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PORTABILITY:
Temporary Relief from a Loss of Exclusion

Thomas W. Abendroth
Schiff Hardin LLP
Chicago, Illinois 60606
(312) 258-5501
tabendroth@schiffhardin.com

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THOMAS W. ABENDROTH is a partner in the Chicago law firm of Schiff Hardin LLP and Practice Leader of the firm's Private Clients, Trusts and Estates Group. He concentrates his practice in the fields of estate planning, federal taxation, and business succession planning. Tom is a 1984 graduate of Northwestern University School of Law, and received his undergraduate degree from Ripon College, where he currently serves on the Board of Trustees. He is co-author of a two-volume treatise entitled *Illinois Estate Planning, Will Drafting and Estate Administration*, and also has co-authored a chapter on sophisticated value-shifting techniques in the book, *Estate and Personal Financial Planning*. He is co-editor of *Estate Planning Strategies After Estate Tax Reform: Insights and Analysis* (CCH 2001). Tom has contributed numerous articles to industry publications, and serves on the Editorial Advisory Board for *ABA Trusts & Investments* Magazine. He is a frequent speaker on tax and estate planning topics at banks and professional organizations. In addition, he is a co-presenter of a monthly teleconference series on estate planning issues presented by the American Bankers Association. Tom has taught at the American Bankers Association National Graduate Trust School since 1990. He is a Fellow of the American College of Trust and Estate Counsel.

PORTABILITY: TEMPORARY RELIEF FROM A LOSS OF EXCLUSION[1]

Thomas W. Abendroth
Schiff Hardin LLP
Chicago, Illinois

I. Introduction

A. For over 30 years, taxpayers and estate planning practitioners have dealt with the extra planning necessary to ensure that both spouses' applicable exclusion amounts are used.

B. A married couple must use a non-marital, or credit shelter, trust to take advantage of the applicable exclusion at the death of the first spouse to die. They often also must retitle their assets, to ensure that each spouse has separate assets to utilize the exclusion.

C. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (hereinafter the "Tax Relief Act of 2010" or the "2010 Act") provided an alternative to these planning steps - the ability of the first spouse to die to transfer his or her unused exclusion amount to the surviving spouse. The exclusion has become portable; hence, "portability."

D. Portability is very much still a drug in clinical trials. Unless Congress extends it, the provision allowing portability will sunset on December 31, 2012. Moreover, during this "trial period" we are learning that portability entails its own complex planning considerations. Portability may prove to be an attractive alternative remedy for clients. But it is unlikely to cure all the ills that require consideration of the marital planning we have engaged in for the last 30 plus years.

II. A Short History of the Estate Tax Exclusion and Planning to Utilize It

A. Key Developments in the Unified Transfer Tax System

1. Since enactment of the Tax Reform Act of 1976, the federal estate and gift taxes have been assessed using a single tax rate table under which all lifetime taxable transfers and all taxable transfers at death are considered together. The 1976 Act also added Section 2010 to the Internal Revenue Code (the "Code") creating a unified credit against the estate and gift taxes that exempts a certain

[1] This outline is based on "Portability: The New Estate Planning Wonder Drug?" presented by Thomas W. Abendroth at the 46th Annual Heckerling Institute on Estate Planning, and is used with the permission of the University of Miami.

amount of property from the tax. The credit is now identified in the Code as the applicable credit amount. The amount sheltered by the credit is the applicable exclusion amount. IRC § 2010(a), (c).

2. The Economic Recovery Tax Act of 1981 brought about the unlimited marital deduction, in effect enacting a policy that the federal government would expect payment of estate tax only once for a married couple. A couple could choose to defer estate tax until the death of the survivor by leaving property at the death of the first spouse to die to the surviving spouse.

3. These two changes to the estate tax system left married couples with a choice. They could take the easy route, leave all property at the first death to the surviving spouse, and defer but not necessarily avoid or minimize estate tax. Or they could create a separate credit shelter trust to utilize the first spouse's exclusion amount. Most couples with knowledgeable counsel chose the latter option. The A/B estate plan with an optimum marital deduction, as we know it today, became an integral part of estate planning.

4. In separate property states, the retitling of assets in order to use the exclusion regardless of the order of deaths also became part of planning. It was less of an issue at first because of the size of the exclusion. With increases to the exclusion over time, it has become an increasingly challenging part of marital planning.

5. From 1977 to 2001, the applicable credit and effective exclusion amounts changed as follows:

Year	Applicable Credit Amount	Applicable Exclusion Amount
1977	$30,000	$131,000
1978	34,000	144,333
1979	38,000	157,666
1980	42,500	172,666
1981	47,000	187,666
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987-1997	192,800	600,000
1998	202,050	625,000
1999	211,300	650,000
2000-2001	220,550	675,000

6. The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for a further increase of the applicable credit amount from $345,800 to $1,455,800, followed by suspension of the estate tax in 2010. The Tax Relief Act of 2010 brought the final changes to the amounts through 2012.

Year	Applicable Credit Amount	Applicable Exclusion Amount
2002-2003	$345,800	$1,000,000
2004-2005	555,800	1,500,000
2006-2009	780,800	2,000,000
2009	1,455,800	3,500,000
2010 (opt-out)	No tax	No tax
2010 (opt-in)	1,730,800	5,000,000
2011-2012	1,730,800	5,000,000

B. Traditional Planning Challenges

1. Resistance to A/B estate plans and the use of credit shelter trusts has not been a major issue for estate planning professionals. For the most part, clients accept the concept, and readily grasp the benefits of credit shelter trusts, both the tax benefits and the general planning advantages of a trust that can benefit both spouse and descendants while insulating the property from misuse.

2. Many clients are reluctant to retitle assets to accommodate future use of the exclusion, however. In community property states, the operation of those laws often provides an automatic solution. Asset titling remains a regular issue in separate property states. There are two overlapping challenges in convincing clients that a more equal division of assets is worthwhile.

   a. First, the spouse with the larger estate may not want to give assets to his or her spouse for personal reasons. These doubts may arise from concern over possible divorce, the spouse's spending habits, or for other reasons.

   b. Second, the couple may strongly oppose the administrative inconvenience of creating additional accounts.

3. Estate planning professionals have many options in responding to the concerns of clients. The responses each have their own drawbacks, however.

C. Retained Controls on Assets

1. Lifetime QTIP Trust. In situations where the wealthier spouse wants to retain control, a lifetime QTIP trust can be used. A gift to a lifetime QTIP trust qualifies for the marital deduction. The trust gives the donee spouse assets that will be included in his or her estate and that can be sheltered with that spouse's applicable exclusion.

    a. The spouse must receive all of the trust income from a QTIP trust, but the spouse's access to principal can be controlled by the trustee, or denied entirely. Most important, as with a testamentary QTIP trust, property held in a lifetime QTIP ultimately passes at the death of the spouse as the donor of the property prescribes.

    b. A lifetime QTIP trust can give the donor spouse an interest in the trust after the donee spouse's death, assuming the donor spouse survives. The QTIP regulations state that a trust interest for the donor spouse after the donee spouse's death will not cause the trust to be included in the donor's estate under Section 2036(a). Treas. Reg. § 25.2523(f)-1(d) and (f), Examples 9, 10 and 11.

    c. Perceived drawbacks of a lifetime QTIP are that it grants the donee spouse an income interest that cannot be terminated in the event of divorce, it requires a separate trust and trust account, and in many cases, the donor spouse should not act as trustee.

2. Joint Trust. One technique used by some practitioners in separate property states to solve the problem of providing each spouse with an estate at least equal to the applicable exclusion amount is the joint revocable trust. This is a revocable living trust created by husband and wife together and funded with all the couple's property. It is similar to the form of trust routinely used in community property states. The trust agreement can provide that all of the couple's property held in the trust will be treated as owned one-half by each, with each spouse having separate control over that share. If the total property in the trust exceeds twice the applicable exclusion amount, each spouse will have property with a minimum value equal to the applicable exclusion amount.

    a. An alternative is to provide that at the death of the first spouse to die, that spouse will have some form of general power of appointment over all or substantially all the trust property that causes inclusion of the property in that

spouse's estate. A portion of that property is then used to fund the non-marital trust. Regardless of which spouse dies first, the applicable exclusion amount can be allocated to the non-marital trust.

b. From a control standpoint, the wealthier spouse may feel comfortable with joint ownership through a joint trust. The less wealthy spouse still must have authority over his or her share of the trust, including power to withdraw that property, but day-to-day administration can be handled largely by one spouse.

c. The joint trust may be undesirable to the client because the wealthy spouse does not want to grant any authority to the less wealthy spouse. The attorney also may be uncomfortable with drafting a joint trust in a separate property state.

3. <u>Revocable Trust With Testamentary Power of Appointment Given to Less Wealthy Spouse</u>. Letter Rulings 200604028 (January 27, 2006) and 200403094 (January 16, 2004) have described a variation on the joint trust approach and a novel solution to the problem of control while still using the less wealthy spouse's applicable exclusion amount. In the rulings, husband created a revocable trust and transferred property held in his separate name to the trust. He retained the power to amend or revoke the trust and to withdraw assets until his death. He then proposed to give his wife, if she predeceased him, to have a testamentary general power to appoint assets of the trust equal to the value of her remaining applicable exclusion, less any property she separately owned.

a. First, the IRS concluded that, despite the fact that the transfer will occur at the moment of the wife's death, the amount over which the wife exercises her testamentary power will be treated as a gift from her husband that will qualify for the marital deduction.

b. The IRS then confirmed that wife's general power of appointment would cause those assets subject to the power to be includable in her gross estate, and thereafter those assets would be treated as coming from her. Therefore, the assets could pass to a non-marital trust for the benefit of the husband and descendants. The husband would not be treated as having a retained interest in the non-marital trust (even though the assets were his until the moment of his wife's death). In addition, the husband would not be treated

as making any gifts to his descendants by virtue of their interests in the non-marital trust.

c. If husband died first, his revocable trust contained provisions for setting aside his applicable exclusion amount in a non-marital trust for the wife and descendants, with the remainder passing as marital deduction property. Thus, the proposed trust would allow whichever spouse died first to fully use his or her applicable exclusion amount.

d. Practitioners have been reluctant to rely on this option based on these two isolated private rulings.

D. Asset Retitling

1. Tenancy-in-common ownership. For couples who favor joint ownership and do not want to create separate accounts to ensure use of their applicable exclusion amounts, one possible solution is to change the title of assets from joint tenancy with right of survivorship to tenancy-in-common. Both forms of ownership allow husband and wife to own the property jointly, with each having an undivided one-half interest. However, property owned tenancy-in-common does not pass by operation of law to the survivor. Instead, the deceased spouse's one-half will pass under his or her estate plan.

EXAMPLE: Martin and Marian have assets of $7,000,000, with a majority of the property owned either by Martin or by Martin and Marian as joint tenants. Their assets include a $2,000,000 home and a $1,000,000 bond account, both owned in joint tenancy. They change title on both assets to tenancy-in-common. Marian now has an additional $1,500,000 that can pass under her estate plan.

a. When recommending title changes like this, the estate planning professional should be sure the clients understand what happens at the first death. If Marian dies first and one-half of the home passes to a credit shelter trust for Martin, he may react adversely to not owning 100% of the home himself.

b. Many financial institutions accommodate estate planners and clients by providing the alternative of a tenancy-in-common account between the couple's revocable trusts. This allows the couple to hold investments in one account, in a form that will avoid probate. Each trust owns an undivided one-half interest in the account. At one spouse's

death, one-half the assets from the account are segregated in a separate account and then used to fund the marital and nonmarital trusts.

2. Holdings Trust. When there are assets for which a tenancy-in-common account is not feasible, an alternative is for the husband and wife, as trustees of their revocable trusts, to create a "holdings trust" that in effect acts as a nominee title holder for the other two trusts.

a. The holdings trust is a simpler alternative to using a traditional business entity, such as a partnership or LLC. Unlike a limited partnership or LLC, the trust does not have to be organized through the state Secretary of State's office, and it is not subject to annual filings with the state. Because husband's and wife's revocable trusts each are grantor trusts, the holdings trust can also be treated as a grantor trust and no separate tax reporting is necessary.

b. The holdings trust provides a useful solution where the couple is using an investment manager or custodian who is not able or willing to create tenancy-in-common accounts. It also is attractive for privacy purposes. Many institutions today request a full copy of an individual's revocable trust in order to create an account in the trust name. If the trust is a simple holdings trust created by the spouses as trustees of their revocable trusts, the clients do not have to make available the documents that contain the specifics of their estate plan.

III. Summary of Portability Provisions

A. Basic Provision and Scope

1. Section 2010 of the Code, as amended by Sections 302(a)(1) and 303(a) of the Tax Relief Act of 2010, is reproduced in Exhibit A to this outline. It creates portability by introducing the concept of "deceased spousal unused exclusion amount" ("DSUEA"). Section 2010(c)(2) defines the applicable exclusion amount as "the sum of (A) the basic exclusion amount, and (B) in the case of a surviving spouse, the deceased spousal unused exclusion amount."

2. The JCT Technical Explanation for the 2010 Act describes the new provision as follows:

"Under the provision, any applicable exclusion amount that remains unused as of the death of a spouse who dies after

December 31, 2010 (the 'deceased spousal unused exclusion amount'), generally is available for use by the surviving spouse, as an addition to such surviving spouse's applicable exclusion amount."

Staff of the Joint Committee on Taxation, 111th Cong., 2d Sess., "Technical Explanation of the Revenue Provisions Contained in the 'Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010' Scheduled for Consideration by the United States Senate," (JCX-55-10) pgs. 51-52 (Dec. 10, 2010) ("JCT Technical Explanation").

EXAMPLE: Janet Jones dies in 2011, and a total of $500,000 of assets pass under her estate plan to a nonmarital trust for her husband, John Jones. Janet's executor elects to have her $4.5 million of unused exclusion amount transferred to John. If John took no further action and died in 2012, he would have a total of $9.5 million of applicable exclusion amount that could shelter property from estate tax.

3. Portability is available without regard to the size of the estate of the decedent or the reason for the decedent having unused exclusion amount.

    a. A decedent with a $2 million estate, all left in taxable form, leaves $3 million of exclusion that is portable.

    b. A decedent with an $18 million estate, who leaves $2 million to his children and $16 million to his spouse and charity, also leaves $3 million of unused exclusion that is portable.

4. The definition of applicable exclusion amount also applies for gift tax purposes. The 2010 Act amended Code Section 2505 (Unified Credit Against Gift Tax) to define the credit for gift tax purposes by reference to "the applicable credit amount in effect under section 2010(c) which would apply if the decedent died as of the end of the calendar year." Thus, a surviving spouse may use his or her enhanced applicable exclusion amount for gifts.

5. Portability does not apply to the GST exemption. Section 2631(c), as amended by the 2010 Act, defines the GST exemption amount as equal to "the basic exclusion amount under section 2010(c)."

6. The basic exclusion amount is $5,000,000 and is adjusted for inflation beginning in 2012. IRC § 2010(c)(3). The expected basic exclusion amount in 2012 is expected to be $5,120,000. The

examples and discussion in these materials will ignore the inflation adjustment to the basic exclusion amount.

B. Deceased Spousal Unused Exclusion Amount

1. Section 2010(c)(4) defines the deceased spousal unused exclusion amount as the lesser of (i) the basic exclusion amount, and (ii) the unused portion of the basic exclusion amount of the last deceased spouse of such surviving spouse.

2. Only the unused exclusion for a deceased spouse dying after December 31, 2010 is considered. The unused exclusion of a spouse who died before that date cannot be used by the surviving spouse.

3. The DSUEA is not adjusted for inflation.

4. The statute limits the surviving spouse to use of the unused exclusion of his or her <u>last deceased spouse</u>. This limitation applies regardless of whether the last deceased spouse has any unused exclusion or whether the last deceased spouse's executor makes or fails to make a timely election. <u>See</u> JCT Technical Explanation, pg. 52, note 57 (Dec. 10, 2010).

5. The JCT Technical Explanation provides the following two examples to illustrate portability and the application of the "last deceased spouse rule":

"<u>Example 1</u>: Assume that Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount or unused exemption. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's exemption is $7 million (her $5 million basic exemption plus $2 million of Husband 1's unused exemption), which she may use for lifetime gifts or for transfers at death."

<u>Example 2</u>: Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's unused exemption. Although the combined amount of unused exemption of Husband 1 and Husband 2 is $3 million ($2 million for Husband 1 and $1 million for Husband 2), only Husband 2's $1 million unused exemption is available for use by Wife because the unused exemption is limited to the lesser of the basic exemption ($5

million) or the unused exemption of the last deceased spouse of the surviving spouse (here, Husband 2's $1 million unused exemption). Thereafter, Wife's exemption amount is $6 million (her $5 million basic exemption plus $1 million of Husband 2's unused exemption), which she may use for lifetime gifts or for transfers at death."

C. Election

1. The surviving spouse may use the unused exclusion amount of a deceased spouse only if the executor of the deceased spouse timely files a Form 706 for the deceased spouse and elects to make that spouse's unused exclusion portable. IRC § 2010(c)(5).

2. The election is irrevocable and must be made on a timely filed, complete estate tax return. Id.

3. Notice 2011-82, 2011-42 I.R.B. 516 (September 29, 2011), contains the Service's initial guidance on the election.

    a. The executor of the deceased spouse must file a complete Form 706 within the time prescribed by law (including extensions) even if a return is not otherwise required.

    b. The IRS will consider the election automatic if the Form 706 is filed. There will be no box to check. The IRS indicates that it might revise the Form 706 to expressly contain a computation of the unused exclusion amount. Until it does, the completed Form will be deemed to contain the computation.

    c. If the executor chooses not to make the portability election, the executor may do this by (1) not filing a Form 706 if the return is not otherwise required or (2) following the instructions on the Form 706 that describe the steps for not electing portability.

    d. The current Form 706 instructions for the return to be used for 2011 decedents states that the election not to grant portability can be made (1) by attaching a statement to the Form indicating that the election is not being made, or (2) by writing across the top of the first page of the form "No Election Under Section 2010(c)(5).

4. The Treasury may produce a more abbreviated Form 706 for estates for which the only purpose of filing is to make the election. However, Treasury could decide that filing the full Form 706 is

necessary, to enforce full reporting of assets and to document the use of the decedent's exclusion amount.

5. The Act provides that, if the portability election is made, there is no statute of limitations for examining the predeceased spouse's Form 706. The waiver of the statute is limited to determining the amount of unused exemption available to the surviving spouse. IRC § 2010(c)(5)(B), as added by Act § 303(a). Thus, if the normal statute of limitations under Code Section 6501 has expired, the IRS will not be able to adjust the deceased spouse's return and increase the tax due. It could, however, make adjustments to the return, such as by modifying the amount of adjusted taxable gifts, including additional assets or changing the valuation of certain assets, for the purpose of reducing the DSUEA.

IV. Conundrums and Matters Needing Clarification

A. DSUEA Portability

1. The last portability example in the JCT Technical Explanation provides as follows:

   "Example 3: Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's exemption is $7 million (her $5 million exemption plus $2 million unused exemption from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's unused exemption, which is $4 million (Wife's $7 million exemption less her $3 million taxable estate). Under the provision, Husband 2's exemption is increased by $4 million, the amount of Wife's unused exemption."

2. The example indicates that a surviving spouse who remarries can pass his or her full unused applicable exclusion amount, including any portion that is DSUEA, to a surviving spouse of the remarriage.

3. The statutory language itself (Code Section 2010(c)(4)) does not support this interpretation. Rather, it indicates that only the spouse's unused basic exclusion amount is portable:

   "the term 'deceased spousal unused exclusion amount' means the lesser of:

   (A) the basic exclusion amount, or

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

4. The limitation under Section 2010(c)(4)(B) refers to the deceased spouse's **basic exclusion amount** not to his or her **applicable exclusion amount**.

5. The Joint Committee has stated that the reference in Section 2010(c)(4)(B) to basic exclusion amount is an error:

"The provision adds new section 2010(c)(4), which generally defines 'deceased spousal unused exclusion amount' of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. A technical correction may be necessary to replace the reference to the basic exclusion amount of such last deceased spouse, so that the statute reflects intent. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the provision."

Joint Committee on Taxation, 111th Cong., 2d Sess., ERRATA – General Explanation Of Tax Legislation Enacted In The 111th Congress, (JCX-20-11) p. 1 (March 23, 2011) ("JCT ERRATA") (emphasis added).

6. Section 2010(c)(4)(B), as enacted, does have an illogical construction, in that it defines the DSUEA as the lesser of two limitations:

   a. The first limitation is the basic exclusion amount.

   b. The second limitation is the unused basic exclusion amount of the last deceased spouse.

   c. The second limitation can never exceed the first – unless one assumes that Congress was trying to address future reductions in the basic exclusion amount, and intended that any such future reduction should, if applicable, reduce the DSUEA of a surviving spouse. See Comments of The American College of Trust and Estate Counsel on Guidance on Electing Portability of Deceased Spousal Unused Exclusion Amount (Notice 2011-82) (www.actec.org/Documents/misc/Radford_Comments_Not

ice_2011-82.pdf) at 4-5, n.2 (October 28, 2011) (hereinafter "ACTEC Notice 2011-82 Comments").

7. Until this technical correction is made, estate planners cannot comfortably rely on Example 3. In light of the current state of deadlock in Congress and the fact that it is an election year, the likelihood of a near-term legislative solution is low. It may be that the IRS will provide clarity by regulation. Section 2010(c)(6) gives Treasury the authority "to prescribe such regulations as may be necessary or appropriate to carry out this subsection." However, Treasury may hesitate to address the issue given the specifity of the contrary language in the statute..

B. Order of Use of Exclusion

1. If Section 2010 is interpreted consistently with Example 3 in the JCT Technical Explanation, then the question of the order in which a surviving spouse uses her applicable exclusion amount should be irrelevant. It should not be necessary to separately track use of the surviving spouse's basic exclusion amount and DSUEA.

EXAMPLE: In Example 3 in the JCT Technical Explanation, Wife had exclusion of $7 million, consisting of her $5 million basic exclusion amount and $2 million DSUEA from Husband 1. If Wife makes a $3 million taxable gift, she has unused exclusion of $4 million remaining. If she makes a $5 million gift, she has exclusion of $2 million remaining. The source of the exclusion is not relevant.

2. If, however, the Treasury interprets Section 2010(c)(4)(B) as written, and there is no corrective regulation, then the exclusion that a spouse can pass on to a surviving spouse is determined only by reference to his or her basic exclusion amount, and cannot include any DSUEA held by that spouse. In that case, the order in which exclusion amounts are used is critical.

EXAMPLE: Same facts as prior Example, with Wife possessing $7 million of exclusion, $2 million of which is DSUEA. Wife makes a $3 million taxable gift. She is assumed to use her DSUEA first, so she has $4 million of basic exclusion amount remaining after the gift. If Wife dies and leaves her entire estate to Husband 2, her executor can elect to pass her $4 million of applicable exclusion to Husband 2.

EXAMPLE: Same facts as prior Example, except that Wife is assumed to use her basic exclusion amount first for a taxable gift. Wife's $3 million taxable gift leaves her with $2 million of unused

basic exclusion amount and $2 million of DSUEA. If Wife dies and leaves her entire estate to Husband 2, her executor can elect to pass only $2 million of unused basic exclusion amount to Husband 2.

3. The other possible options for ordering are to allow the donor to elect which exclusion to use first, to require use of basic exclusion amount and DSUEA equally, or to require proportionate use. Proportionate use in the above examples would mean Wife's $3 million gift consisted of $2,142,857 of basic exclusion and $857,143 of DSUEA.

4. ACTEC's Comments on Notice 2011-82 encourage the IRS to require a surviving spouse to use DSUEA first because it is consistent with the concept behind portability of allowing a spouse to leave most or all of his or her property to the surviving spouse and allowing the survivor to handle all the lifetime tax planning. If the surviving spouse who received that additional property then makes gifts, she should be allowed to treat it as if she was making gifts of the property she received, sheltered by the DSUEA she received. See ACTEC Notice 2011-82 Comments, at 9.

C. Recapture Part 1 – Lifetime Gifts Followed by a New Last Deceased Spouse

1. In light of the possible future reduction in the applicable exclusion amount when the Tax Relief Act of 2010 provisions sunset, estate planning attorneys have been advising clients to use their applicable exclusion for lifetime gifts if possible. The same advice is operative for using applicable exclusion that includes DSUEA.

2. Here, the additional factor for a wealthy surviving spouse to consider is that the DSUEA he or she acquires may be reduced or eliminated entirely if he or she remarries and the new spouse also dies first. The new DSUEA may be smaller than the amount of DSUEA already used to shelter taxable gifts. Will the government recapture the excess DSUEA used at the death of that spouse?

3. The ACTEC Comments on Notice 2011-82 put the issue this way: "The question distills to whether the gift taxes that are offset with applicable exclusion amount attributable to DSUEA are treated as gift taxes payable under Section 2001(b)(2), even if that DSUEA is later reduced by remarriage and survival of a later spouse." ACTEC Notice 2011-82 Comments, at 12.

EXAMPLE: Wife receives $4 million of DSUEA from Husband 1, and has $9 million of applicable exclusion amount in total. Wife

makes $8 million of taxable gifts, sheltered by her exclusion. Wife later remarries Husband 2. Husband 2 dies before Wife and leaves his entire $10 million estate to his children. Wife's DSUEA is now 0. Wife dies with a taxable estate of $4 million and adjusted taxable gifts of $8 million. The tentative tax on her $12 million tax base is $4,180,800. Her applicable credit amount is $1,730,800.

4. Is the estate tax due for Wife in the foregoing example equal to $2,450,000 ($4,180,800 - $1,730,800)? Under this result, Wife in effect pays estate tax on the additional $3 million she transferred by gift without paying gift tax because of the DSUEA from Husband 1.

5. The alternative would be to treat the previously available DSUEA that the spouse used as gift taxes that would have been payable, and give a credit for that amount in calculating the Line 7 credit on the Form 706. With this treatment, Wife's estate tax return would calculate the tax due as follows:

3c	Taxable estate	$4,000,000
4	Adjusted taxable gifts	8,000,000
5	Add Lines 3c and 4	12,000,000
6	Tentative tax	4,180,800
7	Total gift tax payable	(1,050,000)
8	Gross estate tax	3,130,800
11	Allowable applicable credit amount	(1,730,800)
16	Net estate tax	$1,400,000

6. If the IRS adopts a recapture treatment, it could lead to estate tax obligations that exceed the decedent's estate. If Wife in the example above had a separate estate of $1 million, the tentative tax would be $3,130,800, and after the $1,730,800 exclusion, her estate would owe estate tax of $1,400,000. There is no mechanism for the estate to recover tax from the donees of the gifts.

7. The IRS also will need to clarify what happens if a surviving spouse has used all DSUEA from a predeceased spouse and then acquires additional DSUEA from a predeceased spouse in a subsequent marriage. In the foregoing example, what if Husband 2 left Wife $2 million of DSUEA? Presumably, Wife in no event could use more than $5 million of DSUEA in the aggregate (because of the Section 2010(c)(4)(A) limitation) but having previously received and used $4 million of DSUEA from Husband 1, could she use an additional $1 million from Husband 2?

D. Recapture Part 2 – Reduction in Applicable Exclusion

1. All taxpayers face the question, still unanswered, of what happens if the $5 million applicable exclusion amount is reduced after the taxpayer has used part or all of it for lifetime gifts? Will transfer tax on the transfer sheltered by the previously higher exclusion be recaptured at death or will the taxpayer receive "credit" for the previously used exclusion? This issue could arise because Congress allows the Tax Relief Act of 2010 to sunset, or because Congress passes legislation to lower the exclusion, for example to $3.5 million. It is being referred to as "clawback."

   EXAMPLE: John makes a $5 million gift in 2011, using his applicable exclusion amount. He dies in 2013, after the exclusion has reverted to $1 million and the top estate tax rate to 55% plus the 5% surtax on estates over $10 million. John has a $10 million estate. The tentative tax on John's estate is calculated on the $15 million tax base and is $8,140,800. John receives a credit for gift tax payable of only $660,000 ($2,390,800 tax payable on a $5 million gift, based on date of death rates, less applicable credit amount of $1,730,800 available in the year of the gift). The applicable credit amount in his estate is $345,800. John's estate owes estate tax of $7,135,000 ($8,140,800 - $660,000 - $345,800).

2. Most commentators view this result as a computational problem that will be corrected on the Form 706 if the applicable exclusion amount is reduced.

3. The same issue exists with a surviving spouse who received DSUEA. Section 2010(c)(4)(A) limits DSUEA to the basic exclusion amount. If the basic exclusion amount is reduced to $1 million or $3.5 million, but portability is preserved, a surviving spouse may have both his or her basic exclusion amount and the DSUEA reduced.

4. One would hope Congress or the IRS would address the clawback issue consistently and treat both reductions as not leading to recapture of taxes at death when the decedent had used the higher exclusion amounts during life.

E. Triggering Event for Change in DSUEA

1. It seems fairly clear that the event that causes a surviving spouse's DSUEA to change is the death of subsequent spouse, not remarriage or other intervening events.

2. Nevertheless, ACTEC has recommended that the IRS clarify this rule. ACTEC Notice 2011-82 Comments, at pgs. 11-12.

EXAMPLE: Husband received $2 million of DSUEA from Wife 1, who predeceased him. Husband previously made $5 million of taxable gifts. Husband marries Wife 2. While Wife 2 is alive, Husband may use the $2 million DSUEA to shelter additional taxable gifts.

3. The result should be the same regardless of Wife 2's available applicable exclusion. The fact that Wife 2 may have used all $5 million of her exclusion is not relevant. Husband and Wife 2 could divorce or Wife 2 could survive Husband. In either case, Husband's DSUEA will be the DSUEA from Wife 1.

F. QDOTs and Portability

1. The IRS will need to address the mechanics of portability when the surviving spouse is a U.S. resident but is not a U.S. citizen and the deceased spouse creates a qualified domestic trust ("QDOT") for that non-citizen surviving spouse.

2. Section 2056A(b) imposes estate tax on certain principal distributions from a QDOT, and on the remaining principal of the trust at the surviving spouse's death. In each case, the tax is computed as if the assets had been included in the deceased spouse's estate.

3. While it usually would make sense from a planning standpoint for a deceased spouse first to use his or her applicable exclusion amount before creating a QDOT for a non-citizen spouse, the Code does not require that.

EXAMPLE: Wife dies with an estate of $4 million, survived by Husband, who is not an U.S. citizen. They have no children. Wife leaves $1 million to her siblings and $3 million in a QDOT for Husband. Her executor files an estate tax return and elects portability for the $4 million of available exclusion.

4. In this case, is the DSUEA received by Husband reduced by any taxable principal distributions from the QDOT for his benefit? Should Husband not be allowed to use the DSUEA to the extent of the principal value of the QDOT? Should Wife not be allowed to elect marital deduction treatment and be forced to use her applicable exclusion on the QDOT for Husband?

5. The most logical result absent further desire by the IRS to regulate the arrangement is to treat the portability election as a use of the deceased spouse's applicable exclusion amount. As a result, in calculating the estate tax on taxable distributions from the QDOT in the preceding example, the trustee would start with the

assumption that the deceased spouse had a taxable estate of $5 million.

G. Calculation Anomalies

1. The enactment of the Tax Relief Act of 2010 has created a number of circumstances where transfer tax calculations need to be adjusted to bring about the proper results. So far, the IRS has addressed these with changes to the Forms. In some cases, clarifying regulations may be necessary.

2. One of these situations is the calculation of the DSUEA available from the last deceased spouse where that spouse has prior taxable gifts on which gift tax was paid, but also has available applicable exclusion amount because of later increases in the amount.

   EXAMPLE: Wife made a $2 million taxable gift in 2007, when the gift tax applicable exclusion amount was $1 million. Wife paid a gift tax of $435,000. Wife dies in 2012 and leaves a taxable estate of $2 million. The DSUEA available to Husband should be $2 million ($5 million basic exclusion amount less $1 million lifetime exclusion used and $2 million taxable estate).

3. Section 2010(c)(4)(B)(ii) states that the DSUEA is calculated by subtracting from the basic exclusion amount of the last deceased spouse "the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse." This seems to refer to Line 5 of the Form 706, which is before any credit for gift taxes paid or payable with respect to gifts. In the foregoing example, it arguably would reduce the DSUEA available to $1 million, clearly an unintended result.

H. Practical Issues Related to Portability Election

1. Notice 2011-82, providing guidance on the portability election, states that the executor of a decedent who intends to make the portability election must file "a complete Form 706 within the time prescribed by law (including extensions), ..."

2. Treasury officials have acknowledged informally that this requirement places a burden on estates of decedents that are not otherwise required to file an estate tax return. However, they have stated they must have information on the decedent's assets and prior taxable gifts to confirm the amount of DSUEA from that decedent, and that the information needs to be provided promptly, before records disappear. The filing of the estate tax return to make the election is a statutory requirement. The IRS has limited flexibility in addressing the requirement.

3. Practitioners continue to advocate for a short-form return for estates under the inclusion amount. ACTEC has recommended to the IRS that it develop guidelines for filing an abbreviated Form 706 for estates below the filing threshold. It has suggested that the IRS treat a return as sufficient to elect portability if it includes parts 1, 2 and 4 of Form 706, without additional schedules and attachments. ACTEC suggests that the IRS could require the surviving spouse to maintain records to substantiate the information reported, and that the IRS could provide the statute of limitations for audit of such a return remains open, for all purposes. ACTEC Notice 2011-82 Comments, at 21.

4. Some tax preparers are reporting that they are preparing the full Form 706, but not necessarily including all the supporting exhibits and data they would for a taxable estate. There is a risk of course that the IRS would audit the return and ask for more information, either following the decedent's death or at the time DSUEA is used by the surviving spouse. The more significant risk, however, is that the IRS would deny the portability election on the grounds the return is incomplete and therefore the election ineffective.

5. There also are many practical questions about the IRS statutory right to examine, after the limitations period has expired, the Form 706 of a predeceased spouse with respect to the amount of DSUEA claimed.

    a. It is conceivable that DSUEA might not be claimed until 20, 30 or even 50 years or more after a spouse died. Even if a full, very complete Form 706 was filed, the ability of the parties to provide additional support or proof for their positions will be hampered by the passage of time.

    b. The assignment of burden of proof, and the presumption of correctness, if any, assigned to a filed Form 706, will take on a great deal of importance.

V. Planning With Portability

A. Planning Through 2012

1. One of the only certainties about portability is that no married couple should rely on it for planning purposes while it still is possible that the provision will expire. Right now that uncertainty lasts through December 31, 2012. But no one should completely discount the possibility of Congress enacting another temporary extension of the transfer tax provisions, thereby extending the period during which portability should not be relied on.

2. Some practitioners have raised the question whether expiration of the portability provisions at the end of 2012 would clearly eliminate the DSUEA already obtained by a surviving spouse from a predeceased spouse who died before 2013.

3. Absent action by Congress, the sunset of the provisions of the Tax Relief Act of 2010 will eliminate DSUEA, except in cases where both spouses are deceased in 2011 or 2012.

    a. Section 304 of the Tax Relief Act of 2010 applies the sunset provision of EGTRRA to Section 301 to 303 of the 2010 Act, the estate and gift tax provisions, including portability.

    b. Under the sunset section, the Code provisions added or extended by the 2010 Act will not apply to estates of decedents dying, or gifts made, after December 31, 2012, and the Code will be administered as if the provisions had never been enacted.

4. Even though portability may expire, it would not be wise to ignore it, and fail to advise the executors and surviving spouses about using unused exclusion at the first death.

    a. Clearly the portability election should be recommended for estates where the couple is above or near the threshold for incurring tax.

    b. The decision whether to elect portability will be more difficult for estates well under the likely threshold for taxation. The up-front cost of preparing a Form 706 to make the election is not insignificant. It always is possible that assets might appreciate significantly during the surviving spouse's life, or that the surviving spouse will benefit from a major inheritance, or win the lottery. But in many cases, the realistic odds of such an event are minimal.

    c. If the deceased spouse lives in a state with a low state death tax threshold (e.g., New York or New Jersey) the estate may be filing a return anyway, and the incremental cost of preparing the federal return is minimal. Absent this situation, the client will need to weigh the pros and cons and decide.

B. Portability versus Credit Shelter Trust Planning – General Conclusions

1. If portability is made permanent, it will provide a simple alternative to traditional estate planning designed to fund a credit

shelter, or nonmarital, trust at the death of the first spouse to die. In most cases, however, it will prove to be an inferior alternative. Most well-drafted estate plans will continue to use nonmarital trusts and practitioners will work with clients on asset titling to facilitate the funding of those nonmarital trusts.

2. Portability would provide an excellent back-up to planned use of the applicable exclusion amount. In the frequent situations where a couple fails to fully implement asset retitling, or the size or nature of the assets prevents full use of the applicable exclusion amount at the first death, an election to use portability can save applicable exclusion that otherwise would be lost.

EXAMPLE: John and Janet Jones have $11.5 million of total assets. John owns $9 million of the total, Janet has $500,000, and they own their home, personal belongings and bank accounts, totaling $2 million, in joint tenancy. The Jones' attorney advises John to shift some assets to Janet's name. John moves an investment account and a parcel of undeveloped land he owns, but those assets total only $1.5 million. Janet dies unexpectedly. There are $2 million of assets in her name that can pass to the nonmarital trust. John could disclaim joint assets but does not want to create a probate or have their home pass other than to him. Janet's executor files a Form 706, and $3 million of DSUEA passes to John.

C. Advantages of Credit Shelter Trust Planning

1. Shelter of Appreciation and Income. The DSUEA is not indexed for inflation. A credit shelter trust creates the opportunity for future appreciation and income to increase the value of assets outside the estate.

EXAMPLE: Assume the same facts as the preceding example, except that John did transfer an additional $3 million of assets to Jane. At her death, her estate has $5 million of assets, all of which fund the nonmarital trust. John lives another 15 years, during which time the appreciation and retained income from the nonmarital trust average 4% per year. At John's death, the additional $3 million in the nonmarital trust grows to $5,402,830. Full use of the nonmarital trust has sheltered an additional $2,402,830 from estate tax.

2. Generation-Skipping Tax Planning. There is no portability of GST exemption. A couple who wants to maximize the amount of property held in long-term trusts for descendants will want to use credit shelter planning.

3. Impact of Remarriage. A risk with portability is that the surviving spouse will lose some or all of the DSUEA if he or she remarries and the second spouse also predeceases him or her. In addition, DSUEA is not cumulative. By contrast, the surviving spouse's remarriage does not impact the benefits of a credit shelter trust and the surviving spouse can accumulate multiple credit shelter trusts.

   EXAMPLE: John has survived Jane and is now a beneficiary with his children of a credit shelter trust holding $3 million. He also has $2 million of DSUEA from Jane. John marries Mary. Mary also predeceases John and leaves her entire $5 million estate to a trust for her family. John's DSUEA becomes -0-. The credit shelter trust is unaffected.

   EXAMPLE: Same facts as the preceding example except that Mary leaves her $5 million to a credit shelter trust for John and his children. John and his children are now beneficiaries of two credit shelter trusts funded initially with $8 million.

4. Protective Benefits of a Trust. A trust of course provides all the spendthrift protections that are at the core of estate planning. The trust assets are insulated from claims of creditors, are more protected if the surviving spouse remarries, and are better protected from misuse or misappropriation by the children.

   a. A decedent can achieve many of these benefits by creating a marital trust for the surviving spouse, who still can claim DSUEA.

   b. But if the taxpayer is going to the trouble of creating a trust under the estate plan, why not use a nonmarital trust, or at least a QTIP eligible trust for which no election would be made?

5. Avoiding Potential Audit Issues. If the credit shelter trust is funded with non-publicly traded assets that are difficult to value, the family can avoid risk of audit at the second death.

   a. The credit shelter trust also allows a family that owns a closely-held business to isolate voting control outside the estate, or divide a controlling interest so voting control does not end up in the hands of the surviving spouse.

      EXAMPLE: John owns a business that continues to do well and increase in value. Several years ago, John recapitalized the business and created classes of voting stock and nonvoting stock. He transferred 20% of the voting stock to an irrevocable trust and 40% to Jane. Jane

dies. Her estate plan leaves her voting stock to a credit shelter trust, of which John is trustee. At John's death, he is not considered to have voting control for estate tax purposes.

b. Finally, if the deceased spouse's estate is under the threshold for filing an estate tax return, but contains non-marketable assets, the value of which could be subject to question, the estate can avoid a potential audit by not filing the Form 706, as otherwise would be required to elect portability.

D. Advantages of Portability

1. Simplicity. As previously discussed, the main advantage of portability is simplicity. It allows a married couple to prepare a simple estate plan that leaves all property to the surviving spouse, while still preserving the deceased spouse's applicable exclusion amount.

2. Additional Basis Step-Up. The primary benefit of portability after simplicity is that assets passed to the surviving spouse will receive another step-up in basis at the surviving spouse's death, something not available for assets in a credit shelter trust.

a. The basis step-up is not a meaningful benefit in larger estates that otherwise are subject, or potentially subject, to estate tax. By definition, a large unrealized capital gain means significant appreciation. If portability was elected instead of using a credit shelter trust, that appreciation could result in making the estate of the surviving spouse taxable, or increasing the overall estate tax.

b. In estates of couples that clearly will be less than twice the applicable exclusion amount, the basis step-up has more appeal.

EXAMPLE: John and Jane each have estates of $3 million. If John dies and leaves his $3 million in a credit shelter trust for Jane, the trust assets will not receive a step-up in basis at Jane's death. John can leave the $3 million directly to Jane, and his executor can elect portability to avoid estate tax at Jane's death. All unrealized gain on the assets will be eliminated at Jane's death.

c. The problem with examples of the potential benefits of this second step-up is that they assume that the asset or assets

that pass to the credit shelter trust or surviving spouse are retained for the life of the surviving spouse.

d. This is likely to be true only if the assets are closely-held stock in a family business or real estate . These are exactly the type of assets that are difficult to value and subject to significant potential appreciation, both of which factors favor creation of a credit shelter trust.

e. By contrast, a portfolio of marketable securities in a credit shelter trust is likely to turn over during the surviving spouse's life. It may appreciate significantly during the life of the surviving spouse, but the unrealized gain at the surviving spouse's death may be a fraction of the appreciation.

f. In addition, practitioners already are exploring ways to draft credit shelter trusts to facilitate opportunities to obtain a basis step-up at the surviving spouse's death for appreciated assets in the trust (see the discussion in VI.B. below).

3. Use With Depreciating Assets. If the decedent's estate contains assets that likely will depreciate in value, then passing those assets to the surviving spouse is preferable to using them to fund a credit shelter trust. If most of the decedent's estate consists of these assets, then electing portability could be preferable to using a credit shelter trust.

a. This scenario is most likely to occur in an estate that consists mainly of retirement assets. Because the assets are income in respect of a decedent ("IRD"), they will shrink by the income taxes incurred as distributed, and they likely will need to be distributed more rapidly under the minimum distribution rules if allocated to a credit shelter trust.

b. The preferred disposition for many married couples is to leave retirement assets to the surviving spouse. A typical beneficiary designation names the spouse as primary beneficiary and the participant's revocable trust as contingent beneficiary. The spouse then can disclaim a portion of the retirement assets if they are needed to fund the credit shelter trust and the spouse and his or her advisors decide that increasing the funding is worth foregoing the income advantages of rollover by the spouse.

c. With portability, the surviving spouse can avoid the choice between maximizing estate tax benefits and maximizing income tax benefits.

EXAMPLE: John has a $5 million estate, with $3 million consisting of several rollover IRA accounts. John designates Jane as beneficiary of the IRA accounts. At his death, $2 million passes to a credit shelter trust, and the remaining $3 million of IRA accounts to Jane. John's executor elects portability. Jane dies with a separate estate of $6 million, including $2.5 million remaining in the IRAs (a decrease due to minimum distributions). She has applicable exclusion of $8 million consisting of her $5 million and $3 million of DSUEA from John.

E. Impact of State Death Taxes

1. States that have a separate death tax or state estate tax tied to the old federal state death tax credit have not enacted portability for state tax purposes.

2. If the state has an exclusion amount, a couple will forego use of that exclusion at the first death if they are relying entirely on portability.

   EXAMPLE: John and Jane are Illinois residents. Illinois has a $2 million exclusion amount in 2011. John has $6 million of assets and Jane has $3 million of assets. Their assets are not increasing in value and they want their estate plan to be as simple as possible. Pursuant to their estate plan, all of John's assets pass to Jane at his death in 2011. His executor elects portability and passes John's $5 million DSUEA to Jane. At Jane's death, her estate is $9 million. It is sheltered by her $10 million applicable exclusion amount. However, Jane's estate is subject to Illinois estate tax of $801,049.

   John's estate plan instead creates a $2 million credit shelter trust, a $3 million QTIP eligible trust for which state QTIP is elected but not federal QTIP, and a $1 million QTIP marital trust. At Jane's subsequent death, her estate for federal tax purposes consists of the $1 million QTIP marital trust and her separate $3 million. This is sheltered by her applicable exclusion amount and she owes no federal estate taxes. Her Illinois taxable estate also includes the $3 million state-only QTIP trust. The Illinois estate tax on her estate is $565,603.

3. In the foregoing example, the lack of Illinois exclusion planning has a cost of about $235,000. Portability may enable some

simplification in this situation, though. John's estate plan could create the $2 million credit shelter trust, and leave the remaining $4 million to a QTIP trust for, or outright to, Jane. His executor then could elect portability and pass $3 million of DSUEA to Jane. Jane has an estate of $7 million and has $8 million of exclusion amount. The Illinois estate tax would be $565,603.

VI. Predictions for a Portable Exclusion World

A. Changes Will Not Be Significant

1. For reasons discussed in the preceding pages, if portability is made permanent, it is unlikely to change estate planning for married couples in major ways.

2. It will be most attractive in smaller estates where the assets are unlikely to exceed twice the applicable exclusion amount.

    a. A couple in this demographic may wish to leave all the assets of the first spouse to die to the survivor, and rely on portability to avoid estate tax.

    b. The more important factor influencing a movement to simpler plans will be the size of the applicable exclusion amount. If it remains at $5 million, then just one exclusion amount will shelter the vast majority of estates even if there is no credit shelter planning. Couples can rely on portability to cover unanticipated increases in the value of the estate after the first spouse’s death.

    c. Consider, however, whether married couples and their advisors should become comfortable with the assumption that the exclusion will remain at a higher level. If the surviving spouse lives many years, there is an increasing likelihood of federal, or state, tax law changes that could negatively impact the surviving spouse’s estate, but which would not impact a credit shelter trust.

    EXAMPLE: John dies in 2012 with an estate of $3 million. Jane also has an estate of $3 million. John dies at age 72, leaves all his estate to Jane and his executor elects portability. Jane now has $6 million of assets and $10 million of applicable exclusion amount. Sixteen years later, when Jane is 88, Congress reduces the base exclusion amount to $2 million and increases estate tax rates. Jane’s estate is now taxable.

3. Clients whose estates will be taxable even with a $5 million exclusion should continue to use credit shelter planning, for the reasons previously discussed. Portability will provide a safety net to save any applicable exclusion amount of the first spouse to die because he or she lacks separate assets to fully use it.

B. Additional Flexibility for Credit Shelter Trusts.

1. Estate planning professionals are exploring ways to draft credit shelter trusts to capture some of the basis step-up that otherwise is available with portability at the surviving spouse's death.

2. This planning is not motivated by portability but primarily by the higher applicable exclusion. The higher exclusion will increase the number of situations where the surviving spouse's taxable estate will be significantly less than the exclusion. If assets from the credit shelter trust could be included in the spouse's estate without exceeding the exclusion, the additional basis step-up will reduce capital gains tax.

3. A number of papers and articles contain detailed discussions of the alternatives available for enabling the taxation of appreciated credit shelter trust assets in the estate of a surviving spouse. See, e.g., Zaritsky, "Portability: Getting Ready for Game Time," ACTEC 2011 Summer Meeting, at 10-21. Zaritsky suggests four options:

   a. Power in an independent trustee to make discretionary distributions from the credit shelter trusts to the spouse for the purpose of reducing income taxes.

   b. Discretionary power in a disinterested fiduciary to grant the spouse a general power of appointment over certain trust assets.

   c. An automatic grant of a general power of appointment by means of a formula.

   d. A grant of a non-general power of appointment in the surviving spouse trust that the spouse can exercise in a way to trigger Code Section 2041(a)(3) (the "Delaware tax trap").

4. As Zaritsky discusses in detail, all the options present certain challenges and disadvantages. Not the least of the disadvantages is that a power granted to save income taxes ends up being used by a trustee or surviving spouse in a way to divert assets away from the decedent's intended beneficiaries.

C. Gift Planning Using DSUEA

1. Lifetime gift planning to take advantage of DSUEA provides a number of intellectually interesting opportunities and challenges. In practice, it is most likely to be relevant where a lack of prior planning results in the surviving spouse having DSUEA.

   a. In smaller estates, the couple is less likely to be engaged in lifetime planning that will require consideration of lifetime use of the DSUEA available to the surviving spouse.

   b. In estates that clearly are taxable, there will be few situations where an estate planning professional would intentionally forego credit shelter planning to give DSUEA to the surviving spouse in order to enable lifetime planning opportunities.

   c. Nevertheless, estate planning professionals will have opportunities to consider gift planning options using DSUEA. Clients will seek advice late in the game or fail to implement advice given when both spouses are alive. Despite the efforts of the clients, the first spouse to die may not have sufficient assets to fully utilize that spouse's applicable exclusion amount.

2. A very wealthy surviving spouse, who can afford to make significant lifetime gifts, should treat DSUEA like the basic exclusion amount and use it as soon as possible, so that assets can start appreciating outside his or her estate.

   a. This is true even if the IRS ultimately determines that the gifts will result in additional estate tax at the surviving spouse's death if his or her DSUEA is later reduced due to the last deceased spouse rule.

   b. Any recapture will be based on the initial value of the gift. Any appreciation will escape tax.

   EXAMPLE: John survived his first wife Jane and received $3 million of DSUEA at her death. He had used his basic applicable exclusion amount during Jane's life. John now makes an additional $3 million gift in trust and uses the DSUEA. He subsequently remarries. His new wife Mary, dies before John, and her DSUEA is -0-. John dies 20 years after making the gift. At his death, the trust that received the gift has a value of $7 million. Under applicable IRS rules, the $3 million increases his taxable estate and his estate tax. However, the $4 million of growth in the trust has completely escaped taxation.

3. There will be cases where remarriage will allow a wealthy individual to take advantage of his or her new spouse's DSUEA.

   EXAMPLE: Jane is a widow with $3 million of assets and $10 million of applicable exclusion amount, including $5 million of DSUEA. Jane marries Mark, who has a net worth of $40 million. Mark proposes to Jane that he will make a $10 million gift to his children, which Jane will split with him. After the transfer, Jane has $5 million of exclusion, more than adequate to shelter the $3 million of assets she will leave to her children.

4. Clients who make significant gifts using DSUEA will need to carefully consider the possible impact on their estates if the tax benefits of the gift are recaptured at death because DSUEA is later reduced. The additional tax caused by the recapture may not be borne by the same beneficiaries who benefitted from the gift.

   EXAMPLE: Same facts as the previous example. Mark dies before Jane and has no DSUEA. Jane's DSUEA is now -0-. At her death, she has an estate of $3 million and has made $5 million of taxable gifts. Her applicable exclusion is $5 million. Her estate does not receive credit for the DSUEA she used in the split gift with Mark. The estate tax due in her estate is borne by her children.

5. A surviving spouse who makes a large taxable gift using his or her applicable exclusion and DSUEA runs a risk if he or she has remarried.

   a. The amount of the exclusion available for gift tax purposes is tied to the applicable credit amount under Section 2010(c) "which would apply if the donor died as of the end of the calendar year ...." See IRC § 2505(a)(1).

   b. If the donor's second spouse dies before the end of the year in which the gift is made, it may alter the amount of DSUEA available to shelter that gift. See Dunn, "Bypass the Bypass Trust?", Trusts & Estates 24, 26 (Feb. 2011).

      EXAMPLE: John is a widower with $4 million of DSUEA from his first wife, Jane. John has remarried Mary, who has a significant estate that she will leave to her children. In June, John makes a $9 million gift to his children, intending to shelter it with his applicable exclusion amount. In September, Mary dies. John's DSUEA is now -0-. For purposes of the gift, John has $5

million of exclusion, so $4 million of the June gift is taxable.

D. Other Planning Considerations With Remarriage

1. In premarital agreements, spouses might want to address the disposition of the benefit of DSUEA.

   a. A wealthier spouse could ask the less wealthy spouse to obligate her executor to file an estate tax return even if one is not required, in order to pass DSUEA to the wealthier spouse.

   b. The less wealthy spouse may wish to require the wealthier spouse to pay any costs associated with preparation of the return.

2. Even where there is no premarital agreement, spouses might agree that they will include a direction in their wills to require filing a Form 706 in order to elect portability of any unused exclusion.

VII. Conclusion

Portability may not even receive the tax equivalent of FDA approval. If it is not extended beyond 2012, these materials will go the way of presentations on the orphan's deduction and Section 2036(c). If portability becomes a permanent part of the Code, it will provide an attractive alternate treatment, but one that has its own challenging side effects.

EXHIBIT A

§ 2010. UNIFIED CREDIT AGAINST ESTATE TAX

(a) General rule
A credit of the applicable credit amount shall be allowed to the estate of every decedent against the tax imposed by section 2001.

(b) Adjustment to credit for certain gifts made before 1977
The amount of the credit allowable under subsection (a) shall be reduced by an amount equal to 20 percent of the aggregate amount allowed as a specific exemption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) with respect to gifts made by the decedent after September 8, 1976.

(c) Applicable credit amount
(1) In general
For purposes of this section, the applicable credit amount is the amount of the tentative tax which would be determined under section 2001(c) if the amount with respect to which such tentative tax is to be computed were equal to the applicable exclusion amount.

(2) Applicable exclusion amount
For purposes of this subsection, the applicable exclusion amount is the sum of—

(A) the basic exclusion amount, and

(B) in the case of a surviving spouse, the deceased spousal unused exclusion amount.

(3) Basic exclusion amount

(A) In general
For purposes of this subsection, the basic exclusion amount is $5,000,000.

(B) Inflation adjustment
In the case of any decedent dying in a calendar year after 2011, the dollar amount in subparagraph (A) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for such calendar year by substituting "calendar year 2010" for "calendar year 1992" in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10,000, such amount shall be rounded to the nearest multiple of $10,000.

(4) Deceased spousal unused exclusion amount
For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of—

(A) the basic exclusion amount, or
(B) the excess of—
(i) the basic exclusion amount of the last such deceased spouse of such surviving spouse, over
(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

(5) Special rules
(A) Election required

A deceased spousal unused exclusion amount may not be taken into account by a surviving spouse under paragraph (2) unless the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be so taken into account. Such election, once made, shall be irrevocable. No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return.

(B) Examination of prior returns after expiration of period of limitations with respect to deceased spousal unused exclusion amount
Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

(6) Regulations
The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this subsection.

(d) Limitation based on amount of tax
The amount of the credit allowed by subsection (a) shall not exceed the amount of the tax imposed by section 2001.

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