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70 Code § 2010(c)(4); and Temp. Reg. § 20.2010-1T(d)(4); -2T(c) and -3T(b). The definition provided in the Regulations is very different than what the authors would have expected just by a literal statutory reading. This definition is very taxpayer friendly, and it eliminates a number of issues that the authors were concerned about in *Portability – Part One*. We will examine the new regulatory definition throughout this paper.

71 Code § 2010(c)(4)(B)(i), as amended by ATRA 2012.

72 Code § 2010(c)(4)(B)(ii).

73 Temp. Reg. §20.2010-1T(d)(4).

74 Temp. Reg. § 20.2010-2T(c)(1)

75 Code § 2010(c)(4)(B)(i).

76 In fact, the Portability Regulations make it clear that the identity of the last deceased spouse remains unchanged merely by a remarriage or subsequent divorce. Temp. Reg. § 20.2010-3T(a)(3).

77 Temp. Reg. § 25.2505-2T.

78 Temp. Reg. § 20.2010-3T.

Example 12: H1 and W were married. H1 dies. At that point in time, H1 is W's last deceased spouse. Subsequently, W marries H2. At the time of W's marriage to H2, H1 continues to be W's last deceased spouse. Should H2 predeceases W, then H2 steps into the shoes of H1 and becomes W's last deceased spouse.[79]

Before the issuance of the new regulations, as we discussed in our original paper, *Portability – Part One*, the last deceased spouse rule could have caused a number of technical issues, including the possibility of "portability recapture." Under Treasury's new regulations, the last deceased spouse rule does not cause that problem anymore.

I. **Internal Revenue Code**

References to "Section" are to the Internal Revenue Code of 1986, as amended.

J. **Regulations**

References to "Regulations" are to the Treasury Regulations, issued under a section of the Code. When referring to the portability Regulations, we will use the term "Temp. Ref. §", which will precede the particular Regulation section. And in generally, we will refer to the temporary and proposed Regulations under Code § 2010(c) as the "Portability Regulations."

K. **"section"**

The term "section" without a capital "S" (unless the text requires capitalization or clearly states otherwise) is generally reserved for reference to sections in this paper.

[79] This example is based on Example 2 on page 555 of the General Explanation of the Tax Legislation Enacted in the 111th Congress, which was prepared by the staff of the Joint Committee on Taxation ("JCT") on March 2011, which is commonly referred to as the JCS-2-11. The website link is: http://www.JCT.gov/publications.html?func=startdown&id=3775. This