FLEXIBLE MARITAL DEDUCTION PLANNING

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TABLE OF CONTENTS

I. INTRODUCTION. 1
A. Nothing Could Be Simpler and More Treacherous. 1
B. One of the Great Misnomers. 1
C. Scope of the Outline.. 2

II. REQUIREMENTS FOR THE MARITAL DEDUCTION. 2
A. In General.. 2
B. Passing from the Decedent.. 3
C. To the Surviving Spouse. 4
D. Includible in the Client's Estate.. 5
E. Exceptions under Section 2056(b) of the Code - Terminable Interest Property. 6
1. General Rule. 6
2. Qualifying Bequests of Terminable Interest Property 7

III. TRADITIONAL MARITAL DEDUCTION/CREDIT SHELTER PLANNING. . . . 20
A. The Classic Marital Deduction/Credit Shelter Plan. 20
1. In General.. 20
2. Formula Bequests.. 21
3. Methods of Structuring Marital Deduction/Credit Shelter Planning. 22
B. Marital Deduction Funding Methods. 22
C. Pecuniary Formulas. 23
1. Preresiduary Credit Shelter 23
2. Preresiduary Marital.. 24
D. Fractional Share Formula.. 25
E. How to Select a Funding Method and Structure. 26

IV. NEED TO INCORPORATE FLEXIBILITY INTO MARITAL DEDUCTION/CREDIT SHELTER PLANNING. 27
A. Higher Applicable Exclusion Amount. 27
B. State Death Taxes. 27
1. States that Do Not Impose an Estate Tax.. 28
2. States that Impose an Estate Tax. 28

V. METHODS FOR INCORPORATING FLEXIBILITY INTO MARITAL DEDUCTION/CREDIT SHELTER PLANNING. 29

A. Building Flexibility into the Estate Plan. 29
1. Disclaimers.. 29
2. Partial QTIP Elections.. 34
3. Clayton (or Contingent Income) Trusts.. 36

VI. TAILORING THE USE OF FLEXIBILITY TECHNIQUES 40
A. Use Flexibility Techniques in Combination. 40
B. Combinations of Techniques Can Achieve Tax Savings and Ease Tensions. 40

VII. PORTABILITY. 41
A. No Longer New. 41
B. Simplification?.. 42
C. Transfer of Exclusion Amount.. 42

VIII. HOW PORTABILITY WORKS. 42
A. Requirements in the Code. 42
B. Regulations. 43
1. Making the Election.. 43
2. Computing the DSUE Amount. 46
3. When the DSUE Amount Can be Used.. 49
4. Definition of Last Deceased Spouse. 50
5. Ordering Rule and Effect in the Case of Multiple Deceased Spouses. 51
6. Authority to Examine Returns of Deceased Spouses 53

IX. ADVANTAGES OF PORTABILITY. 53
A. No Separation of Assets.. 53
B. No Loss of Basis Adjustment.. 54
C. No Trust Required. 54
D. Avoids Planning with “Difficult” Assets.. 54
E. Planning Opportunities in States with State Death Taxes. 54

X. DISADVANTAGES OF PORTABILITY.. 55
A. Future Growth. 55
B. Loss of DSUE Amount. 56
C. Unexpected State Estate Tax. 56
D. Complex Family Structures. 56
E. GST Exemption. 62

XI. APPLICATION OF PORTABILITY RULES.. 63

A. Married Couples with Modest Wealth. 63
B. The More Wealthy/Less Wealthy Couple. 64
C. Planning with Difficult Assets. 65
D. Portability Planning for Wealthy Clients. 66

XII. PORTABILITY AS A POST-MORTEM DECISION. 68
A. The Need for Flexibility.. 68
B. Effect of Portability. 69
1. The Effect of Portability on Disclaimers. 69
2. The Effect of Portability on Partial QTIP Elections. . 70
3. The Effect of Portability on Clayton Elections. 71

XIII. CONCLUSION. 71

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FLEXIBLE MARITAL DEDUCTION PLANNING

I. INTRODUCTION

A. Nothing Could Be Simpler and More Treacherous.

1. From an estate tax perspective, the marital deduction is simply a mechanism to permit the surviving spouse to have the benefit of a couple's assets until the death of the survivor of them, in recognition of the couple's combined estates as their economic unit. From a gift tax perspective, it permits transfers between spouses to occur without transfer tax consequences, again in recognition of the couple's assets as their economic unit.

2. A number of fairly technical rules apply to limit the applicability of this hugely generous estate tax deduction, and failure to abide by them can have disastrous consequences.

B. One of the Great Misnomers.

1. The marital deduction is one of the greater misnomers in the estate and gift tax usage: it is the marital deferral, not deduction, because it merely defers the estate tax until the death of the survivor of a marital couple. A charitable deduction for example, once taken, eliminates the transfer tax on that transfer for all time. The marital deduction will apply to protect from tax the assets of the first spouse to die when they are transferred to the surviving spouse, but those same assets (to the extent they are not spent) are taxed at the survivor's death.

2. Successful marital deduction planning includes planning for the use of the client's available applicable exclusion amount,[1] which when

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[1] Prior to the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRUIRJCA" or the "2010 Act"), § 2010(c) of the Internal Revenue Code of 1986, as amended (the "Code" or "IRC"), defined the applicable exclusion amount as a specific dollar amount stated in the section. As amended by TRUIRJCA, § 2010(c) now uses the term "basic exclusion amount" to refer to the specific dollar amount that can be sheltered from estate tax. The term "applicable exclusion amount" now refers to the sum of the basic exclusion amount and, in the case of a surviving spouse, any deceased spousal unused exclusion amount, as defined in § 2010(c)(4). For persons other than surviving spouses, the basic exclusion amount and

combined with the use of the marital deduction, may reduce the estate tax in the estate of the first to die to zero, while preserving the benefit of transferring assets that will not be subject to estate tax in the estate of the survivor.

C. Scope of the Outline.

1. Entire treatises have been devoted to the breadth of the topic of the marital deduction. This outline will focus primarily on the estate tax marital deduction.

2. Some topics that bridge the span of the marital deduction topic with other areas of estate, gift and generation-skipping tax planning have been left to others to cover. For example, this outline does not address marital deduction issues related to planning with retirement assets or the applicability of the marital deduction to the terms of a separation agreement in a divorce.

3. Finally, a substantial portion of the outline is devoted to planning with portability because, although it is a statutory technique, few provisions are included in the estate planning documents of a taxpayer who contemplates incorporating it into her estate plan; it truly is the silent partner of estate planning.

II. REQUIREMENTS FOR THE MARITAL DEDUCTION

A. In General.

1. Section 2056(a) of the Code provides that, except as limited by subsection (b), the value of a decedent's estate is reduced by the value of property passing from the decedent to her surviving spouse if the property is included in the value of the decedent's gross estate for estate tax purposes.

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the applicable exclusion amount are identical. The Tax Cuts and Jobs Act (P.L. 115-97) signed by the President (December 22, 2017) (the "2017 Act") increased the applicable exclusion to $11,000,000, indexed annually for inflation, currently $13,610,000. Absent a change in the law, the exclusion amount will remain at that level, adjusted for inflation in 2025, after which, in 2026, it will return to the prior $5 million, adjusted annually for inflation as though it had never been changed. All references in this outline to sections are references to sections of the Code, unless otherwise indicated.

2. A lot is packed into the few short lines that provide the most important deduction available to a married couple. Each requirement is reviewed below.

B. Passing from the Decedent.

1. This requirement is not complex; the decedent must have been the source of the property passing to the surviving spouse.

2. However, in cases where an estate is contested in some way, if a settlement ensues, the property may not be treated as having passed from the decedent.

a. Whenever a settlement agreement modifies the terms of a bequest otherwise passing to a surviving spouse, care must be taken to ensure that the modification is the *bona fide* resolution of enforceable rights in the estate among beneficiaries.[2] For example, if a spouse exercised his right of election against the decedent's estate, regardless of the terms of any bequest to the surviving spouse included in the decedent's Will, the assets passing to the surviving spouse pursuant to his right of election would qualify for the requirement that the property passed from the decedent and would qualify for the marital deduction. Alternatively, a consensual agreement among beneficiaries to permit a portion of the bequests passing to the children to instead pass to the surviving spouse would not meet the requirement. Many gray areas may occur when beneficiaries, including a surviving spouse, argue about an estate and it is the lawyer's task to be sure that the resolution of the disagreement carries adequate evidence of a *bona fide* controversy of rights in the estate.

b. A second pitfall is to be certain that, even when the controversy over the estate is *bona fide*, the terms of the share passing to the surviving spouse under the settlement agreement meet the other requirements for the marital deduction. For example, if in the example above, the agreement provides that the surviving spouse's share would be held in trust for his life and then pass to the other beneficiaries, if the terms of the trust do not meet the requirements for a trust eligible for the marital deduction, then even if the bequest is treated as passing from

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[2] Reg. § 20.2056(c)-2(d)(2).

the decedent, it is treated as passing in a manner that does not qualify for the marital deduction, discussed further below.

C. To the Surviving Spouse.

1. Again, although this may seem like a simple requirement (indeed much simpler now that same sex marriages qualify for the marital deduction), the wise attorney assumes nothing.

2. A client's marital status should not be taken for granted and is determined at the moment of death.

a. A client's marriage may not be respected under the law. Consider the possibility that a disgruntled beneficiary advises the Internal Revenue Service ("Service") that the decedent's marriage of many many years was not legal because the decedent never legally divorced her prior husband. Although the Service will not raise the issue of the validity of a marriage on its own,[3] once advised of an issue, they do indeed follow up and raise the issue on audit of the estate tax return.

b. Although direct inquiries into the validity of a client's marriage may be viewed as inappropriate or even rude, a good practice is to routinely request copies of significant documents from your client's past, including settlement agreements, prenuptial agreements, buy sell agreements, the estate tax returns of predeceased spouses, etc., even if obtaining them requires substantial follow up on your part. All of these documents can affect the availability of the marital deduction in your client's estate.

3. In the event that the decedent's Will includes a contingency that the surviving spouse must survive the decedent by a specified period of time in order to be treated as having survived the decedent, such a provision will not disqualify a bequest to the surviving spouse provided that such period does not exceed six months.[4]

4. Even if the decedent's marriage is valid, a surviving spouse must be a US citizen in order for a bequest to or for his benefit to qualify for the

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[3] *See* Rev. Rul. 67-442, 1967-2 C.B. 65.

[4] Section 2056(b)(3).

marital deduction, unless the bequest qualifies for the special exception under § 2056A of the Code that requires the bequest to be held in a Qualified Domestic Trust ("QDOT").[5]

(1) As the name implies, the QDOT includes provisions that ensure the value protected from estate tax by the marital deduction at the decedent's death will be subject to US estate tax at the death of the foreign surviving spouse, discussed further below.

(2) Unlike most requirements, citizenship of the surviving spouse is not determined on the date of death of the decedent if (i) the surviving spouse becomes a US citizen before the estate tax return is filed and (ii) he is a US resident for all of the period following the decedent's death until the estate tax return is filed. This permits a non-US citizen spouse to avoid the use of a QDOT if the spouse becomes a US citizen by that date.[6]

D. Includible in the Client's Estate.

1. As § 2056(a) states expressly, "estate" in this case refers to the client's estate for federal estate tax purposes, not for probate purposes.

2. Non-probate property passing to the surviving spouse by joint ownership, from insurance policies includible in the client's estate, from retirement plans of which the decedent was the participant are eligible for the marital deduciton.

3. In addition, property passing to the surviving spouse as the result of the decedent's exercise of a general power of appointment is eligible for the marital deduction even though the decedent was not the actual source of the property.

4. Property that was transferred by the decedent during life that is includible in the decedent's estate and passes to the surviving spouse

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[5] IRC § 2056(d).

[6] Reg. § 20.2056A-1(a)(1)(iii). Generally, an estate tax return must be filed within 15 months of the decedent's death (includes one automatic six month extension), giving the surviving spouse 27months in which to become a citizen (*see* discussion of QDOT's at II.E.2.d.).

will also qualify for the marital deduction. Includible property in a GRAT, QPRT, or an irrevocable life insurance trust to which a policy was transferred within three years of the decedent's death can qualify for the marital deduction if the surviving spouse's interest in the property meets the other requirements for the marital deduction, discussed below.

E. Exceptions under Section 2056(b) of the Code - Terminable Interest Property.

1. General Rule. No marital deduction is allowed for non-deductible terminable interest property. The definition of non-deductible terminable interest property is convoluted and introduces the concept that some terminable interest property is deductible.

   a. Terminable interest property is an interest in property that for some reason (the passage of time or the occurrence or non-occurrence of an event) will terminate. Two classic examples would be (i) a patent or royalty interest which is an interest protected under law only for a specified period of time or (ii) an interest passing to a surviving spouse that terminates and passes to children if the surviving spouse remarries.

   b. An interest that is includible in the decedent's estate is non-deductible if it is terminable and either purchased by the decedent's executor at her direction or passes to or for the benefit of someone other than the surviving spouse at the termination of the surviving spouse's interest. A life estate in property to a surviving spouse with the remainder to children is a classic example of a non-deductible terminable interest.

   c. A deductible terminable interest is an interest in property owned by a decedent that was terminable in the hands of the decedent (in other words, that is all the decedent ever owned in the property), because it does not pass to someone other than the surviving spouse at the decedent's death. If a decedent bequeaths her interest in a royalty stream to her surviving spouse, the interest will terminate at some point, possibly before the surviving spouse dies, but the spouse is given all that the decedent had to give and thus the interest qualifies as a deductible terminable interest.

   d. While these examples may seem clear and discrete, this is an area in which issues are easy to miss and in a large estate, the

failure to qualify a bequest for the marital deduction could result in an enormous amount of tax.

(1) Clearly, under the general rule, bequests in trust for the surviving spouse do not qualify for the marital deduction because the surviving spouse's interest would be a life interest or could permit others to enjoy the trust property in addition to the surviving spouse. However, several types of otherwise nondeductible bequests to trusts can qualify for the marital deduction if they meet specific requirements, discussed below.

(2) Of some help is the boilerplate provision included in well drafted wills[7] that the marital bequest cannot be funded with assets that do not qualify for the marital deduction if other assets that do qualify are available. This provision addresses the requirement of § 2056(b)(2) of the Code that if the estate includes an asset that does not qualify for the marital deduction but could be used to fund it, the value of the marital deduction is reduced by the value of the asset. For any estate where you did not draft the Will (!) that includes non-deductible property, be sure to check for this provision.

2. Qualifying Bequests of Terminable Interest Property.

a. Estate Trust. Any bequest in trust for the benefit of a surviving spouse that holds property otherwise qualifying for the marital deduction will be eligible for the marital deduction if, at the death of the surviving spouse the trust terminates and pays to the estate of the surviving spouse.

(1) This type of bequest actually does not fall within the terminable interest rules at all because the trust property does not pass to a third party at the death of the surviving spouse.

(2) For this reason, the terms of the trust during the surviving spouse's life time may vary broadly,

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[7] References to wills apply equally to revocable trusts and any other testamentary substitutes.

including terms that do not permit any distributions of any kind to the surviving spouse during his life.

(3) All of the trust property will be included in the surviving spouse's probate estate.

(4) For a trust to qualify as an estate trust, the surviving spouse is not permitted to hold a testamentary power of appointment because the Service has taken the position that the potential beneficiaries of the power of appointment would be third parties to whom property passes at the termination of the interest of the surviving spouse, thus making the trust property non-deductible terminable interest property.[8]

b. General Power of Appointment Trust.

(1) Under § 2056(b)(5) of the Code, a specific exception is carved out for bequests of an interest to or for the benefit of a surviving spouse of otherwise non-deductible terminable interest property. The purpose of this exception is to permit the property to be held in trust but also to make the benefits of the trust property accrue sufficiently to the surviving spouse to warrant the tax benefit of the marital deduction. The result of the requirements to the exception is that, even though the property is held in trust for the benefit of the surviving spouse, the surviving spouse will be taxed similarly as if the trust property were owned by the surviving spouse.

(2) The requirements to meet the exception are:

(a) All trust income must be distributed to the surviving spouse at least annually for life.

(b) No one other than the surviving spouse can be a beneficiary of the trust during the life of the surviving spouse.

[8] Rev. Rul. 75-128, 1975-1 C.B. 308.

(c) The surviving spouse must have a general power of appointment over the trust property that permits the surviving spouse to appoint the trust assets to himself or to his estate.

(3) The " all income" requirement and the "no other beneficiary" requirements are clear in meaning, but may inadvertently be violated by inclusion of provisions the client has requested (e.g., a direction not to distribute all income if the spouse remarries or a direction to pay the education expenses of the children). In addition, the Service has made clear that "income" is satisfied by the meaning of income under § 643(b), including income under an appropriate unitrust election. One final requirement is that income accrued but unpaid at the surviving spouse's death must be required to be paid to the surviving spouse's estate or be subject to a general power of appointment.

(4) To qualify the trust for the marital deduction, the general power of appointment must meet further requirements.

(a) Although the definition of a general power of appointment under § 2041 includes a power to appoint to the taxpayer, her creditors, her estate or the creditors of her estate, in order to satisfy the § 2056(b)(5) requirement, the power must be exercisable in favor of the spouse or his estate. A power to appoint in favor of the creditors of the spouse's estate would cause inclusion of the trust in the spouse's estate but would not qualify the trust for the marital deduction in the decedent's estate.

(b) In addition, the power may not include any substantive restrictions or contingencies on the surviving spouse's ability to exercise the power. It must be exercisable in any event without the consent of anyone else.

(c) Although an *inter vivos* general power of appointment may meet the requirements for the

marital deduction, inclusion of a testamentary power provides a reliable method of ensuring the requirement is met. Certainly, both types may be included if the client would like for the surviving spouse to be able to make transfers of the property in the trust during his life.

(d) Finally, to avoid a trustee's ability to limit income to the surviving spouse through investment in (or continuing to hold) non-income producing property, the spouse must have the right to require the trustee to invest in income producing property.

i) Care should be give to this issue in a general power of appointment trust in which a large percentage of its assets may be an interest in a family business for which the decedent would not want the surviving spouse to have the power to force a sale.

ii) Planning for an appropriate buy-sell agreement applicable to the decedent's estate and planning for a method to fund it may be the best course of action to avoid this result, if possible.

iii) Of course, so long as the family business produces a reasonable rate of return, this should not be an issue.

c. Qualified Terminable Interest Property Trust.

(1) Qualified terminable interest property ("QTIP") trusts were created under § 2056(b)(7) specifically to address the dilemma that a married testator, particularly one with children from a prior marriage, faced: should she provide for her surviving spouse - who then might not leave the testator's property to the testator's children at his death - or should she provide for her children from the prior marriage to be sure they would receive her

property - leaving the surviving spouse without maximum financial security.[9]

(2) Since both types of trusts for surviving spouses that qualified for the marital deduction (estate trusts and general power of appointment trusts) required that the surviving spouse have control over the ultimate disposition of the trust property, Congress created a special category of trusts as an exception to the terminable interest property rule that permitted property to be held in trust for the surviving spouse during his life with a remainder interest in the trust passing to the decedent's children or other objects of her bounty. If a trust meets the requirements for a QTIP trust, the bequest to the trust that creates a terminable interest in the surviving spouse will qualify for the marital deduction.

(3) The legislative difficulty with a trust designed in this fashion was that the surviving spouse may not have any interest in the trust that requires its value to be included in his estate at his death, permitting the trust to escape estate taxation altogether at the death of the surviving spouse. To address the need to tax the trust property in the surviving spouse's estate without giving the surviving spouse a power to dispose of the trust assets, the value of the trust is required to be included in the surviving spouse's estate under § 2044 if a marital deduction for the trust was elected to be taken in the decedent's estate.

(4) The requirements for a QTIP trust are similar to those of a general power of appointment trust to be sure that the surviving spouse has sufficient interests in the trust to warrant the marital deduction.

(a) The property must pass from the decedent.

(b) All of the income must be paid to the surviving spouse at least annually for his life. In addition,

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[9] *See*, *e.g.*, H. Rep. No. 97-201, 97th Cong., 1st Sess., at 159-60.

the spouse must have the right to make non-income producing property productive.[10]

(c) No one, with or without the consent of the surviving spouse, can receive a distribution from the trust other than the surviving spouse during the surviving spouse's lifetime.[11]

(d) An irrevocable election to qualify the trust for QTIP treatment must be made by the executor on the estate tax return.[12]

(5) QTIP treatment provides a number of advantages not available to other forms of marital bequests.

(a) Partial QTIP Election.

i) QTIP trusts offer an opportunity not available to any other form of marital bequest: an executor may elect to qualify only a portion of the bequest for marital deduction treatment. The elected part must be a fractional or percentile share of the trust. The balance remains in trust for the surviving spouse, but is subject to estate tax in the estate of the first spouse to die (unless protected from tax by the first spouse's applicable credit) and not in the estate of the surviving spouse.

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[10] Treas. Reg. §§ 20.2056(b)-7(d)(2) and 20.2056(b)-5(f)(4).

[11] Treas. Reg. §§ 20.2056(b)-7(d)(1) and 20.2056(b)-7(d)(6).

[12] IRC § 2056(b)(7)(B)(v). To reduce the number of returns on which the executor mistakenly failed to "check the box" on Schedule M of Form 706, the IRS has administratively reversed the presumption of the election, and a trust which qualifies as "QTIP-able" listed on Schedule M for which a marital deduction is taken qualifies as a QTIP trust "unless the executor specifically identifies the trust (all or a fractional portion or percentage). . . to be excluded from the election." *See* Form 706, Schedule M.

ii) The advantage of this flexibility is that it permits an executor to determine how large a marital deduction to take without changing the value of the assets passing from the estate for the surviving spouse's benefit.

iii) In considering whether to make a partial QTIP election, the executor can choose which of several approaches to take without incurring federal estate tax:

a) She can make an election that minimizes the marital deduction and takes full advantage of the decedent's available applicable credit amount to protect the non-elected portion of the marital trust from estate tax, which may require payment of some state estate tax in certain states.[13]

b) Alternatively, the executor can also decide whether it may be more advantageous to elect QTIP treatment for the entire trust, not use any of the decedent's applicable exclusion amount to protect the trust from estate tax, and take advantage of portability.

c) Finally, the executor can decide to make a partial election to have the marital deduction apply only to the amount of assets in the QTIP trust in excess of the

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[13] For example, in New York, the state estate tax exclusion amount currently is $6,940,000. Certainly, amounts in excess of this amount would be expected to attract state estate tax. However, in New York, if the taxable estate exceeds the New York exclusion amount by more than five percent, the New York exclusion amount is unavailable, subjecting the entire taxable estate to New York estate tax. NY Tax Law § 952.

amount that can pass free of state estate tax in states that impose a death tax.

(b) Reimbursement for Estate Taxes Paid by the Surviving Spouse's Estate

i) As noted above, the value of the QTIP trust will be included in the value of the surviving spouse's estate for estate tax purposes.

ii) Under § 2207A of the Code, the surviving spouse's estate has a right of reimbursement from the QTIP trust for the amount of the estate tax due from the surviving spouse's estate at the highest marginal rate (if tax brackets were to apply) as a result of the inclusion of the QTIP trust in his estate. Since the beneficiaries of the QTIP trust may not be the same as the beneficiaries of the surviving spouse's estate, this provision prevents the surviving spouse's beneficiaries from being required to pay any estate tax on assets that they will not receive.

iii) This right of reimbursement may be waived in the will of the surviving spouse, but the waiver is effective only if it specifically refers to the right of reimbursement.

iv) Note that, if the beneficiaries of the QTIP trust and the surviving spouse's estate are not identical, failure to exercise the right of reimbursement if it is not waived will result in a taxable gift by the beneficiaries of the survivng

spouse's estate to the beneficiaries of the QTIP trust.[14]

(c) Reverse QTIP Election.

i) Without digressing too deeply into generation-skipping transfer ("GST") tax issues, the general rule is that the transferor of a testamentary trust for GST tax purposes is the person in whose estate the trust was most recently subject to estate tax. It is the GST exemption of the transferor that may be allocated to a transfer to protect it from GST tax.

ii) This means that the surviving spouse at his death will be the transferor for GST tax purposes of assets in marital trusts created for his benefit since they are required to be included in the estate of the surviving spouse, thus potentially wasting GST exemption of the decedent.

iii) If the decedent's available GST exemption exceeds the amount of the decedent's remaining applicable exclusion amount,[15] the decedent is confronted with the choice of whether to:

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[14] Reg. § 20.2207A-1(a)(2).

[15] A bequest to or for the benefit of grandchildren can be made using the decedent's available applicable exclusion amount without attracting estate tax in the decedent's estate. Even though the amount of the decedent's basic exclusion amount and GST exemption initially are equal, rarely has the decedent used GST exemption for every gift she has made and she no longer has as much applicable exclusion amount as she does GST exemption remaining by the time of her death. As a result, if the decedent only bequeaths an amount equal to her available basic exclusion amount, she may have unused GST exemption remaining.

a) leave the maximum amount of her assets for the benefit of her spouse without incurring estate tax using a credit shelter trust and a QTIP trust, thus wasting her excess GST exemption, or

b) take maximum advantage of her ability to protect some of her assets for the benefit of her grandchildren without estate taxation in the hands of her children, but thus incurring some estate tax in her own estate on the amount not protected from estate tax by her applicable exclusion amount or the marital deduction.

iv) To permit the decedent to transfer her assets to a QTIP trust for the benefit of her surviving spouse and also permit the decedent to use fully her GST exemption to protect the remainder of the trust for the benefit of grandchildren, a special election is available that permits the decedent's executor to cause the decedent to be treated as the transferor of the QTIP trust and to allocate her GST exemption to the QTIP trust.[16]

a) If the total value of the assets passing to the QTIP trust exceeds the value of the decedent's GST exemption available to be allocated to the QTIP trust, to preserve efficient GST planning, two QTIP trusts must be created

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[16] IRC 2652(a)(3).

and the reverse QTIP election made for only one of them.[17]

b) The surviving spouse may then use his available GST exemption to protect the non-exempt portion of the QTIP trust or other bequests for the benefit of grandchildren.

c) In the event that two QTIPs are created, one exempt from GST tax and one not, the decedent's will should include two provisions:

1) A direction that any distributions of principal to the surviving spouse be made first from the non-exempt QTIP trust and

2) A direction that estate taxes payable from the QTIP trusts at the death of the surviving spouse be paid first from the non-exempt trust and, only if it is insufficient to cover all of the tax, then from the exempt trust.

(6) It is significant to note that if a trust includes a general power of appointment that qualifies under § 2056(b(5), the trust will be protected from estate tax by the marital deduction, but it will be treated as a general power of appointment trust, regardless of whether a QTIP election is made. Thus care must be taken when giving the surviving spouse rights of withdrawal during life

[17] As with all GST exemption allocations, this division should be made on a formula basis.

and powers of appointment at death to ensure that the advantages of QTIP treatment are available.

d. Qualified Domestic Trust.

(1) A QDOT for the benefit of the decedent's non-US spouse may be created under the terms of the decedent's Will or, for property bequeathed or otherwise passing directly to the surviving non-citizen spouse, the surviving spouse may create a QDOT for his own benefit and transfer the interests received from the decedent to the QDOT.[18]

(2) The election to treat a qualifying trust as a QDOT must be made on a timely filed estate tax return (including extensions) or, if filed late, on the first return filed no more than one year after the due date (including extensions).[19]

(3) The requirements for a QDOT include the requirements for an estate trust, general power of appointment trust or a QTIP trust with added requirements.

(a) At least one trustee must be a US citizen or domestic corporation;

(b) No distribution (other than a distribution of income which must be required unless an estate trust is used) may be made from the trust unless a US trustee has the right to withhold the estate tax due from the distribution.

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[18] Reg. § 20.2056A-2(b)(2) and § 20.2056A-4(b)(1). Note that if the surviving spouse creates the QDOT for his own benefit, the trust will be a grantor trust for income tax purposes. In addition, to avoid a gift to the remaindermen upon the creation of the QDOT, the surviving spouse should be given a special power of appointment over the remainder.

[19] IRC § 2056A(d). This actually gives the surviving spouse an additional 12 months (over the 15 months permitted for a timely filed estate tax return) to file an estate tax return on which a QDOT election could be made. If the surviving spouse has become a US citizen by that time, no QDOT would be required.

(c) Separate requirements apply depending on the size of the trust. If a surviving spouse is the beneficiary of multiple QDOTs all funded by the same spouse, the values of these trusts must be aggregated to determine the applicability of the different requirements based on size. QDOTs created in relation to a different spouse are not included.

i) If the trust will not have a value in excess of $2 million, the trust instrument must prohibit investment of more than 35% of the trust assets in off-shore real estate.

ii) If the trust value will exceed $2 million, either:

a) at least one US trustee must be a qualifying US bank or trust company or

b) the trust must furnish a bond or letter of credit equal to 65% of the value of the trust corpus.

iii) For purposes of determining the $2 million threshold and the 65% bond or letter of credit security requirement, up to two personal residences (one of which is the principal residence) and including furnishings, but not to exceed $600,000, may be excluded.[20]

(4) Taxation of QDOT's.

(a) Although all marital deductions are conceptually deferrals of estate tax, a QDOT is treated as a deferral of the decedent's actual estate tax until distributions (other than income as required) are made from the trust. It is as though, once

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[20] Reg. 20.2056A-2(d)(1)(iv).

distributed, that amount did not qualify for the marital deduction in the decedent's estate.

(b) The estate tax is due upon the earlier of:

i) The date the surviving spouse dies,[21]

ii) The date or dates when distributions of principal are made to the surviving spouse,[22] except distributions of corpus on account of hardship,[23] or

iii) In the event that the trust's status as a QDOT fails, such date of failure.[24]

(c) The payment of estate tax from the QDOT is treated as a distribution to the surviving spouse in the year in which it is paid, unfortunately triggering a potentially endless series of annual distributions for a distribution made during the life of the surviving spouse.

(d) In the event that the surviving spouse becomes a US citizen, the QDOT tax rules no longer apply[25] and, if the terms of the trust permit, the trustee may distribute the trust outright to the surviving spouse without imposition of the decedent's estate tax. The trustee is required to

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21 IRC § 2056A(b)(1)(B).

22 IRC § 2056A(b)(1)(A).

23 IRC § 2056A(b)(3)(B). Distributions are permitted for immediate and substantial financial needs for the health, education, maintenance, or support of the surviving spouse or anyone the surviving spouse is legally obligated to support to the extent that other resources are not reasonably available. These distributions must be reported to permit audit.

24 IRC § 2056A(b)(4).

25 IRC § 2056A(b)(12).

report that the surviving spouse became a US citizen.

III. TRADITIONAL MARITAL DEDUCTION/CREDIT SHELTER PLANNING

A. The Classic Marital Deduction/Credit Shelter Plan.

1. In General.

    a. To review, in its classic form the marital deduction/credit shelter plan carves out the amount of the client's available applicable exclusion amount[26] and bequeaths it to a trust for the benefit of her surviving spouse and children.

    b. The credit shelter trust can be structured in a variety of ways, the most flexible of which permits discretionary distributions of income and principal to be made among the surviving spouse and children, and, at the death of the surviving spouse, passes to the couple's issue, either *per stirpes* or pursuant to the surviving spouse's exercise of a special testamentary power of appointment.

    c. The balance of the estate passes to or for the benefit of the surviving spouse in a manner that qualifies for the marital deduction (*e.g.*, an outright bequest or a bequest to a QTIP trust).[27]

    d. At the death of the first spouse to die, no federal estate tax is due because a portion of the estate is protected by the applicable exclusion amount and the balance is protected by the marital deduction. At the death of the surviving spouse, the credit shelter trust is not includible in the surviving spouse's estate (assuming he has no rights in the trust that would make it includible in his estate) and the surviving spouse's available applicable exclusion amount protects as much as possible of the surviving spouse's assets and, if a marital trust was used,

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[26] The decedent's available applicable exclusion amount is equal to her basic exclusion amount plus any DSUE she may have, reduced by taxable gifts and other preresiduary specific bequests she has made.

[27] *See* IRC § 2056(b)(7).

those in the marital trust. Thus, the children receive the benefit of both spouses' applicable exclusion amounts.

2. Formula Bequests.

a. Since a client may have used some or all of her applicable exclusion amount making taxable gifts during her life, it may be impossible to know how much of it she will have at the time of her death, especially since the amount of the applicable exclusion amount is now indexed for inflation and currently is scheduled to be drastically reduced in 2026, and since the law relating to the estate tax has begun to change with such frequency.

b. Given such unpredictability, if a credit shelter bequest is included in the estate plan, it is prudent to express this bequest as a formula, rather than an exact number.

3. Methods of Structuring Marital Deduction/Credit Shelter Planning.

a. Preresiduary (pecuniary) credit shelter trust with the residue to the spouse or a marital trust;

b. Preresiduary (pecuniary) marital bequest (outright or to a marital trust) with the residue to a credit shelter trust; or

c. Fractional Share with division of the residue into two fractional shares, one of which is the size of the decedent's available applicable exclusion amount which passes to a credit shelter trust and the other of which is the balance which passes to the spouse or a marital trust.

B. Marital Deduction Funding Methods.

1. While the marital deduction/credit shelter plan appears simple on its face, it actually involves complex issues related to limiting the amount that can pass to the credit shelter trust. Congress and the Service have long been concerned that when a transfer tax benefit, through a deduction, credit, or exemption, is available, the value of the property protected by the benefit should not exceed the amount Congress intended. Estate planners, on the other hand, want to wring every possible drop of advantage they can from every tax benefit available for their clients.

2. As a result of the delay that occurs during the administration of an estate, assets usually are not worth the same value when the estate plan is funded as they were when the decedent died. If a credit shelter trust were funded with appreciated assets and a marital share were funded with slow-growing or depreciating assets, two would benefits occur. The credit shelter trust would protect more than its pro rata share of the total increase in the decedent's assets and the amount includible in the surviving spouse's estate would be minimized. A number of rules apply to marital deduction funding to limit this leveraging.

3. As a result, in designing a credit shelter/marital deduction plan, several decisions must be made: whether to use a pecuniary formula or a fractional share formula, whether to pay state estate tax, if applicable,[28] and the type of funding to use once that choice is made.

C. Pecuniary Formulas.

1. Preresiduary Credit Shelter (also known as reverse pecuniary marital): This approach uses a preresiduary formula bequest of a non-marital pecuniary amount (*e.g.*, the amount permitted to pass free of federal estate tax by reason of the applicable credit amount). This type of formula can be funded in two ways:

a. True worth funding, which is satisfied with assets valued at date of distribution. This approach permits the maximum "pick and choose" flexibility and is definitely the simplest to administer.

(1) True worth funding freezes the value of the pecuniary credit shelter amount which moves appreciation to the residuary marital if the estate increases in value and preserves the credit shelter amount if the estate decreases in value.

(2) However, one of the most significant disadvantages of this approach is that it requires recognition of gain or loss upon funding. A second related disadvantage is

[28] As discussed below, because many state estate tax laws are "decoupled" from the federal estate tax law, funding a preresiduary bequest with the largest amount that can pass free of federal estate tax may result in a state estate tax liability.

that this technique requires revaluation of the assets at the time of distribution.

b. Fairly representative funding, which is satisfied with assets valued at their federal estate tax value (or cost if acquired after death), but selected on a basis that fairly represents aggregate of the net appreciation and depreciation of all of the assets available to fund the bequest from the valuation date to date of funding.

(1) Fairly representative funding permits substantially less flexibility in selecting assets to fund the bequest because they must be balanced to equal the net appreciation and depreciation of all of the assets in the estate, taken as a whole.

(2) The primary advantage of this approach is that no gain is subject to capital gains tax on funding.

(3) This approach may overfund or underfund the credit shelter bequest because the assets used to satisfy the bequest are not likely to have the same value as the federal estate tax value of the pecuniary bequest. Even though this approach uses the federal estate tax value of the assets, it nevertheless also requires revaluation of all assets in order to determine the net appreciation and depreciation that occurred since the estate tax valuation date.

(4) Example: If an estate held three assets each worth $1 million at date of death, one of which appreciated by 40% since the federal estate tax valuation date, one of which did not change in value, and the other of which depreciated by 10% since that date, the net appreciation in the estate is 10%. To fund a preresiduary trust of $1 million using fairly representative funding, the executor must fund it with assets that total $1.1 million, in any ratio that would yield that result (e.g., 30% of the appreciated asset ($420,000), 23% of the asset that did not change ($230,000) and 50% of the depreciated asset ($450,000). Obviously, other ratios are possible even in this simplistic example, but since the typical estate has

many assets and they change in value by varied amounts, the calculations can get very complicated.

2. Preresiduary Marital: This is a preresiduary formula pecuniary marital deduction bequest (*e.g.*, the smallest amount necessary to reduce the federal estate tax to zero after taking the applicable credit amount into account). Like the preresiduary credit shelter bequest, this bequest can be funded in several ways:

    a. True worth funding, which is funded using date of distribution values.

        (1) This approach has the same advantages and disadvantages that apply to true worth funding of a preresiduary credit shelter trust.

        (2) The main difference is that any appreciation which has occurred will accrue to the residuary credit shelter trust. Alternatively, if assets decline in value, the value of the marital bequest is preserved.

    b. Fairly representative funding, which is satisfied with assets which are fairly representative of appreciation and depreciation in all assets available to fund the bequest using federal estate tax values (or cost if acquired after death).

        (1) Like preresiduary credit shelter bequests funded using values that are fairly representative of changes in estate tax values, gain is not subject to capital gains tax.

        (2) This method risks over- or underfunding of the marital bequest and requires the assets to be revalued when funding.

    c. Minimum worth funding, which is funded with assets using the lesser of federal estate tax or date of distribution values.

        (1) Minimum worth funding risks overfunding the marital bequest with the attendant risk that the residuary credit shelter trust might be bankrupted.

        (2) This approach should not be used in conjunction with GST tax exemption allocation because it will require

use of date of distribution values as the denominator of the applicable fraction.[29]

D. Fractional Share Formula.

1. The concept underlying a fractional share formula is entirely different than that underlying a pecuniary formula bequest. Instead of "carving out" pieces and leaving an undefined residuary amount, it divides the estate into two or more portions which are defined in terms of fractions of the estate.

   a. The numerator of the fraction is similarly worded to a pecuniary bequest.

   b. The denominator is the value of the assets available to fund the share.

2. The common approach to funding a fractional share formula is to divide each and every asset of the estate into the required shares, based on the fraction allocable to each share. However, if state law or the terms of the will permit non-prorata distributions of assets in kind, the calculation of the allocation of assets will be the same as when using fairly representative funding with a preresiduary formula bequest.

3. This approach does not require the recognition of gain or loss or the revaluation of assets when funding the bequests.

4. However, it has several major disadvantages:

   a. No pick and choose flexibility.

   b. It requires a pro rata division of every asset. If a non pro rata distribution is made, a taxable exchange among beneficiaries is likely to result, which would generate gain or loss recognition.

   c. It is difficult to administer. For example, each time a distribution is made to one beneficiary and not to others or if an asset is revalued on audit, the fractions will need to be adjusted and the assets will need to be revalued.

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[29] *See* IRC § 2642(a)(2).

E. How to Select a Funding Method and Structure.

1. Generally, the factors involved in choosing which funding method to use are not materially affected by changes in the estate tax rate or the amount of the applicable exclusion. Instead, they are most affected by whether the assets appreciate or depreciate post-death. Since estate planners usually do not know when their clients will die, much less whether the markets will be rising or falling at the time, the choice of funding method is best picked based on which will be the most convenient to administer.

2. However, where the true worth funding method is used, it is usually preferable for the smaller of the credit shelter amount and the marital bequest to be the preresiduary bequest to minimize recognition of any capital gain on funding and to minimize the risk of a bankrupt residuary estate.

3. For example, in smaller estates, now that the federal applicable exclusion amount is over $11 million, many estates that were designed to have a fully funded preresiduary credit shelter trust may have bankrupt residuaries. As a result of the volatility of the applicable exclusion amount, good drafting may suggest adding a provision directing that the credit shelter trust be treated as the residue if the residue is bankrupt.

IV. NEED TO INCORPORATE FLEXIBILITY INTO MARITAL DEDUCTION/CREDIT SHELTER PLANNING

A. Higher Applicable Exclusion Amount.

The increase in the estate tax basic exclusion amount from $675,000 in 2001 to the current $13,610,000 has had a huge influence on wealth transfer planning, particularly for clients who are not in the ultra high net worth category. In many cases, for various reasons, these clients may choose not to utilize the entire available exclusion amount of the first spouse to die.

B. State Death Taxes.

The phaseout and repeal in 2001 of the § 2011 state death tax credit by the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA")[30] has created substantial planning issues in states that continue to impose some form of death tax.[31] Because full use of the federal applicable exclusion amount in states that impose some form of state death tax may require payment of state death tax, many estate planners in these states have chosen to draft their clients' wills using flexible techniques that permit deferral of the decision of whether full use of the federal applicable exclusion amount in the estate of the first spouse to die will be advantageous. Portability now creates yet another choice to consider under these circumstances.

1. States that Do Not Impose an Estate Tax.

a. Needless to say, in states that do not impose an estate tax, the analysis of whether or not to use the full amount of the federal applicable exclusion amount and whether to elect to use portability in a particular situation is simpler because the consequences of the state estate tax do not need to be considered.

b. BUT, in the event that the client also has property in other states, the laws of each of these states must be considered. If any of them impose an estate tax, the effect of the tax may be significantly more substantial than might be expected.

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[30] P.L. 107-16.

[31] *See*, *e.g.*, New York Tax Law, §§ 951-952. Historically, New York required that the amount of New York estate tax be calculated using the now repealed state death tax credit under § 2011 using an applicable exclusion amount of $1,000,000. However, as of April 1, 2014, New York amended its estate tax law to reach a result very similar to that required under § 2011 prior to the 2017 Act, gradually increasing the exclusion amount up to the then federal amount: $2,062,500 for decedents dying after April 1, 2014; $3,125,000 for decedents dying after April 1, 2015; $4,187,500 for decedents dying after April 1, 2016; $5,250,000 for decedents dying after April 1,2017 and before January 1, 2019; and thereafter to what would have been the federal applicable exclusion amount had the 2017 Act not been enacted, with cost of living adjustments (currently $6,940,000). *See* 2014-15 New York State Executive Budget Revenue Article VII Legislation, Part X.

2. States that Impose an Estate Tax.

a. In states where the amount that can pass free of state estate tax is lower than the federal applicable exclusion amount, then generally a formula is used to fund the credit shelter amount that refers to "the amount that can pass free of federal and state estate tax."[32] This preserves the use of the amount that can pass free of state estate tax without requiring the payment of state estate tax on the difference between the state "exclusion amount" and the federal applicable exclusion amount. Then generally, a flexibility technique is incorporated into the estate plan, like disclaimers, QTIPs or Clayton Trusts, to allow a post-mortem decision about what to do with the balance of the federal applicable exclusion amount. Some states permit a state QTIP election that protects this amount from state estate tax with the marital deduction even while it is protected from federal estate tax by the applicable exclusion amount.

b. In states that have an "exclusion amount" equal to the federal applicable exclusion amount (or that permit portability of the state exclusion amount), the state estate tax likely will not affect the use of the full federal applicable exclusion amount and of portability.

V. METHODS FOR INCORPORATING FLEXIBILITY INTO MARITAL DEDUCTION/CREDIT SHELTER PLANNING

A. Building Flexibility into the Estate Plan.

Although tentative decisions about funding or not funding a credit shelter trust at the first death can be made at the time that the clients execute their wills, such decisions almost always can more prudently be made after the first spouse's death, based on up-to-date information regarding the family's personal and financial circumstances, along with knowledge of the actual tax laws that apply.

[32] Note that when planning for death taxes in a state that has an inheritance tax, this analysis may need further refinement.

1. Disclaimers.

Although disclaimers have long been used to "fix up" an estate plan following a decedent's death, since the enactment of EGTRRA the use of disclaimers as a planning technique has become commonplace.

a. In General.

Disclaimers are utilized to permit all or part of a bequest or other disposition to pass as though the designated beneficiary had predeceased the decedent. From a tax perspective, this permits the transfer of the disclaimed assets to someone other than the initial beneficiary without imposition of gift tax on the disclaiming beneficiary. To obtain this benefit, both state law requirements and federal law requirements must be met.[33]

b. Requirements of Section 2518 of the Code.[34]

In order for a disclaimer to be a qualified disclaimer for federal transfer tax purposes, five requirements must be met:

(1) The disclaimant must not have accepted the benefits of the property to be disclaimed.

(2) The refusal must be in writing.

(3) The disclaimer must be delivered to the transferor, legal representative or holder of title of the property to be disclaimed within nine months after the later of creation of the interest -- in most cases death of the testator -- or age 21.

(4) Except in the case of the decedent's spouse, the disclaimed interest must pass to someone other than the disclaimant.

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[33] Be aware of possible additional requirements under state law for a disclaimer to be effective for state law purposes. *See, e.g.,* New York's requirements for "renunciations" in EPTL 2-1.11.

[34] For a complete discussion of the requirements of § 2518, see Mary F. Radford, *The Use of Disclaimers: Navigating the Interplay between Federal and State Law*, Georgia Federal Tax Conference (Summer 2003).

(5) The disclaimant must not have the power to direct to whom the disclaimed property will pass. The property must simply pass as it would have if the disclaimant had not been alive at the time of the transfer to the disclaimant, or, assuming state law permits, the testator may direct in her will to whom the property will pass if it is disclaimed.[35]

(a) This means that the disclaimant cannot:

i) serve as the sole trustee of a trust to which the disclaimed property will pass if the trustee holds any discretionary powers. Note that a trustee power to make distributions to a beneficiary that is limited by an ascertainable standard will not be problematic for a disclaimant to hold following her disclaimer.[36]

ii) serve as a trustee or director of a foundation to which the disclaimed property will pass, unless some kind of firewall is created around the disclaimed assets to be sure the disclaimant does not participate in any decision of which charities will receive the income or principal of the disclaimed property.

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[35] *See, e.g.*, under New York law, EPTL § 2-1.11(e), which provides "*[u]nless the creator of the disposition has otherwise provided*, the filing of a renunciation, as provided in this section, has the same effect with respect to the renounced interest as though the renouncing person had predeceased the creator or the decedent or, if the renounced interest is a future estate, as though the renouncing person had died at the time of filing or just prior to its becoming an estate in possession, whichever is earlier in time, and shall have the effect of accelerating the possession and enjoyment of subsequent interests, but shall have no effect upon the vesting of a future estate which by the terms of the disposition is limited upon a preceding estate other than the renounced interest." (*Emphasis added*).

[36] Treas. Reg. § 25.2518-2(e)(1)(i).

iii) hold a special power of appointment (if the disclaimant is the surviving spouse) over the credit shelter trust property that has been disclaimed into the trust by the surviving spouse.

(6) Caution: a disclaimer may be effective under state law to transfer property away from the disclaimant, but not meet the requirements for a federal qualified disclaimer. In this case, the disclaimant will be treated as having made a gift to the recipient of the disclaimed property for federal transfer tax purposes.

c. Example of Credit Shelter Disclaimer Planning.

The surviving spouse can disclaim all or a portion of his interest in the marital trust created for his benefit, and if the will so provides and state law permits direction of the disclaimed property under the will, the property can thereby be shifted to the credit shelter trust. The spouse can continue to be the income beneficiary of that trust, but cannot retain any power of appointment over the trust. (Note: An otherwise disqualifying special power of appointment can be disclaimed.)

d. Partial Disclaimers.

Treasury Reg. § 25.2518-3 allows disclaimers of partial interests in property, including, *inter alia*, powers of appointment, undivided fractional interests and pecuniary amounts.

e. Successive Disclaimers.

In order to ensure that a disclaimer is qualified and that no part of the disclaimed interest passes to the disclaimant (if the disclaimant is not the spouse), it may be necessary for the disclaimant to disclaim several successive interests under the will and ultimately under intestacy.[37]

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[37] *See, e.g.,* PLR 200846003 (7/30/08) (under convoluted facts, determination that children's disclaimer of their interest in decedent's IRA was not qualified because, upon their disclaimer, IRA was instead paid to Trust 1 of which decedent's spouse was income beneficiary and, at spouse's death, was to be paid to Trust

f. Rules to Live By.

(1) Never disclaim until it is certain to whom the property will pass after the disclaimer. Assume nothing!

(2) Estate plans based on post-mortem disclaimers require that the client's family be educated about the requirements for a disclaimer and the "no acceptance of benefits" rule.

g. Simple Credit Shelter Trust Disclaimer.

(1) The following scenario illustrates a typical use of a disclaimer to effectuate a flexible marital deduction/credit shelter estate plan:

(a) The client, who has an estate valued at $20,000,000, currently has a standard credit shelter-based will, that is to say, the applicable exclusion amount passes to a discretionary trust for spouse and issue, with the balance outright to spouse, protected from estate tax by the marital deduction.

(b) Leaving the entire estate to the client's spouse, with a provision in the will that, in the event he disclaims any portion of his bequest, the disclaimed amount passes into the credit shelter trust, is a far more flexible plan. Following the client's death, her spouse can decide what percentage, if any, should pass to the credit shelter trust based on the tax law and the financial circumstances applicable at the time.

(2) Note that utilizing a disclaimer trust approach will prevent the client from giving her surviving spouse a special power of appointment or other control over the ultimate disposition of the trust.

2, which then paid out to decedent's children, which interests the children had not disclaimed).

(3) Note also that this sort of disclaimer planning is probably inappropriate when the client's surviving spouse and children may not have a unity of interest.

h. Complex Credit Shelter Trust Disclaimer.

Consider whether a plan for successive disclaimers by a surviving spouse may be designed under the will to provide several alternatives for the disposition of the disclaimed property. For example, the will could provide that the residuary passes outright to the spouse or, to the extent he disclaims this bequest, to a QTIP trust, or, to the extent he disclaims his interest in the QTIP trust, to a credit shelter trust. The spouse could then decide how much of the bequest to him he would like to own directly, how much he would like to protect from creditors by permitting it to pass to the QTIP trust,[38] how much he would like to pass to a credit shelter trust for his benefit and that of the children (reducing the DSUE that otherwise passes to him), and, assuming he is the executor of the estate, by making the portability election, the amount of DSUE he would like to use making gifts.

2. Partial QTIP Elections.

a. Just as the division between the marital share and the credit shelter share may be defined by formula, it is advantageous to make the partial QTIP election by formula.[39] In this event, if values of assets in the estate are adjusted on audit, the share passing to the marital deduction portion of the trust for the benefit of the surviving spouse will self-adjust to obtain the desired tax result.

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[38] For a discussion of state law issues in protecting disclaimed property from the claims of creditors, see Kevin A. White, *A Clash of Expectations: Debtors' Disclaimers of Property in Advance of Bankruptcy*, 60 Wash. & Lee L. Rev. 1049, 1054 (2003).

[39] The formula should be expressed as a fraction of the total value of the trust, *e.g.*, "the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary trust (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate)." Treas. Reg. § 20.2056(b)-7(h), Example 7.

b. If a partial QTIP election is made, good practice suggests taking advantage of the provision in the regulations that permits the marital trust to be divided into two identical trusts if authorized by the instrument or governing law: one which qualifies for the estate tax marital deduction and one which does not.[40] This division facilitates accounting for the separate shares of the marital trust in the event distributions from principal are made only from the portion of the trust that is includible in the surviving spouse's estate. To ensure the availability of this alternative, whenever a QTIP trust is included in the estate plan, the will should include a provision authorizing division of the trust if a partial QTIP election is made.

c. Partial QTIP elections also permit planning to take advantage of the credit for tax paid on prior transfers - the "PTP credit" - under § 2013. If, at the death of the first spouse to die, it appears likely that the surviving spouse may die within a short time after the first spouse or if he in fact does die shortly after the first spouse to die, the executor can elect to qualify a smaller portion of the marital trust for QTIP treatment, intentionally pay federal estate tax in the estate of the first spouse to die, and take advantage of the PTP credit under § 2013 for the actuarially determined value of the surviving spouse's interest in the nonqualified portion of the marital trust, even though the trust is not includible in the surviving spouse's estate.

(1) For this reason, it is generally prudent to put the estate tax return on extension when a QTIP trust is utilized so that the executor has 15 months, rather than only nine months, to determine whether this credit will be available in the estate of the surviving spouse.

(2) The full amount of the credit is allowed if the surviving spouse dies within two years of the first spouse to die. Thereafter, the credit is reduced by 20% every two years, until it is exhausted at the end of ten years.

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[40] Treas. Reg. § 20.2056(b)-7(b)(2)(ii)(A).

(3) Note that the value of the surviving spouse's interest is determined under § 7520 of the Code which prohibits use of the valuation tables if the surviving spouse was terminally ill at the death of the first spouse.

d. The primary disadvantage of estate plans relying on partial QTIP elections is that all of the income from the non-elected trust must be distributed to the surviving spouse, thereby increasing his taxable estate and subjecting that income to estate tax before it passes to the children. Also, there can be no discretion to make distributions to children and other family members.

e. The primary reasons to use a QTIP trust as the planning vehicle are:

(1) The assets will be held in trust regardless of whether the election is made, to be preserved for ultimate distribution to the beneficiaries chosen by the decedent.

(2) The decision regarding the QTIP election (which will effectively also decide to what extent portability will be exercised) will be made by the executor, who may be in a better position than the surviving spouse to make the most prudent decision based on an objective analysis.

3. Clayton (or Contingent Income) Trusts.[41]

a. These trusts, in many ways, utilize and combine the advantages of disclaimer credit shelter trusts and partial QTIP trusts.

b. Clayton trusts, named after the case, *Estate of Clayton v. Comm'r.*,[42] are hybrid trusts that include a set of trust terms that meet the requirements for QTIP treatment if a QTIP election is made and a set of trust terms that permit beneficiaries other

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[41] For a more thorough discussion of Clayton elections, see Barbara A. Sloan, *Funding Formulas Fail on Flexibility: Variations on Traditional Marital Deduction/Credit Shelter Planning*, U. Miami Heckerling Inst. on Est. Planning, Ch. 9 (2004).

[42] 976 F.2d 1486 (5th Cir. 1992).

than the surviving spouse to be included if and to the extent that the QTIP election is not made.

(1) Initially, the government was hostile to the concept of a trust designed to make the requirement that all of the income be paid to the surviving spouse contingent on whether the QTIP election was made.[43]

(2) Ultimately, the government abandoned its position and reissued Treas. Reg. § 20.2056(b)-7(d)(3) to provide that an income interest that is contingent on the election of the executor will not fail to be a qualifying income interest for purposes of the marital deduction.

(3) The non-marital alternative of the Clayton trust does not need to require that all of the income from the trust be distributed to the surviving spouse, can permit the surviving spouse to have a special power of appointment over the trust property and can include income beneficiaries other than the surviving spouse. Indeed, the surviving spouse need not be a beneficiary at all of the non-marital portion of the Clayton trust.

c. Terminology.

(1) Clayton Trust. For purposes of this outline, a "Clayton trust" refers to the entire mutable entity of a QTIP-able trust which, to the extent that a QTIP election is not made, becomes a trust containing provisions that would disqualify it as a QTIP trust.

(a) Marital component. This component of the trust provides that if the spouse survives the testator, the spouse will have a mandatory income interest and no one other than the surviving spouse will have the right to receive anything

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[43] In TAM 8631005, the Service ruled that a marital deduction was available where the surviving spouse served as executor for an estate which included a QTIP-able trust which poured over to a non-QTIP-able trust, because the election was in the hands of the surviving spouse. However, this position was reversed in subsequent rulings and audits and Treas. Reg. § 20.2056(b)-7(d)(3) took the position that such a trust did not qualify for the marital deduction.

from the trust during the surviving spouse's lifetime (including through the exercise of a power of appointment). This QTIP-able component of the Clayton trust may or may not provide that the surviving spouse can receive distributions of principal.

(b) Non-marital or family component. This second trust usually benefits the children and may or may not include the surviving spouse as a beneficiary. During the period when a QTIP election could but might not be made, this component of the Clayton trust has as much viability as the marital component.

(c) Either the marital or non-marital component of a Clayton trust may never actually become operational, depending on the election that the executor makes. Alternatively, in the case of a partial QTIP election, they will both be funded.

(2) Clayton election. The only formal election involved in a Clayton trust is the QTIP election which, to the extent made, eliminates the non-marital component of the Clayton trust. The "election" which gives life to the non-marital component of a Clayton trust is actually the *absence* of a QTIP election and, in that sense, is not an affirmative act. The term, "Clayton election," actually refers to the decision not to QTIP and the filing of the return without the QTIP election.

d. The interesting challenge presented in drafting a Clayton trust is that it is created upon the *nonoccurrence* of an event. While the making of a QTIP election itself is irrevocable, the nonelection cannot always be said to have occurred with the same definiteness.

(1) The issue raised here is that under Treasury Regulations §§ 20.2056(b)-7(b)(4) and (5), a QTIP election may be made or modified on a return until the final due date for the return, including extensions actually granted, or on the first late return.

(2) To trigger the funding of the non-marital component of the Clayton trust, the drafting language can refer to a failure or refusal of the executor to elect the marital deduction for some portion (or all) of the marital trust under § 2056(b)(7)(B)(ii)(V) on the last federal estate tax return filed for the estate on or before the due date of the return, including extensions, or if a timely return is not filed, the first estate tax return filed by the executor after the due date. Since this leaves the time period open indefinitely if no return is filed, making uncertain who the beneficiaries will be, one alternative is to provide in the will that if the Clayton election is not made within a specified period of time, that alternative ends and thereafter only a partial QTIP election may be made.

(3) It is possible that a surviving spouse who serves as the sole executor of the estate may have adverse gift tax consequences as a result of his power to direct property away from himself without actually meeting the qualified disclaimer requirements. Until guidance is issued, it may be prudent not to name the surviving spouse as the sole executor of an estate that includes a Clayton trust and to provide that an independent executor will make the decision regarding the QTIP election. In most cases a co-executor could be appointed who would have no responsibility other than making or not making the QTIP election.

e. Advantages of Clayton Trusts.

(1) Clayton trust planning has almost all of the advantages of traditional partial QTIP planning:

(a) The executor has fifteen months instead of only nine months to make his decision.

(b) The surviving spouse can have a special power of appointment over the non-marital trust.

(c) Control is in the hands of the executor, who should not be the surviving spouse and so can be a disinterested independent party.

(d) There is no danger that the plan will be jeopardized by accidental acceptance of benefits by the surviving spouse of assets which were intended to be disclaimed.

(e) Income need not be distributed to the surviving spouse from the non-marital portion, thus avoiding unnecessarily enlarging his estate.

(f) The non-marital component can be structured as a sprinkling credit shelter trust, just as with disclaimer credit shelter trusts, and can be held for the benefit of the surviving spouse and the decedent's children, with discretionary income and principal distributions to any of them.

f. Disadvantages.

(1) Just as with a partial QTIP election, the assets must be divided between the two trusts on a fractional share basis.

(2) If the two spouses die within a short period of time of each other, the estate of the surviving spouse will not qualify for the credit for previously taxed property under § 2013 of the Code. This is because a Clayton trust which does not require that the income from the non-marital portion be distributed to the surviving spouse (or which permits distributions to other people) does not give the surviving spouse an interest in the trust which is capable of being valued actuarially.

VI. TAILORING THE USE OF FLEXIBILITY TECHNIQUES

A. Use Flexibility Techniques in Combination.

Given that each of these techniques has advantages and disadvantages, depending on the size of the estate and the client's tolerance for complexity, it may make sense to combine some of the techniques. One combination that always exists is, of course, the possibility of making a portability election in any estate where the decedent has some applicable exclusion amount.

B. Combinations of Techniques Can Achieve Tax Savings and Ease Tensions.

1. One of the primary issues in determining which of these techniques to use is its appropriateness for the client's family structure and the personalities involved. Although it is tempting to design estate plans that simply maximize tax planning results, a significant portion of the job of a successful estate planner is also to factor in how the parties who survive the decedent will react to the plan and to build in provisions to account for these reactions.

2. If, for example, there is any concern that the client's spouse may choose not to disclaim an outright bequest to a credit shelter trust - because he does not want his assets encumbered in trust, for example - the will can leave an outright specific bequest to the spouse so that he receives some assets directly and leave the balance of the estate to a QTIP trust. The will can provide that if the spouse disclaims any portion of the QTIP, it will pass to a credit shelter trust (without special power of appointment, of course). If the spouse then fails to disclaim (less likely since he will be choosing between holding his bequest in trust no matter what), the executor (if she is not the spouse) still has the fall back position of making a partial QTIP election to take advantage of the client's unused applicable exclusion amount.

3. A plan such as this allows the spouse to feel involved in the post-mortem planning for the decedent's estate without leaving all of the control in his hands if that is not appropriate, for example, because the decedent's children are from a prior marriage. Although a similar result could have been obtained by making an outright bequest to the spouse and then giving the executor the option of making a Clayton election, assuming the surviving spouse is not the executor (to avoid potential adverse gift tax consequences if for no other reason), the surviving spouse would have not been a participant in these decisions.

VII. PORTABILITY

A. No Longer New.

Now that portability, which permits the unused applicable exclusion amount of a deceased spouse to be transferred to the surviving spouse for use in his

estate planning,[44] has been around for a few years as a permanent part of our estate planning tool kit,[45] it is important to know not just how to use it, but also when to use it, when not to use it, and when the decision should be made. It simplifies estate planning in many estates, particularly those that are smaller, and creates potential substantial estate tax savings in many larger estates, particularly in decoupled states.

B. Simplification?

Portability has the enticing look of simplification. It was designed to simplify the estates of couples with combined estates greater than one basic exclusion amount and less than two times the basic exclusion amount. For 30 years, these couples, if they visited estate planners, had been creating estate plans where, by combining two separate bequests for the benefit of the surviving spouse, one using the applicable exclusion amount and the other the unlimited marital deduction, the applicable exclusion amount of the first spouse to die could be preserved for the benefit of the testator's descendants and no tax would be due until the death of the surviving spouse. This technique of using a combination of a marital deduction bequest with a credit shelter trust had been the backbone of their estate planning. The concept of using portability of the deceased spouse's unused applicable exclusion ("DSUE") amount in lieu of a credit shelter trust is simple on its face, but, like many things, becomes more complex as rules to implement it are developed.

C. Transfer of Exclusion Amount.

In December 2010 as a part of TRUIRJCA, Congress authorized a taxpayer dying in 2011 or thereafter to allow any of her unused applicable exclusion amount to be transferred to her surviving spouse without the need for a credit shelter trust to preserve the use of the credit at the death of the surviving spouse.[46] This change represents a breakthrough in planning, particularly for

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[44] IRC § 2010(c). Section 2010 of the Code remains titled "Unified Credit Against Estate Tax" even though the text of the section no longer refers to the unified credit and instead refers to the "applicable credit amount" and the "applicable exclusion amount." Note that the term "applicable credit amount" refers to the actual amount of tentative tax that would be payable if the tax base were equal to the applicable exclusion amount.

[45] Section 101(a)(2), P.L. 112-240.

[46] Specifically, Congress amended § 2010(c) of the Code to add, *inter alia*, subsection (2) that provides that "the applicable exclusion amount is the sum of (A) the

those taxpayers with combined estates that total an amount greater than one applicable exclusion amount, but less than two - what may be referred to as the "wealthy middle class." And, even for those of our married clients who fully used their applicable exclusion amounts making gifts in 2011 and 2012, portability will continue to be of interest since the applicable exclusion amount has, for the moment, increased substantially in size and is indexed for inflation.

VIII. HOW PORTABILITY WORKS

A. Requirements in the Code.

1. In § 2010(c) of the Code, in addition to authorizing portability of the applicable exclusion amount and providing the definitions of the components of portability, Congress provided that in order to take advantage of portability, the executor of the estate of the deceased spouse must file an estate tax return on which the amount of the DSUE is calculated and an election to permit the surviving spouse to use the DSUE amount is made.

2. Congress also provided that the details of how portability would work would be developed by Treasury in legislative regulations.

B. Regulations.

1. Making the Election.

a. By Executor on Timely-Filed Return.

As required by the Code, the executor is required to make the portability election on a timely-filed estate tax return.[47]

(1) The filing of a complete and properly prepared timely return will constitute a making of the election if there is

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basic exclusion amount and (B) in the case of a surviving spouse, the deceased spousal unused exclusion amount." P.L. 111-312, § 303(a).

[47] Treas. Reg. §§ 20.2010-2(a) (flush language) and (a)(6)(i).

a surviving spouse. The executor may affirmatively opt out of portability when filing the Form 706.[48]

(2) The last-filed timely-filed return is determinative of whether the election was made and that decision is irrevocable thereafter.[49] The regulations do not provide a procedure for making a protective portability election or for relief to make a late portability election, although the regulations make clear that an extension of time to elect portability may be available under §§ 301.9100-1 and 301.9100-3 to an estate that otherwise is not required to file a return because the value of the gross estate does not exceed the basic exclusion amount.[50]

b. No Executor.

In the event that no executor is appointed for an estate, any person in actual or constructive possession of the decedent's property (a "non-appointed executor") may file the estate tax return and make the election for portability to apply to the decedent's DSUE amount or not.[51]

(1) A significant distinction regarding a portability election made by a non-appointed executor is that, unlike one made by an appointed executor, it cannot be superseded by a contrary election made by a different non-appointed executor.

(2) This means that in the case where there is no appointed executor, a race to the mailbox with the Form 706 may determine whether or not an election will be made.

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[48] Treas. Reg. § 20.2010-2(a)(2).

[49] Treas. Reg. § 20.2010-2(a)(4).

[50] Treas. Reg. § 20.2010-2(a)(1). *See* Rev. Proc. 2022-32 which allows an estate otherwise not required to file a federal estate tax return a simplified method to obtain an extension of time to file a return to make the portability election for the five year period following the decedent's death.

[51] Treas. Reg. § 20.2010-2(a)(6)(ii).

c. Complete and Properly-Prepared Return.

The regulations reiterate the requirement that the election is made by filing a "complete and properly-prepared" estate tax return.[52] However, for estates not otherwise required to file a return, a special rule applies to make completion of the return less expensive and less burdensome.

(1) For smaller estates, executors are not required to report the value of certain transfers that qualify for the marital or charitable deduction and may, exercising due diligence, estimate the total fair market value of the gross estate.[53] The regulations explain that the instructions for Form 706 provide dollar ranges for the executor to use in identifying the executor's best estimate of the value of the estate.[54]

(2) With respect to marital and charitable deduction property included in the gross estate, the executor must provide only a description of the property, who the owner of the property was, and/or who the beneficiary of the property is, along with information sufficient to establish the estate's right to the marital or charitable deduction.[55]

(3) As a result, the only assets requiring the usual procedure for determination of value on a Form 706 are those not qualifying for the marital or charitable deduction.

d. Opting Out of Portability.

Although several post-mortem decisions may affect whether the decedent has a DSUE amount (e.g., QTIP elections and

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52 Treas. Reg. §§ 20.2010-2(a)(2) and (7)(i).

53 Treas. Reg. § 20.2010-2(a)(7)(ii).

54 Treas. Reg. § 20.2010-2(a)(7)(ii)(B).

55 Treas. Reg. §§ 20.2010-2(a)(7)(ii)(A) and (B).

disclaimers), it is possible, particularly in some dysfunctional families, that even though the decedent has a DSUE amount, the executor does not wish to elect portability. In order for the portability election not to apply to the decedent's DSUE amount, if a return is required to be filed, the executor must state affirmatively on a timely-filed return that the estate is not electing portability.[56] If no return is required to be filed and the executor in fact does not file a return, then, as always, the lack of a timely filed return will prevent the application of portability.

e. Nonresident Non-Citizens.

No portability election is available for nonresident decedents who were not US citizens at the time of their deaths.[57] In addition, a nonresident surviving spouse who is not a US citizen at the time of making a gift or at the time of her death may not take into account any DSUE amount of a deceased spouse, except as may be allowed under an applicable treaty obligation of the United States.[58]

2. Computing the DSUE Amount.

a. Where Calculated.

(1) In order to meet the requirements to elect portability treatment on an estate tax return, the executor must include a calculation of the DSUE amount on the return.[59]

(2) Even if it appears that there is no DSUE amount, the return should still include the calculation of a zero DSUE amount in order to preserve portability in the event that an adjustment to the taxable estate results in a DSUE.

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56 Treas. Reg. § 20.2010-2(a)(3).

57 Treas. Reg. § 20.2010-2(a)(5).

58 Treas. Reg. §§ 25.2505-2(f) and 20.2010-3(e).

59 Treas. Reg. § 20.2010-2(b)(1).

b. How Calculated.

(1) In order to calculate the DSUE amount, it is necessary to understand several terms defined in the Code:

(a) Each individual has a "basic exclusion amount" defined as $11 million plus any cost of living adjustment determined to be applicable, currently $13,610,000.

(b) The "applicable exclusion amount" is the sum of the basic exclusion amount and, in the case of a taxpayer who is a surviving spouse, the DSUE amount.[60]

(2) Definition of DSUE Amount.

(a) Treas. Reg. § 20.2010-2(c)(1) provides:

"General rule. Subject to paragraphs (c)(2) through (4) of this section, the DSUE amount of a decedent with a surviving spouse is the lesser 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 § 2001(b)(1)."

(b) The regulations clarify that the first reference to "basic exclusion amount" in the code section

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[60] § 2010(c)(2).

means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE is being computed.[61] This appears to be a determination by Treasury and the Service that, in the event the basic exclusion amount is reduced in future years, the amount of the DSUE nonetheless is determined based on the basic exclusion amount in effect at the time of the decedent's death.

(3) In addition, to avoid using exclusion for amounts on which gift tax was actually paid, solely for purposes of computing the DSUE amount, the amount of the decedent's adjusted taxable gifts is reduced by the amount of any gifts on which gift tax was paid.[62]

(4) *Example:* Decedent, while alive, makes a total of $2.5 million of gifts in 2002, when the applicable exclusion amount for gift tax purposes was $1 million. Decedent pays gift tax on $1.5 million of gifts. In 2024, Decedent dies with an estate of $2 million. Her DSUE is calculated as the lesser of $13.61 million (the basic exclusion amount at the time of her death) or the excess of $13.61 million over $3 million ($1 million of adjusted taxable gifts and $2 million in her estate) or $10.61 million. For the purposes of this calculation only, the $1.5 million of gifts on which Decedent paid gift tax is not included in her adjusted taxable gifts.

c. Special Rule when Property Passes to Qualified Domestic Trust ("QDOT").

(1) Although the DSUE amount is calculated on the decedent's federal estate tax return, in the case of a decedent who has left property to a QDOT, this amount is tentative, subject to reduction for any tax due on

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[61] Treas. Reg. § 20.2010-2(c)(1)(i).

[62] Treas. Reg. § 20.2010-2(c)(2).

distributions made from the QDOT or any other taxable event that could occur with respect to the QDOT.[63]

(2) At the termination of the QDOT, the decedent's actual DSUE amount can be determined because all potential estate tax deferred by the use of the QDOT will then be due under § 2056A and the amount of the decedent's applicable exclusion amount that will be necessary to reduce that tax can be finally determined.[64] The surviving spouse will have access to the decedent's DSUE only after the QDOT ends, either during the surviving spouse's life or at her death.[65]

(3) *Example:* Decedent, a US citizen, while alive, makes a taxable gift of $1 million in 2002 when the applicable exclusion amount for gift tax purposes is $1 million. Decedent dies in 2023 when the basic exclusion amount is $12.92 million owning assets of $11 million. Surviving spouse is a US resident, but not a US citizen. Decedent's will leaves $10.5 million to a QDOT for surviving spouse and decedent's executor makes the QDOT election and elects portability on her estate tax return. Decedent's estate receives a marital deduction of $10.5 million and Decedent's DSUE amount is calculated to be the lesser of $12.92 million or the excess of $12.92 million over $1 million in gifts and $500,000 taxable estate or $11.42 million. Later in 2023, surviving spouse dies without having taken any distributions of principal from the QDOT or having any other taxable events under § 2056A occur. At the time of surviving spouse's death, the value of the QDOT is $10.6 million. Decedent's DSUE amount is adjusted to cover the $10.6 million in the QDOT in addition to the $500,000 taxable estate and $1 million in gifts, leaving

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63 Treas. Reg. § 20.2010-2(c)(4).

64 Treas. Reg. §20.2010-3(c)(3).

65 *See* Treas. Reg. § 25.2505-2(d)(3).

a DSUE amount of $820,000 available to surviving spouse's estate to protect his assets from estate tax.[66]

3. When the DSUE Amount Can be Used.

The regulations provide that a DSUE amount can be used by the surviving spouse at any time following the decedent's death, assuming the portability election is made on the Form 706 filed for the decedent and that the decedent is the last deceased spouse of the surviving spouse at the time of the transfer by the surviving spouse.[67]

4. Definition of Last Deceased Spouse.

a. The regulations define last deceased spouse as "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."[68]

b. The identity of the last deceased spouse of a surviving spouse is unchanged by her marriage to a new spouse or by her subsequent divorce from the new spouse. Needless to say, however, if the new spouse dies, he becomes the last deceased spouse of the surviving spouse.[69]

c. The most recent spouse who has died is the last deceased spouse of the surviving spouse, regardless of whether portability was elected in his estate.[70]

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[66] For many of the examples in this outline which occur over the course of a year's time for both spouses to die, the applicable exclusion amount for 2023, $12,920,000, is used.

[67] Treas. Reg. §§ 20.2010-3(a)(1) and 25.2505-2(a)(1).

[68] Treas. Reg. § 20.2010-1(d)(5).

[69] Treas. Reg. §§ 20.2010-3(a)(3) and 25.2505-2(a)(3).

[70] Treas. Reg. §§ 20.2010-3(a)(2) and 25.2505-2(a)(2).

5. Ordering Rule and Effect in the Case of Multiple Deceased Spouses.

a. When a surviving spouse makes a taxable gift, the DSUE amount from her last deceased spouse will be applied against the amount of the surviving spouse's taxable gifts for that calendar year, prior to the application of the surviving spouse's own basic exclusion amount.[71]

b. The DSUE amount available to the surviving spouse at any given moment in time during her life or to her estate at her death includes the DSUE amount of the surviving spouse's last deceased spouse and any DSUE amount she actually applied to taxable gifts even if that DSUE amount was from a decedent who is no longer the surviving spouse's last deceased spouse.[72]

(1) This means, for example, that a surviving spouse who has survived the deaths of several spouses may use the DSUE amount from each of them before the death of his next spouse, assuming a portability election was made for each of them.

(2) However, the DSUE amounts of the deceased spouses cannot be aggregated and all used at once.

(3) At the death of the next spouse, any remaining DSUE amount left from a prior deceased spouse may no longer be used by the surviving spouse.

c. *Example:* Decedent, while alive, makes gifts of $1 million in 2002 when the gift tax applicable exclusion amount is $1 million. Decedent dies in January, 2023, with an estate of $2 million which she leaves entirely to her surviving spouse. Her executor makes a portability election on her estate tax return and calculates her DSUE amount to be $11.92 million. In May of 2023, surviving spouse remarries and in June makes gifts of $2 million to his children. Tragically, in August, 2023, surviving spouse's second spouse dies, having used $1.5 million of her applicable exclusion amount making gifts to her sister. She leaves the balance of her estate to surviving

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[71] Treas. Reg. § 25.2505-2(b).

[72] Treas. Reg. §§ 25.2505-2(c) and 20.2010-3(b).

spouse. Second spouse's executor makes a portability election and properly calculates her DSUE amount to be $11.42 million. At that point, Surviving spouse's applicable exclusion amount is his own basic exclusion amount of $12.92 million which he has not used yet, $2 million of his first spouse's DSUE which he used making gifts to his children, and $11.42 million of DSUE amount from his second spouse, for a total $26.34 million. Although he forfeited the remaining $9.92 million of DSUE amount available from his first spouse when his second spouse died, he is still better off for having received his second spouse's DSUE. Surviving spouse now marries his third spouse and makes additional gifts to his children of $7 million. Third spouse dies in September, 2023, without having used any of her applicable exclusion amount. She leaves her estate to surviving spouse and her executor elects portability treatment on her estate tax return. Surviving spouse now has an applicable exclusion amount of his own $12.92 million, the $2 million he used from his first spouse, the $7 million he used from his second spouse, and the $12.92 million DSUE amount he just received from his third spouse, or $34.82 million. In January of 2024, surviving spouse has an applicable exclusion amount of $35.56 because his basic exclusion amount increased to $13.61, but the DSUE from his third wife is not increased. *Note, however, that $9 million of the DSUE amount functions to offset surviving spouse's taxable gifts of $9 million, which will be included in his estate tax base as adjusted taxable gifts*.

6. Authority to Examine Returns of Deceased Spouses.

a. For purposes of determining the DSUE amount included in the applicable exclusion amount of the surviving spouse, the Service may examine any tax returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for the return.[73]

b. The Service may adjust or eliminate the DSUE amount reported on a return, but may not assess additional tax on that

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[73] Treas. Reg. §§ 20.2010-2(d), 20.2010-3(d) and 25.2505-2(e).

return if the period of limitations for assessment for that return has expired.[74]

IX. ADVANTAGES OF PORTABILITY

Aside from its most obvious advantage of simplification by permitting taxpayers to avoid the need to create trusts in order to utilize their exclusion amounts, portability offers other advantages.

A. No Separation of Assets.

Many taxpayers have crafted marriages in which all of their wealth is jointly owned, and they feel this is a significant component of their relationship with each other. When told they should separate their assets to permit more efficient tax planning, they may do it, but not happily, even when using techniques designed to give them more comfort (e.g., using separate revocable trusts where both spouses are co-trustees of each trust). Portability obviates the need for separating assets. All assets can remain jointly owned, and for some clients, this will be a substantial benefit.

B. No Loss of Basis Adjustment.

Portability may also resolve one of the few disadvantages of credit shelter trusts - the loss of basis adjustment under § 1014 at the death of the second spouse to die. Because the surviving spouse can own all of the assets directly, these assets can all receive a basis adjustment at his death which can be a valuable benefit. Of course, this advantage also holds if the surviving spouse is the beneficiary of a QTIP trust.

C. No Trust Required.

Although many estate planners are big believers in trusts and the many advantages that they offer, many of our clients see the use of trusts as a bother that adds unnecessary complexity to their estate plans. Again, portability can be the solution for these clients, permitting the simple “I love you” wills that most of them think will be sufficient for their needs.

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[74] Treas. Reg. §§ 20,2010-3(d) and 25.2505-2(e).

D. Avoids Planning with "Difficult" Assets.

Another difficulty that portability can address is that of taking full advantage of the applicable exclusion amount in the estate of the first spouse to die when the couple's assets are composed primarily of assets that are difficult to use to fund a credit shelter trust, such as retirement plans. Portability avoids wasting applicable exclusion amount when attempting to fund the credit shelter trust with "difficult" assets.

E. Planning Opportunities in States with State Death Taxes.

In states that have a state death tax but no gift tax, portability will permit the surviving spouse to use the DSUE amount of the first spouse to die to make gifts that escape state transfer taxation altogether. Since in these states full use of the decedent's federal applicable exclusion amount to fund a credit shelter trust generally necessitates payment of some state estate tax, this can be a big advantage. And since the regulations provide such a favorable ordering rule, allowing the DSUE amount to be used for gifts prior to using the donor's basic exclusion amount,[75] this technique permits the maximum benefit to be derived from the DSUE. Although gifting assets by the survivor does mean that the beneficiary loses out on an adjustment in basis at the death of the surviving spouse, this disadvantage is no worse than the result obtained through the use of a credit shelter trust, which we have all been living with for years. On the plus side, the gift can be to an intentionally defective grantor trust.[76]

X. DISADVANTAGES OF PORTABILITY

A. Future Growth.

1. By giving assets directly to the surviving spouse, rather than wrapping them in a credit shelter trust, the future growth in the assets is not

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[75] Treas. Reg. § 25.2505-2(b).

[76] An intentionally defective grantor trust is one over which the grantor has been given so much control or has retained so great an interest that the trust is subject to the income tax grantor trust rules. The grantor's retained control or interest is structured in such a way that the trust is disregarded for income tax purposes, but not for estate tax purposes, and all of the income and deductions associated with the trust are passed directly to the grantor. Furthermore, purchase and sale transactions between the grantor and the grantor trust do not result in gain or loss recognition. Rev. Rul. 85-13, 1985-1 C.B. 184. *See* IRC §§ 671-679 for the grantor trust rules.

inside the protective wrapper, but instead is subject to estate tax at the death of the surviving spouse. This is one of the first disadvantages estate planners mention in thinking of portability and can be significant, particularly in the case of young clients.

2. Generally, this will not be a significant issue where the clients' net worth is modest. However, when the clients are young, it may be difficult to predict the extent to which their estates will increase over the years.

3. A partial offset not to be overlooked, however, is the fact that the assets will receive an adjustment in basis at the death of the second spouse. The adjustment may or may not be significant depending on the nature of the assets and the applicable state income and estate tax regimes. In some states, avoidance of income taxation of capital gain may be as valuable as avoidance of estate taxation, making the loss of an adjustment in basis at the death of the surviving spouse as expensive as payment of estate tax on the assets. Note that it will likely be the income tax regimes applicable to the family's children that will be the most relevant.

B. Loss of DSUE Amount.

1. A risk with portability is that the surviving spouse will lose some or all of the DSUE amount if he remarries and the second spouse, who has a smaller or no basic exclusion amount, also predeceases him. The DSUE amount is not cumulative unless used making gifts prior to the death of the succeeding spouse.

2. 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.

C. Unexpected State Estate Tax.

1. Assume clients are living in a state that does not impose a state estate tax and they rely on portability of the entire basic exclusion amount of the first spouse to die because no tax, federal or state, is due at the death of the first spouse to die. Then assume that the surviving spouse moves nearer to grandchildren in a state that does impose an estate tax. The assets inherited by the surviving spouse that could have been protected from state estate tax in a credit shelter trust established at the

death of the first spouse to die will all be subject to state estate tax at the death of the surviving spouse.

2. This circumstance and the one prior to it (loss of DSUE amount) create imponderables in estate planning. The best an estate planner can do is ask the right questions, advise the client of the potential risks and benefits, let the client make the decisions, and hope for the best.

D. Complex Family Structures.

1. Perhaps an even more troubling disadvantage of portability is that it does not work well in many complex family structures, and in many cases, this disadvantage has no "work around."

2. The first issue involves selection of the executor for the first spouse to die. The regulations clearly provide that, for a testate decedent, only the executor can make the portability election.[77]

a. Several situations may occur where this can raise an issue. First, if the estate is not large enough to independently require the filing of an estate tax return under § 6018, the executor may choose not to incur the expense and trouble of filing an estate tax return solely for the purpose of making the portability election, particularly if the spouse is a second spouse and the executor is a child of the decedent's first marriage.

(1) Unfortunately, the author is already aware of circumstances in which an executor has suggested that the children of the decedent's first marriage should share in some of the benefit of the portability election (should receive a payment from the surviving second spouse) in order to obtain the executor's agreement to file an estate tax return.

(2) Even in less egregious cases, the executor may require the surviving spouse to cover the expenses of filing the return since he will be receiving the benefit of the election. These costs may be treated as including the cost of gathering information regarding the assets and their value, in addition to the actual preparation of the

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77 Treas. Reg. § 20.2010-2(a)(6).

return, even though some of the costs likely would have been incurred even if a return had not been filed.

b. As a caution, in cases such as these, we may serve our clients best by asking if they would like to include language in the will directing whether an estate tax return should be filed if not otherwise required if there is a DSUE amount and if so, directing the source of funds to be used to cover the cost of the preparation and filing.

3. An even more difficult situation may be posed by a family structure in which each spouse has children from a prior marriage and assets in excess of the basic exclusion amount. Typically, in a complex family structure where a client has children from a prior marriage, we, as planners, rely on QTIP trusts to obtain the marital deduction and allow the surviving spouse to receive the economic benefit of the deceased client's assets while ensuring that, at the death of the surviving spouse, the client's assets pass to the client's descendants (or whomever the client chooses). QTIP trusts were designed to address these complex family structures, work well and give the clients (and us) comfort that the surviving spouse and the children from the prior marriage are adequately protected. However, different results may follow where a QTIP trust is combined with portability, and this combination may actually defeat the client's goals.

a. In this case, if the decedent were to bequeath all of her assets to a QTIP trust for the benefit of her second spouse, with the remainder to her children, and permit her second spouse to serve as executor, he would likely elect QTIP treatment for the trust and elect portability for the DSUE amount.

(1) If the surviving second spouse then were to make gifts to his children of his first marriage of his applicable exclusion amount (including the DSUE amount from the decedent), at his death there would be no credit left and the decedent's children would be required to pay all of the tax generated by the inclusion of the QTIP in the estate of the surviving second spouse, even though the decedent's DSUE amount had protected gifts of the surviving second spouse's assets to his children from tax.

(2) Even if the surviving second spouse did not make gifts of the applicable exclusion amount to his children, assuming that at his death his estate were large enough to absorb his entire applicable exclusion amount, nothing would require him to exonerate the QTIP trust from its statutory tax contribution.

Example: Frieda is married to Harvey. Both are married for the second time with children from prior marriages. Frieda dies first early in 2023 (applicable exclusion amount of $12,920,000) with an estate of $10 million which she leaves in a QTIP trust for Harvey with the remainder to her children. Harvey, as her executor, elects QTIP treatment and portability. Harvey has separate assets of $18 million. At his death late in 2023, shortly after filing Frieda's estate tax return, he has a taxable estate of $28 million. He has an applicable exclusion amount of $25.84 million. Everything above that is taxed at 40% resulting in estate tax of $864,000. Because § 2207A requires reimbursement from the QTIP at the marginal rate, the $864,000 of tax will all be payable from the QTIP, and Frieda's children will receive $9.136 million. All of the benefit of Harvey's applicable exclusion, including Frieda's DSUE amount, goes to Harvey's children. This is on top of the fact that Harvey also got all of the income from Frieda's QTIP.

b. Even in cases where the combined assets of a married couple are less than their combined applicable exclusion amounts, use of portability may be contraindicated and traditional credit shelter planning may be the more prudent course of action.

Example: John is 55 years old with three children. Jane, John's first wife, died in 2008 and John has married Sally who has no children, but does have nieces and nephews she favors. John has assets of about $10 million, as does Sally. John has said (in front of Sally) that he wants all of his separately owned assets to pass to his children whether or not Sally survives him. Sally is willing for her separately owned assets to go to a trust for John if she predeceases, but she wants the remainder to go to her nieces and nephews. If Sally leaves her assets in a QTIP trust for John and permits him, as her executor, to elect portability of her $13,610,000 exclusion amount, it is not hard to imagine that, if John lives to his life expectancy (about another 30 years), the combined value of his assets and the

assets in the QTIP trust may exceed the value of his applicable exclusion amount even though his basic exclusion amount is indexed for inflation[78] because Sally's DSUE amount is not indexed. Assuming (1) the tax laws do not substantially change in the next 30 years (other than potentially decreasing the amount of the basic exclusion amount), (2) John does not remarry a woman who also dies - thus potentially losing Sally's DSUE amount, and (3) John, in his will, does not exonerate the QTIP trust from paying its required reimbursement for estate tax, at John's death, estate tax likely will be due and the QTIP trust will be required to pay the marginal estate tax due on its value. John's children will get the benefit of Sally's DSUE amount and Sally's nieces and nephews will receive their share reduced by estate taxes.

c. In cases such as these, the more prudent course of action would be to say that portability may not be appropriate for this family structure and caution your clients to go forward with traditional credit shelter/marital deduction planning.

(1) It is true that in some cases, placing assets in a credit shelter trust where they will not receive an adjustment in basis at the death of the surviving spouse, rather than in a QTIP trust where they will, may actually cost tax dollars rather than saving them due to the range of state estate and income tax laws.

(2) However, given the number of uncertain variables (how long the surviving spouse will live, changes in the tax laws, which state income tax law will apply to the beneficiaries at the time they wish to sell inherited assets, rates of inflation and rates of return), the only way to be sure that the applicable exclusion amount of the first spouse to die benefits her beneficiaries is to lock its use in with a credit shelter trust at the time of her death. Any excess amount can pass to the surviving spouse as DSUE so that it is not wasted.

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[78] This example does not necessarily take into account the possibility that John’s basic exclusion amount may be reduced dramatically in 2026 if the basic exclusion amount is reduced to $5 million, adjusted for inflation. Such an event would only excerbate the facts of the example.

d. At a minimum, these issues do require some discussion with your client about her preferences and a careful selection of the party to serve as executor – perhaps coupled with a direction in the will as to what elections the executor should make.

e. These issues could also be addressed in a prenuptial or postnuptial agreement. For example, the parties could agree to permit the surviving spouse to have the use of any remaining exclusion amount not used by the first spouse to die on lifetime gifts, in return for an agreement that the surviving spouse would waive the right of reimbursement for estate tax due as a result of the inclusion of the QTIP trust benefitting the children of the first spouse to die in the surviving spouse's estate.

f. For clients who are already married and (1) do not have a prenuptial agreement or do not have a provision addressing the use of the DSUE in their prenuptial agreements, and (2) live in a state where postnuptial agreements are not effective or the clients prefer not to negotiate a postnuptial agreement, there may be another option. In these cases, consider whether the testator can unilaterally address the issue by including a provision in her will that directs her executor to make the QTIP election for a trust created under her will only upon receiving a binding agreement executed by the surviving spouse agreeing to waive in his will the right of reimbursement from the QTIP trust.

Example: Returning to Frieda and Harvey, Frieda created an $10 million QTIP for Harvey, who had $18 million of his own. At Harvey's death in 2023, if his Will exonerated Frieda's QTIP from reimbursement for estate tax under § 2207A, then all of Frieda's $10 million would go to her children. Harvey's children would get the benefit of Frieda's $2.92 million of unused DSUE amount (in effect, $10 million of her DSUE amount protects the QTIP), and all of Harvey's basic exclusion amount.

BUT, consider the following example:

Example: Flora and Herbert are on their second marriages, each with children from a prior marriage. Flora dies first in February of 2023 with an estate of $23 million which she leaves to a QTIP for Herbert. Flora's Will has a provision

permitting her executor to make a portability election if Herbert agrees to exonerate the QTIP from reimbursement under § 2207A. Herbert agrees to exonerate the entire QTIP. At Herbert's death a few months later in 2023, he has separate assets of $13.84 million, making his taxable estate $36.84 million including the $23 million QTIP. He has an applicable exclusion of $25.84 million, leaving $11 million subject to tax at 40% ($4.4 million). His $13.84 million estate will pay the entire $4.4 million of tax and the entire $23 million in the QTIP will pass to Flora's children. If, instead, Flora's will had created a credit shelter trust of $12.92 million with the remainder of the trust to her children and Herbert had not waived his right of reimbursement for estate tax from the QTIP trust, the QTIP trust would have been funded with $10.08 million for which it would have reimbursed the estate $4.032 million in tax, leaving Herbert's estate to pay only $368,000 in tax from Herbert's assets. Herbert's children would have received the full benefit of Herbert's applicable exclusion amount and paid tax on the excess and Flora's children would have received the full benefit of her applicable exclusion amount and paid tax on the excess. Exoneration of the entire QTIP trust can over-compensate the QTIP beneficiaries.

(1) Under circumstances such as Flora and Herbert's, consider segregating the QTIP into two shares: one equal in value to the DSUE amount and one equal to the balance and exonerate only the first QTIP from the right of reimbursement for taxes.

(2) A final point to consider in using the exoneration technique to preserve benefits from the DSUE amount for the beneficiaries of the first to die is the importance of a solvent surviving spouse. The surviving spouse's estate may have huge adjusted taxable gifts made immediately before death, and not many assets remaining in the estate. In this case, there might not be enough left in the estate to pay the tax due on the QTIP. Even in cases of well-meaning surviving spouses, these deathbed gifts may have been made by a child of the surviving spouse under a power of attorney.

E. GST Exemption.

1. A final disadvantage of using portability is that the GST tax exemption is not portable. The use of portability for the client's applicable exclusion amount may cause the client's GST tax exemption amount to be wasted, or, at best, make its use inefficient.

2. Under current law, the amount of the GST tax exemption and the amount of the basic exclusion amount are equal. Assuming the decedent's remaining applicable exclusion amount is being transferred to the surviving spouse through a portability election, the only way the decedent can take advantage of her remaining GST exemption is to make a bequest for the benefit of grandchildren using a reverse QTIP trust.[79]

3. In conjunction with making the portability election, if the executor were to make a reverse QTIP election to allocate the decedent's remaining GST tax exemption to a trust for the surviving spouse with her grandchildren or more remote descendants as the ultimate remaindermen, this would result in an inefficient use of GST tax exemption. First, the value of the assets in the trust would not appreciate as quickly as would be desirable because all of the income of the trust would be required to be distributed to the surviving spouse. In addition, if the reverse QTIP trust is the only QTIP trust created in the estate of the first spouse to die, or, in the worst case, if the regular QTIP is not obligated to pay the estate tax due on the reverse QTIP trust, the estate tax due at the death of the surviving spouse might have to be paid from the GST tax exempt assets in the trust. This will clearly reduce the effectiveness of the GST exemption allocation.

XI. APPLICATION OF PORTABILITY RULES

The concept of portability is most useful in three particular situations: (1) where the combined estate of a married couple is taxable but does not exceed twice the amount of the basic exclusion amount; (2) where the bulk of value in the combined estate of a married couple is in assets that are hard to use to fund a credit shelter trust; and (3) for wealthy couples.

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[79] § 2642(a)(3).

A. Married Couples with Modest Wealth.

1. The Ideal Couple.

Married couples with combined estates of greater than one basic exclusion amount but less than two times the basic exclusion amount are generally the taxpayers for whom portability was implemented. These individuals (with the help of their estate planners) have been creating credit shelter trusts in their documents because, although their separate estates were not taxable, their combined estates potentially would be taxable at the death of the survivor of them. Generally, had it not been for tax planning, the vast majority of these taxpayers would not have created trusts for their spouses and would instead have been happy with simple "I love you" wills.

a. Now, using portability, the first spouse can simply leave all of her assets to her surviving spouse, with the knowledge that her credit will still be of use in protecting her assets from tax at the death of her spouse.

b. The simplest example might be a couple where each of them has $6 million of assets. At the death of the first spouse, she leaves all of her assets to her spouse who, after her executor elects portability on her estate tax return, then has an applicable exclusion amount of $27.22 million, under current law.[80] This exceeds the amount of the couple's combined wealth by a nice margin, and assuming they are not too young, is likely to be sufficient to protect all of their assets from tax at the death of the survivor, even permitting some growth in the assets.

c. Note, however, that if they reside in a state that imposes a death tax, additional state death tax will be due at the death of the surviving spouse since any state death tax exemption of the first spouse will have been wasted.

d. For this reason, for clients residing in states that continue to impose a death tax, a credit shelter trust in the amount that can pass free of state estate tax will still be a prudent course.

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[80] Even if the basic exclusion amount were reduced to approximately $7 million in 2026, the combined exclusion amounts would likely still exceed the value of their combined estates.

2. But What about the Growth?

A more troubling example might be a couple where each of them has a little over $10 million of assets. In this case, if it were likely that the value of the assets would increase, a credit shelter trust in the estate of the first spouse to die would protect any future appreciation of the value of the credit shelter trust from estate tax. Note, however, in states that impose a death tax, state estate tax is likely to be due at the death of the first spouse on any amount in the credit shelter trust that exceeds the amount that can pass free of state estate tax. In addition, the appreciation in the value of the assets between the two deaths will qualify for a § 1014 basis adjustment if owned directly by the surviving spouse or by a QTIP trust, which would not be the case if a credit shelter trust were to be used. Estates in this range can pose conundrums and it may be difficult to determine whether portability in excess of the amount that can pass free of state estate tax is the best choice for these clients.

B. The More Wealthy/Less Wealthy Couple.

On the other hand, if the two spouses do not have assets of equal value, but instead have most of the wealth in the hands of one spouse, portability can permit them to take full advantage of the applicable exclusion amount, regardless of who is the first to die.

1. If the less wealthy spouse is the first to die and his executor elects portability, then the more wealthy spouse will have the maximum amount of exemption available to protect her assets from tax at her death. Again, this is subject to the caveat that it may be prudent to be sure the less wealthy spouse can take advantage of the amount that can pass free of state estate tax, if any.

2. Alternatively, if the more wealthy spouse is the first to die, she can leave all of her assets either outright or in a QTIP trust for the less wealthy spouse, have her executor elect portability and at the death of the second spouse, the less wealthy spouse will have all of the assets includible in his estate and will have both exclusion amounts available to him.

3. This eliminates the need for the couple to retitle assets in order to fully use each of their applicable exclusion amounts, an exercise that often distorted a couple’s otherwise preferred financial structure.

C. Planning with Difficult Assets.

Regardless of the size of a couple's combined estate, there are some assets that may represent a substantial portion of the value of the couple's assets but that are difficult to use to fund a credit shelter trust. A couple of examples are presented below.

1. IRD Assets.

Retirement plans can be used to fund credit shelter trusts, but even when done properly, it is very easy to end up with a trust that is inefficiently funded because a big chunk of it is required to be expended for income tax. The same is true of other deferred compensation plans.

2. Residences.

In some cases, the clients' home is their most valuable asset, but it may be laden with issues that make it a poor candidate to use to fund a credit shelter trust.

a. For example, the client may want to continue to take deductions generated by the real estate taxes and the home mortgage on her personal income tax return.

b. If there is a mortgage, there may not be any cash in the trust with which to make the mortgage payments, and asking the beneficiary to pay those expenses may raise issues about whether the beneficiary has become a grantor of the trust by making principal payments on the mortgage.

c. If the house is owned in part by the credit shelter trust and in part by the surviving spouse, keeping track of each payment and the allocation of every expense will be bothersome and can be expensive.

d. In addition, if it is necessary to transfer the home to either spouse to be sure that spouse has sufficient assets to fund a credit shelter trust and the "wrong" one dies first, there may not have been any adjustment in the basis of the residence if the surviving spouse would like to sell the property.

D. Portability Planning for Wealthy Clients.

1. As noted above, the clear intent in passing a law permitting portability of the applicable exclusion amount of the first spouse to die was to simplify the estates of couples who otherwise would not create trusts for each other at their deaths. However, as is often the case, the folks who can use this technique to hit the ball out of the park are the wealthy, particularly those living in states that impose a death tax.

2. An *inter vivos* defective grantor trust created by the surviving spouse can be used in place of a credit shelter trust created at the death of the decedent.

   a. Instead of creating a credit shelter trust for the amount that can pass free of *federal* estate tax, the will of the first spouse to die could leave the balance of the client's estate to her spouse (perhaps with a disclaimer option into the credit shelter trust in case the tax laws change again). Assuming that her executor elects portability and that gifts are not subject to state transfer tax, this sets the stage for excellent estate planning.

   b. The surviving spouse then makes a gift of the DSUE amount to an intentionally defective grantor trust for the benefit of their descendants. If the surviving spouse also wishes to use the balance of his applicable exclusion amount, he could make a gift of up to $27.22 million (depending on their available applicable exclusion amounts) to a defective grantor trust on which he will be required to pay all of the income taxes without any state or federal transfer tax consequence.[81] If he chooses to use his GST tax exemption, he can divide the gift into two parts: a trust that is GST tax exempt for grandchildren using his GST exemption and the balance to a trust for children.[82]

   c. This result is far more efficient than disclaiming into a credit shelter trust.

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[81] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[82] To avoid wasting the GST exemption of the first spouse to die, a bequest to a QTIP trust in the amount of her available GST exemption could be made in the Will of the first spouse to die and a reverse QTIP election could be made for this trust to utilize her available GST exemption.

(1) If a traditional credit shelter trust is created at the decedent's death, the trust (or its beneficiaries) will pay the income tax on trust income. Unlike the credit shelter trust, the assets in the defective grantor trust will not be diminished by payment of income tax and will compound at a much higher rate. This advantage of a defective grantor trust is such a powerful estate planning benefit, it may outweigh other considerations.

(2) Moreover, in a state that imposes a state death tax, using the full amount of the decedent's applicable exclusion amount to fund a credit shelter trust likely would require payment of some state estate tax in order to take full advantage of the federal credit. The defective grantor trust can be fully funded with the amount of the federal applicable exclusion amount without payment of any transfer tax.

d. Although an adjustment in basis is not necessarily available in either case, the credit shelter trust or defective grantor trust, in the case of the latter it is possible the assets could receive an adjustment in basis if the surviving spouse swaps them out for cash or unappreciated assets shortly prior to death. Under current law, this transaction would avoid any recognition of gain by the grantor or the trust and permit the trust assets to receive a basis equal to their fair market value at the death of the surviving spouse.

3. This plan works for the wealthy since they can afford to make gifts of this size and pay the income tax on income they do not receive. The difficulty with this plan for clients of more moderate size is that the surviving spouse, who is the grantor, should not also be a beneficiary of the trust. To use this technique, even if the only amount gifted is the amount of the DSUE, the surviving spouse must have adequate assets to be able to live without the benefit of the gifted assets. Some planners have suggested that including the grantor/spouse as a beneficiary might be successful in states that protect self-settled trusts from creditors, but the results of this do not seem reliably predictable at this time.

4. Although the focus above is on states with an estate tax but no gift tax, many of the benefits of this technique also work well in the absence of a state estate tax.

XII. PORTABILITY AS A POST-MORTEM DECISION

Because of the number of factors and fact-specific considerations to be taken into account, the decision on whether to utilize portability likely will need to be a post-mortem decision. As should be obvious from the analysis of the factors above, in most estates the surviving spouse will need to review his circumstances and make a decision about the best course of action, both economically for the family and for himself.

A. <u>The Need for Flexibility</u>.

In order to permit the decision to use portability to be made post-mortem, it will be necessary to incorporate one of the three standard flexibility techniques into the estate planning documents to preserve the ability to use the applicable exclusion amount of the first spouse to die in the event that portability is not elected. Generally, marital planning at death focuses on techniques for dividing the testator's estate between the use of the testator's remaining applicable exclusion amount and a marital bequest, usually with the goal of paying no estate tax at the death of the first spouse to die. Even for clients who have fully used their applicable exclusion amounts during life, it is nevertheless prudent to include a flexibility technique described below that will allow use of any applicable exclusion amount the client may unexpectedly have at death. Although a portability election will now preserve any unexpected applicable exclusion amount of the first spouse to die by transferring it to the surviving spouse, as noted below, it may not be the best alternative in some cases.

B. <u>Effect of Portability</u>.

1. The Effect of Portability on Disclaimers.

   a. Prior to the enactment of portability, a surviving spouse's decision not to disclaim, for example to avoid the imposition of state estate tax, would have had the effect of wasting the first spouse's applicable exclusion amount, which would generally result in a greater estate tax liability at the surviving spouse's death. With the availability of portability, however, if the surviving spouse chooses not to disclaim, he will "inherit" the decedent's DSUE amount, which he can use to make lifetime gifts, or save and use at his own death (unless he becomes a surviving spouse of a later deceased spouse). The decision

whether or not to disclaim – essentially a decision whether or not to use portability – will involve a sophisticated analysis of the advantages and disadvantages of using portability, as described in detail above.

b. Portability may also address two of the thorny problems associated with disclaimers.

(1) A primary difficulty with disclaiming is that clients often do not realize the significance of their actions and do things that constitute the acceptance of the property they plan to disclaim. Thereafter, those assets generally cannot be disclaimed, although a partial disclaimer may, under certain circumstances, still be possible. Even clients who have been educated during the estate planning process about not accepting benefits of the assets still take actions which prevent a qualified disclaimer. For couples who engage in disclaimer credit shelter trust planning, it is imperative that the surviving spouse seek legal assistance in administering the deceased spouse's estate as quickly as possible and not take any action with regard to assets owned by the deceased spouse or jointly with the deceased spouse until he has done so.

(2) A second issue in disclaiming (which can get fairly technical but should not be overlooked) is that a pecuniary disclaimer, that is, a disclaimer of a specific amount, likely will cause capital gain to be recognized on the assets transferred as a result of the disclaimer.

(a) Use of formula disclaimers is often advisable in order to ensure that the credit shelter amount is not over- or underfunded in the event that assets are revalued on audit or later discovered.

(b) Since disclaimers to a credit shelter trust may be pecuniary disclaimers even if they are made by formula, it is generally good practice not to delay too long in making the decision to disclaim, particularly in a rising market.

(c) In addition, a sometimes overlooked requirement for a pecuniary disclaimer is that the disclaimed amount and any income attributable to such amount immediately must be segregated from other estate assets following the disclaimer.[83]

(3) A portability election is not affected by the actions of the surviving spouse with respect to the decedent's assets and does not require the recognition of gain on the amount of the DSUE nor the segregation of the disclaimed assets.

2. The Effect of Portability on Partial QTIP Elections.

a. Portability is not as effective a solution to the issues raised by partial QTIP elections as it is in addressing disclaimer issues. Certainly the executor can make a full QTIP election and allow the decedent's applicable exclusion amount to pass to the surviving spouse to use for gifting during life. If the surviving spouse promptly gifts assets with a value equal to the DSUE amount, all of the income from the assets that would otherwise increase the value of his estate will be transferred to his donees. However, this alternative raises two issues that do not arise if a partial QTIP election is made:

(1) To take advantage of this alternative, the surviving spouse must have assets sufficient to support himself without the benefit of the income from the gifted assets and

(2) The surviving spouse might gift the assets to his own choice of beneficiaries and not the beneficiaries the first spouse to die would have selected.

b. For these reasons, the use of portability as an alternative to partial QTIP elections may not be appropriate.

3. The Effect of Portability on Clayton Elections.

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[83] Treas. Reg. § 25.2518-3(c).

a. As with a partial QTIP election, the decision whether and to what extent to elect Clayton treatment will to a large extent be driven by the executor's determination whether and to what extent to utilize portability.

b. Again, if the reason a Clayton structure has been selected is because the decedent has children from a prior marriage and is interested in protecting their bequests, then portability likely will not be a viable alternative to Clayton trust planning.

XIII. CONCLUSION

A. To sum up, marital deduction/credit shelter planning is not simple. Although the need to incorporate flexibility techniques into clients' estate plans began in an effort to address the ever changing estate tax laws applicable since 2001, now, even though the current estate tax law is temporarily more stable, the use of flexibility techniques in clients' estate plans has never been more important.

B. Care to preserve the benefit of the marital deduction is the most basic of considerations, requiring attention not only to the terms of the disposition for the benefit of the surviving spouse, but also to the nature of the assets themselves and who the key players in the estate plan will be.

C. The importance of incorporating planning for state death taxes also cannot be overstated, even in states that currently do not have a state death tax. Client mobility and assets located in "foreign" states can provide very unpleasant results.

D. Portability adds an interesting element to testamentary planning because, other than possibly providing in the will that the executor should make the election if the decedent has a DSUE amount, there are no provisions included in the will directing how it will or will not be implemented. It is the silent partner of testamentary estate planning.

E. It appears it is absolutely necessary to continue to incorporate flexibility techniques into marital deduction/credit shelter estate plans and to draft to permit the decision on whether or not to use portability to be a post-mortem decision.