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Post Mortem Estate Planning
Doing It After You’re Dead

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I. Income Tax Consequences of Planning and Funding

A. Types of Testamentary Gifts

There are four primary types of testamentary gifts: a gift of specific property, a gift of a specific sum, a formula gift of a specific sum, and a gift of a fractional portion.

1. A specific gift of property is a gift of a readily identifiable item of property. Reg. §1.663(a)-1(b)(1). For example, a gift of 1,000 shares of IBM stock.

2. A gift of a specific sum is a gift which is readily ascertainable as of the moment of death. Reg. §1.663(a)-1(b)(1). For example, a gift of $10,000 to decedent’s brother.

3. A formula gift of a specific sum is a gift which is ascertainable at a time subsequent to death. Reg. §1.661(a)-2(f). For example, a pecuniary marital formula gift.

4. A gift of a fraction of a fund generally occurs in the residuary estate.

B. Income Tax Consequences of Funding a Gift of Specific Property

1. If the gifted property is distributed, IRC §663 provides that the distribution does not carry out distributable net income ("DNI"), or undistributed net income ("UNI") provided that the terms of the will do not require payment of the gift in more than three installments. Reg. §1.663(a)-1(a). This may be used when a trust has built up substantial UNI while it is a foreign trust. For example, if the distributions are limited to the pecuniary gifts, the UNI throwback tax will not be triggered. This is one way to avoid the confiscatory
tax that results from the distribution of UNI from a foreign trust or a trust that was foreign and was later domesticated.

2. No gain or loss is recognized on distribution even though the value on the date of distribution is different from the property's adjusted basis. Reg. §1.661(a)-2(f)(1).

3. The estate may not elect to recognize gain or loss on the distribution. IRC §643(e)(4).

4. The estate cannot deduct the distribution for income tax purposes. IRC §663(a)(1).

5. The recipient of the gift takes the estate's basis in the property. IRC §1014; Reg. §1.1014-4(a), §1.661(a)-2(f)(3).

6. The recipient of the property is entitled to the income from the property (net of deductions) from the date of death to the date of distribution. See, e.g., Cal. Prob. Code §12002(b). Such income may not be includible in DNI. See Reg. §1.661(b)-1, §1.662(b)-1. See also, Sanborn v. Comm'r, 88 F.2d 134 (8th Cir. 1937), Hibernia Nat'l Bk v. Donnelly, 121 F. Supp. 179 (E.D. Ca. 1954), aff'd, 214 F.2d 487 (5th Cir. 1954).

7. If property other than the specifically gifted property is distributed, IRC §663 is applicable, but gain or loss may be recognized because the distribution is treated as an exchange of the distributed property for the specifically bequeathed property. Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940); IRC §643(d)(4).

   a. If the estate distributes appreciated property, the estate must recognize gain.

   b. If the estate distributes depreciated property, the estate has a non-deductible loss. IRC §267 now applies to estates unless the distribution is in satisfaction of a pecuniary gift. IRC §267(b)(13).

   c. If the distribution is made from a trust, the gain is recognized, but loss may not be recognized. See IRC §267.

   d. The recipient's basis for the distributed property is the property's fair market value at the time of distribution. Reg. §1.1014-4(a)(3), §1.661(a)-2(f)(2).

C. Income Tax Consequences of Funding Nonformula Pecuniary Gifts (Specific Sum of Money)
1. If the gift is a specific sum of money, and if the terms of the instrument require that the gift be paid in three or fewer installments, the gift does not draw out DNI or UNI when funded with cash or property. IRC §663(a)(1). See P.L.R. 200210002.

2. If the instrument is silent as to the payment mode, it is assumed that the gift is required to be paid in a single installment. Reg. §1.663(a)-1(c).

3. If the terms of the instrument require payment in four or more installments, the payments will draw out DNI or UNI even if the gift actually is paid in less than four installments. Reg. §1.663(a)-1(b)(2).

4. The funding of a specific gift of money with appreciated or depreciated property will result in realization of gain or loss under most circumstances. Reg. §1.1014-4(a)(3).
   a. If the distribution is made from an estate, gain or loss is recognized. IRC §267(b)(13).
   b. If the distribution is made from a trust, gain is recognized, but loss is not recognized. IRC §267.
   c. If gain or loss is recognized, the beneficiary receives a basis equal to the fair market value of the property on the date of distribution. Reg. §1.1014-4(a)(3).
   d. The recognition of gain or loss is not elective. IRC §643(d)(4). See Reg. §1.661(a)(f)(1); Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940).

5. If income in respect of a decedent or other "ordinary income" property is distributed to satisfy a pecuniary gift, the estate or trust will recognize ordinary income or capital gain, depending on the nature of the asset. For example, if an IRA is used to fund a pecuniary marital gift, the estate will recognize income.

D. Income Tax Consequences of Funding Formula Pecuniary Gifts

1. If a gift of a specific dollar amount is not ascertainable as of the date of death because it is expressed as a formula, distribution of cash in satisfaction of the gift is not "sheltered" by IRC §663, the estate receives a distributions deduction, and the recipient must include the gift in income to the extent of the estate's or the trust's income. IRC §661, §662. See P.L.R. 200210002.

2. If cash is distributed, IRC §643(e) does not apply. IRC §643(e)(2).
3. If a formula pecuniary gift is funded with property, the distribution carries out DNI equal to the property's fair market value at the date of distribution. Reg. §661(a)-2(f)(1).

4. The recipient receives a basis equal to the fair market value of the property at the time of distribution. Reg. §1.661(a)-2(f)(3).

5. If a pecuniary formula gift is funded at federal estate tax values, no gain or loss will be recognized on funding, but as to marital and charitable gifts, the marital deduction or the charitable deduction may be lost unless the instrument provides for a fair allocation of appreciation and depreciation between the date of death and the date of funding among all gifts. See, Rev. Proc. 64-19, 1964-1 C.B. 682; Rev. Rul. 81-20, 1981-1 C.B. 471; P.L.R. 8339005.

6. IRC §267 disallows a loss for distribution of depreciated property to a beneficiary. However, if the beneficiary later sells the property at a gain, the gain will not be recognized to the extent of the nondeductible loss. IRC §267(d).

E. Income Tax Consequences of Funding Fractional Share Gifts and Residuary Gifts

1. Funding fractional share and residuary gifts always carries out DNI to the beneficiaries to the extent of the estate's or trust's income. For the tax consequences of funding without a court order in a state that requires a court order, see Bohan v. U.S., 456 F.2d 851 (8th Cir. 1972); Murphy v. U.S., 91-1 USTC ¶ 50,167 (W.D.Oklahoma 1991), rev'd, Buckmaster v. U.S., 93-1 USTC ¶ 50,054 (10th Cir. 1993).

2. Prior to the enactment of IRC §643(e), a distribution in kind in satisfaction of such a gift gave the beneficiary a "free" stepped-up basis. IRC §643(e) provides that an in-kind distribution does not result in the recognition of gain or loss unless an affirmative election is made. Absent the election, the beneficiary's basis is a "carry-over" basis from the estate or trust. IRC §643(e)(1).

3. The fiduciary may elect to have gain or loss recognized on the distribution. IRC §643(e)(3). If the election is made and the estate or trust recognizes gain, the beneficiary's basis is the fair market value on the date of distribution. IRC §643(e)(2).

4. The IRC §643(e)(3) election is made annually, and once made, is irrevocable unless the Service consents to the revocation. The election applies to all distributions made during the taxable year; it cannot be made for specified distributions only.
5. If the election under IRC §643(e)(3) is not made, the beneficiary's holding period is determined by tacking onto the beneficiary's holding period the holding period of the estate or the trust.

6. Distributions of depreciated property should not be made by a trustee because the loss will be disallowed if the IRC §643(e)(3) election is made. IRC §267.

7. A non-pro rata distribution to residuary beneficiaries in the absence of a governing instrument provision permitting such distributions or state law permitting such distributions will result in taxable exchanges among the beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159; P.L.R. 9625020 (non-pro rata distribution taking into account potential tax liabilities approved).

F. Income Tax Consequences of Distributions of Income in Respect of a Decedent

1. Income in respect of a decedent received by the estate or trust is taxed to the estate or trust. If the estate distributes income in respect of a decedent payments, the estate will be entitled to a distributions deduction under IRC §661, and the beneficiary will include the item in his income.

2. The distribution will retain its character in the hands of the beneficiary, and the beneficiary is entitled to the IRC §691(c) deduction for estate taxes.

3. If the estate transfers the right to receive future payments of income in respect of a decedent, the income tax consequences depend on the nature of the distribution.

   a. Generally, a transfer of future income in respect of a decedent requires the estate to include in its gross income the fair market value of the asset on the date of transfer. IRC §691(a)(2).

   b. A "transfer" includes a "sale, exchange or other disposition," but does not include a distribution by the estate to a specific legatee or a residual legatee. Reg. §1.691(a)-4.

4. Distributions of the right to receive future income in respect of a decedent do not result in a basis change. The distributee continues to retain the estate’s basis.

5. Funding of a pecuniary gift (either formula or nonformula) with a right to receive income in respect of a decedent will result in the recognition of income on the part of the estate and trust to the
extent of the value of the right to receive the future income payments. The estate or trust receives an IRC §661 deduction, the recipient receives a new basis equal to the fair market value of the asset distributed (Reg. §1.1014-4(a)(3)), and the legatee is entitled to the IRC §691(c) deduction.


G. Allocation of Income and Gain During Administration

1. Under state law, income earned during administration generally is allocated to the residue. See e.g. Cal. Prob. Code §12006.

2. Specific gifts of cash generally are entitled to interest if not paid within a specified period of time following death. See, e.g. Cal. Prob. Code §12003.

   a. If prolonged administration is anticipated, many wills waive interest on specific bequests.


4. The issue of how to allocate income and gain belonging to the residue among residuary beneficiaries generally arises in the context of residual shares that bear differing amounts of estate or inheritance taxes, or in situations when preliminary distributions to one or more beneficiaries have "upset" the balance that existed as of the date of death among beneficiaries.

5. The typical marital deduction fractional gift is a pre-tax determination of the fractional shares. The residue of the estate (after payment of debts, administration expenses and specific gifts, but before payment of death taxes) is divided among the fractional shares.
6. Under a "true" fractional plan of distribution, death taxes also are removed from the residue prior to division into the fractional shares. If the true fractional plan of distribution is adopted, any portion of the estate qualifying for the marital deduction or charitable deduction will be reduced by a proportionate share of taxes, with the result that the marital or charitable deductions will be reduced.

7. Two theories of income and gain allocation have emerged, the "fixed fraction approach" and the "changing fraction approach."

a. Under the fixed fraction approach, the fraction of income and gain allocated to various shares is determined as of the date of death (before payment of taxes), and remains constant throughout administration, notwithstanding that some of the shares may be reduced by payment of taxes. See Matter of Williams' Estate, 12 Misc.2d 136, 176 N.Y.S.2d 895 (1958); Matter of Mattis Estate, 12 Misc.2d 502, 172 N.Y.S.2d 303 (1958); In re Shubert's Will, 10 N.Y.2d 461, 180 N.E.2d 410 (1962).

b. While the fixed fraction approach has as its primary advantage simplicity, it is not equitable. Absent a specific indication of a decedent's intention with respect to the allocation of income and gain during administration, the changing fraction approach has emerged as the rule of preference in those jurisdictions that have considered the question, either by statute or case law. See Estate of Palitz, 70 Misc.2d 136, 331 N.Y.S.2d 929 (1972); Matter of Estate of White, 20 N.Y.2d 791, 284 N.Y.S.2d 95, 230 N.E.2d 735 (1967); Estate of Greenfield, 484 Pa. 141, 398 A.2d 293 (1979); Estate of Cole, 491 A.2d 770 (N.J.Super.Ch. 1984); Estate of Lewis E. Landoli, 22 Fla.Supp.2d 8 (1986), aff'd, 547 So. 2d 664 (1989); Alexandria National Bank v. Thomas, 213 Va. 620, 194 S.E.2d 723 (1973).

c. Statutory law is helpful, but does not cover all situations. See N.Y. EPTL2.1(d)(2).

d. Changing fraction approach adopted for income, but not necessarily gain; Conn.Gen.Stat. §45-277a (changing fraction approach for "significant" distributions and tax payments); New Uniform Principal and Income Act §5(b)(2) (income allocated in proportion to beneficiaries' respective interests in undistributed assets computed at times of

e. Although out of date, summaries of all state statutes can be found in R. Covey, *The Marital Deduction and the Use of Formula Provisions*, pp. 65-70 (3d Ed. 1984).

f. With respect to the marital deduction (and perhaps the charitable deduction), federal law is silent on whether any particular method should be used. The Regulations merely provide that in determining the value of property passing to a spouse, “account must be taken of the effect of any material limitations placed upon [a spouse's] right to income from the property.” Reg. §20.2056(b)-4(a).

g. Even under the changing fraction approach, it is unclear whether the allocation is made based on inventory values or on fair market value at the time of the change.

8. New Regulations have been issued under the separate share rule of IRC § 663(c). The Regulations were made final on December 28, 1999 with respect to decedents who died after that date and apply to estates and trusts that made the IRC § 645 election to be treated as part of an estate for income tax purposes. The function of the separate share rule is to allocate DNI among the various beneficiaries who have substantially separate and independent shares of an estate or trust.

a. The separate share rule is not elective; Reg. § 1.663(c)-1.

b. Under the Regulations, a beneficiary has a separate share if the beneficiary (or a class of beneficiaries) have identifiable economic interests that, under a standard in the final Regulations, neither affect nor are affected by economic interests accruing to another beneficiary. For example, a specific bequest that is payable in more than three installments (and which fails to qualify for the IRS § 663(a)(1) exclusion from distributable net income carry out rule) or where there is a formula not determinable at death (like a marital deduction formula) this is a separate share. The Rule precludes much of the potential to impose a disproportionate share of distributable net income (“DNI”) on one beneficiary. While this makes the planning more equitable it precludes planning by allocation of income to beneficiaries more able to absorb the income.

c. The problem that exists with a rolling fractional marital formula and the ever changing fraction will now exist in
every administration. Income and deductions need to be allocated according to the initial fraction but this will change when a new lock step distribution is made to one of the beneficiaries. To do this, the estate has to be revalued.

d. The Regulations do contain a loosely worded relief provision. Regulation § 1.663(c) – 4(c) talks about “reasonable and equitable” which provides some flexibility.

e. One of the major consequences of the new Regulations is the pecuniary formula marital will now require the same complexity as the fractional formula (assuming that the professionals adhere to the Regulations.)

f. Example 3 in the Regulations has a formula marital bequest and a partial non pro rata distribution.

Example 4 has a credit shelter pecuniary bequest distributable in not more than three installments. No DNI would carry out with this distribution.

g. Examples 8, 9 and 10 all of these examples deal with income in respect of a decedent (“IRD”). See Regulation § 1.663(c) – 2(b)(3). The rule is that IRD is only allocable to those shares that could be funded with these amounts (pro rata to the size of the shares). If the document apportions the IRD away from the pecuniary formula, this will be respected.

h. Example 7 deals with a spousal elective share and the fact that the elective share is a separate share if state law provides that the spouse is entitled to neither income nor a share of the appreciation or depreciation.

i. Example 8 deals with a specific bequest of property and this is not a separate share.

II. Post-Mortem Valuation Philosophies

A. It is tempting in a no-tax estate (e.g., unlimited marital deduction) to value assets on the high side rather than on the low side in order to produce a higher income tax basis. However, there are countervailing considerations:

1. IRC §6662 must be considered. IRC §6659 (the predecessor to IRC §6662) was used to assert a penalty against an estate beneficiary who claimed an increased cost basis for accelerated

2. A high valuation of assets could compromise a surviving spouse’s ability to make noncharitable gifts or sales of that property at reasonable values (e.g., QPRTs, sales to defective trusts, etc.).

3. A high valuation in the first decedent’s estate may become a floor for the value of those same assets in the surviving spouse’s estate.

4. Even if no federal estate tax is paid, if state death tax is payable, higher values will generate additional state death taxes which must be compared with potential income tax savings achieved by the higher basis.

5. A higher valuation will be useful if assets will be given to charity by the beneficiary. However, IRC §6662 is applicable, and the charitable gift appraisal and reporting requirements may result in an inconsistency.

6. There is a temptation not to claim discounts for minority and lack of marketability interests. If such discounts had been taken with respect to previous gifts that were actually made, and there is little to distinguish the death situation from the lifetime situation, the estate tax audit (which seldom occurs in a no-tax estate) might result in the disallowance of discounts claimed for gift tax purposes. In light of the case law, do preparers of estate tax returns and their advisers have an obligation to claim discounts in a no-tax estate? See, Jameson v. Comm’r, 77 T.C.M. 1381 (1999).

7. There is a rebuttable presumption that estate tax value applies for income tax, but the presumption can be overcome if the taxpayer asserting a different value for income tax purposes was not involved in the estate tax valuation. See Rev. Rul. 54-97, 1954-1 C.B. 113; P.L.R. 199933001.

8. Inside basis in a partnership may be higher than outside basis, thus arguing against the IRC §754 election.

B. In taxable estates, the inclination will be to value on the low end of reasonable.

1. If values are unreasonably low, undervaluation penalties could apply, together with increased estate taxes, plus penalties and interest. IRC §6662(g). For a case which reviews the
circumstances under which an undervaluation penalty could be applicable, see *M. Jung Estate v. Comm'r.*, 101 T.C. 28 (1993).

2. If the assets being valued for estate tax purposes were also the subject of lifetime gifts to charity, an attempted low valuation for estate tax purpose could result in the disallowance of previously claimed charitable income tax deductions, assuming that the income tax statute of limitations is still open.

3. Qualification of the estate for IRC §303 (redemption), IRC §6166 (installment payment of estate tax), and IRC §2032A (special use value "treatment") will also be affected by values chosen for estate tax purposes.

III. Funding/Distribution With the Same Interests Owned by Decedent

A. Little opportunity exists for "gamesmanship" on the part of the taxpayer or for the imposition of penalties by the Service if the same property that is included in the estate is distributed to the beneficiaries without change (i.e., decedent owned 20% of real property and 20% is distributed to one beneficiary). Suppose the beneficiary owns the other 80%? This fact should be irrelevant for valuation purposes. See TAM 9432001; *Estate of Cervin v. Comm'r*, 68 T.C.M. 1115 (1994).

B. Funding at date of distribution values could produce gain or loss. Reg. §1.1014-4(a)(3); IRC §267. See Section I above.


D. Interest in assets distributed may be worth less than what decedent held (e.g., 100% of asset included in decedent's estate, 50% of asset distributed to beneficiary "A", and 50% to trust "B", resulting in discounts applicable to both). See TAM 9403005.

E. Interest in assets distributed may be worth more than what decedent held (i.e., in a community property estate, a nonvertical split is made of community property assets so that 100% of an asset is distributed to a beneficiary or a trust, and 100% of another asset of equal value is distributed to the surviving spouse). For distribution valuation purposes, the 100% interest should be worth more than twice the 50% interest owned by the decedent. See, *Propstra v. U.S.*, 680 F. 2d 1248 (9th Cir. 1982). Suppose estate is divided equally between marital and nonmarital shares and 100% of one asset is distributed to the nonmarital share; is nonmarital share overfunded?
F. Suppose distributed interest places recipient in control position (e.g., 2% interest in common stock of closely held stock distributed to owner of 49% interest). See TAM 9432001. Is there fiduciary liability to other shareholders if distribution is discretionary? See, Estate of Curry v. U.S., 706 F.2d 1424 (7th Cir. 1983).

G. Examples of how such disparities can occur:

1. Distribution of less than the decedent’s entire interest in property by reason of a direction in the will (i.e., 100% of closely held stock is divided equally among five children). See Rev. Rul. 93-12, 1993-1 C.B. 202; TAM 9449001 and 9403005. See, TAM 9436005 (“swing vote” value may offset the discount). Swing vote theory of Service rejected in Richard R. Simplot, 112 T.C. 130 (1999), rev’d, 249 F.3d 1191 (9th Cir. 2001). See, Estate of Winkler v. Comm’r, 57 T.C.M. 341 (1978); A.D. Davis v. Comm’r, 110 T.C. 530 (1998); Furman v. Comm’r, T.C. Memo 1998-157 (1998).

2. By direction in the will (i.e., disposition of preferred stock to children, common stock to grandchildren; disposition of voting stock to children, nonvoting stock to grandchildren). See TAM 9403005.

3. By discretionary action of executors or trustees (e.g., a nonpro rata allocation permitted under state law or the governing instrument).

4. By applying the value fixed by a buy-sell agreement, but disallowed by the Service as fixing value, to assets distributed to the marital share. See, TAM 9327005; compare Estate of Lauder, T.C.M. 1994-527 (10/19/94).

5. Child disclaims asset so that smaller portion of the same asset which would have passed to child passes to five grandchildren. Can you leverage the value of the $1,000,000 generation-skipping exemption? See, Rev. Rul. 93-12, 1993-1 C.B. 202.

6. Surviving spouse disclaims decedent’s 55% interest in closely held stock and three children take by reason of disclaimer. One child owns 45% of corporation so his receipt of 18+% shares gives him control. See, TAM 9449001, 9432001 and 9436005.

7. Suppose executor allocates stock following disclaimer so that one child has a majority of the disclaimed shares and results in child’s control of the corporation. See, TAM 9432001 and 9436005.

H. Recapitalization directed by will or action of executor (possible IRC §2701 problem), resulting in voting and nonvoting stock, or preferred and
common, perhaps coupled with a buy-sell agreement containing restrictions on transfer, with distribution of one class of stock to one beneficiary, and other class to other beneficiary or beneficiaries.

I. Creation of partnership by executor with estate assets, with distribution of partnership interests to, for example, marital and nonmarital share, or both.

J. Exchange or sale of estate assets; distribution of newly acquired assets to estate beneficiaries (e.g., assets sold to children for note given to estate; note is distributed to surviving spouse or marital share).

K. Executor enters into joint purchase of asset with children, with estate purchasing life estate (which is used in part to fund the marital share) and the children purchasing the remainder interest.

IV. Tax Effect of Funding Decisions on Tax Sensitive Areas: Marital Deduction, Charitable Deduction and Generation-Skipping Transfers

A. The marital deduction gift may be underfunded. See, Chenoweth v. U.S., 88 T.C. 1577 (1987), in which 51% of a closely held corporation was bequeathed to the surviving spouse and 49% to the children. The estate had argued and the Court agreed that the 51% block bequeathed to the spouse should carry a control premium, and that the minority interest bequeathed to the children should be valued in that manner. This enabled fewer assets to have been placed in the marital deduction trust, and hence more assets passed to the children. What if spouse already owed 49% and 2% was distributed to the spouse? See, TAM 9436005; 9432001; 9403005. Consider subsequent gifts by spouse of interests owned outright to reduce control premium in his or her estate. Contrast Chenoweth with Provident Nat'l Bk v. U.S., 581 F. 2d 1081 (3d Cir. 1978), in which the value of nonvoting common stock that was recapitalized after death into preferred stock as required by will was not altered. Presumably, the recapitalization gave the marital gift preferred stock equal in value to the nonvoting common stock. See also, Estate of DiSanto v. Comm'r, T.C.M. 1999-421.

B. The marital deduction gift can be reduced (causing a taxable estate increase) when what passes to the marital deduction share is, by reason of discounts, worth less than the aggregate value for estate tax purposes.

1. P.L.R. 9050004 (49% interest in closely held corporate stock allocated to marital deduction trust) and P.L.R. 9147065 (marital deduction reduced where decedent's will directed split up of closely held stock with result that son received voting stock and marital trust received a "truncated" interest in the stock). Both of these bifurcations were directed by the decedent's will -- should the result be otherwise when the bifurcation is the result of
discretionary actions by the executor? What if what bases to the marital has simply fallen in value?

2. If nonvoting stock or a partnership interest (each created by executor) is distributed to the marital gift, should the marital deduction be reduced because of minority and lack of marketability discounts? The answer should be no if the conversion of decedent’s assets was for equal value. See, *Provident Nat’l Bk*, supra. Better planning would be for the marital and nonmarital gifts to enter into a partnership after the shares are funded. Such planning could reduce the value of the surviving spouse’s estate. The surviving spouse and the marital trust could then sell their partnership interests to the nonmarital share for a note, further reducing the potential value of the spouse’s estate.

3. With respect to the joint purchase mentioned in XI.D, the marital gift could be underfunded by distributing to it only a life estate. It would be better to have the marital share, after funding, and the children (or credit shelter trust after funding) engage in the joint purchase. Is IRC §2702 relevant? Is there a transfer? Does there have to be? See, Example 3 of Reg. §25.2702(d)(1), which provides that if a settlor creates a trust with a life estate to his spouse, and remainder to children, there is no IRC §2702 problem because the spouse did not hold an interest in the trust both before and after its creation. If the joint purchase is of a personal residence, utilizing a qualified personal residence trust, there should be no problem. However, see P.L.R. 9412036, denying IRC §2702 protection to a joint purchase involving a GRAT.

4. In TAM 9327005, the marital deduction was reduced because closely held stock passing to the marital trust could only be sold at a value below its federal estate tax value by reason of a buy-sell agreement which fixed values as between the parties. The QTIP election was made with respect to a fixed percentage of the stock (in effect, a dollar amount tied to the buy-sell agreement values). Had the election been by way of formula either to eliminate estate tax (which had been the intent of the taxpayer in the TAM) or to pay a certain amount of estate tax, there would have been no estate tax deficiency.

5. Tax clauses must be drawn with the possibility in mind that a buy-sell agreement will not fix value and there will be, in effect, a bequest to the shareholders entitled to purchase stock at a lower value than that determined for estate tax purposes. A "pay all from residue" tax clause would be inappropriate because the decedent’s beneficiaries would, under such a clause, typically pay
the additional estate taxes attributable to the stock's value for buy-sell purposes as opposed to federal estate tax purposes.

6. Funding opportunities exist with respect to IRC §2032A assets. It has been held that assets can be distributed to the marital share at their fair market value, even though they have been valued for federal estate tax purposes under IRC §2032A. This rule allows more assets to pass to the credit shelter/taxable portion of the estate than to the marital share, resulting in a lesser inclusion in the surviving spouse's estate. *Thomas C. Simpson v. U.S.*, 92-2 USTC ¶60,118 (D.C.N.M. 1992); P.L.R. 9314004, and TAM 8943004 and 8314005.

C. Underfunding the marital gift will have unintended tax consequences:

1. If a marital deduction gift has been underfunded by reason of the fiduciary's action as opposed to a discretion in the Will, and a credit shelter trust overfunded, the surviving spouse could have been deemed to have made a gift at the first death of the difference between what should have passed into the marital trust and what did pass. Rev. Rul. 84-105, 1984-2 C.B. 198. In TAM 9116003, which held that the particular assets being used to fund a marital deduction bequest need not be identified on the estate tax return, it was stated:

"[w]e note that any underfunding of the marital trust as a result of the valuation of estate assets, or otherwise, would have gift tax consequences as discussed in Rev.Rul. 84-105, 1984-2 C.B. 198, or alternatively, could result in an additional inclusion under section 2044 on the surviving spouse's death."

The theory is that even if the spouse is not executor, he or she should have objected to such underfunding, and the failure to do so constitutes a gift at the time of funding. However, if the spouse had a lifetime or testamentary power of appointment, there would be no gift at that time. Reg. §25.2511-2(c).

2. There also may be an inclusion in the surviving spouse's estate of such excess under IRC §2036(a)(1) if the surviving spouse has an income interest in the credit shelter trust. As noted earlier, TAM 9116003 suggests inclusion under IRC §2044, but IRC §2044 seems inapplicable because no election was made as to the excess. If an election was made for the marital gift, IRC §2044 might be applicable because the excess should be part of that gift. However, see *Katherine Bergerson*, 25 T.C.M. 1177 (1986) (surviving spouse failed to assert her rights to claim her share of property from an estate and result was increased funding of
bypass trust for spouse’s benefit, but no gift because probate court determination decree can always be amended).

D. The distribution of interests in decedent’s assets to the surviving spouse or to a marital trust may have an impact at the survivor’s death.

1. If the same asset is included in the surviving spouse’s estate in part by reason of IRC §2044 and in part by reason of the normal inclusion sections (IRC §§2031; 2033; 2038), the Service has ruled that the interests must be aggregated in the surviving spouse’s estate, P.L.R. 9140002; 9550002; 9608001, but has lost all the cases.

a. The Service’s position was based on Rev. Rul. 79-7, 1979-1 C.B. 294, in which interests in property owned at death and interests in property gifted prior to death but included in the gross estate under old IRC §2035 were aggregated. See TAM 9403002.

b. In Rev. Rul. 79-7 and P.L.R. 9140002, both assets were the decedent’s assets. However, IRC §2044 property is the property of one decedent, and under the usual inclusion sections, property is the property of another decedent. The “fiction” of IRC §2044 should not result in aggregation. See Reg. §25-2518-3 in which the period for disclaiming a remainder interest in a QTIP trust is different from the period in a general power of appointment trust. Is the difference due to the fact that the QTIP trust represents the assets of the first decedent and the general power of appointment trust represents the assets of the survivor? The Service has lost all cases on this issue. In Estate of Bonner v. U.S., 84 F.3d 196 (5th Cir. 1996); Estate of Mellinger v. Comm’r., 112 T.C. 26 (1999), acq. AOD-CC-1999; Estate of Nowell v. Comm’r, T.C.M. 1999-5; Estate of Lopes v. Comm’r, 78 T.C.M. 46 (1999). See also Peterson Marital Trust v. Comm’r, 102 T.C. 790, aff’d, 96-1 USTC ¶60,225 (1996); Reg. § 25.2518-2(c)(3). In the Nowell case, the spouse had a limited power of appointment over the assets and could combine the QTIP with the other assets under the spouse’s control. The tax court ignored the fact.

c. The Bonner line of cases was distinguished and not followed when the surviving spouse had a general power of appointment over a trust. Estate of A. Fontana, 118 T.C. 318 (2002). The court in this case ignored the Nowell case where the court came to the opposite conclusion with a
limited power of appointment. The court in *Fontana* treated the general power as equal to ownership.

2. If at the surviving spouse's death, the marital trust owns a factional interest in an asset and the spouse owns no interest in the asset outright, the marital trust asset should be subject to a discount if one is otherwise available.

E. The same principles applicable to the marital deduction should be applicable to the charitable deduction. In *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir. 1981), 99% of closely held stock was changed, pursuant to the decedent's direction, after death to nonvoting stock, and bequeathed to a charitable foundation. The remaining 1% became the only voting stock and was put into a trust for the decedent's son. *Ahmanson* held that the 99% bequeathed to the charity should be valued as a minority interest and hence increased the value of the taxable estate passing to the son. See also, *Estate of Schwan v. Comm'r*, T.C.M. 2001-174.

F. The final Regulations to the generation-skipping transfer tax provisions of the Code impose certain requirements that are designated to avoid "gamesmanship". These requirements may be helpful or harmful to the taxpayer.

1. If a single trust is treated as separate trusts for Chapter 13 purposes, all additions to and distributions from such trust are allocated pro rata to the shares, unless otherwise provided in the governing instrument. Reg. §26.2654-1(a)(2).

2. A pecuniary amount payable in kind will be treated as a separate share only if it is distributed at date of distribution values or using Rev. Proc. 64-19 principles if at other than distribution values. Reg. §26.2654-1(a)(1)(ii)(B).

3. If fractional interests in 100% owned property are left to skip persons (i.e., I give Blackacre in equal shares to my five grandchildren), there may be an opportunity to leverage the generation-skipping tax exemption, but the Regulations are not clear. If the value of Blackacre is $100,000 on the date of death, Reg. §26.2632-1(d)(2) requires allocations based on estate tax values. However, the value of what each grandchild receives is less than $20,000. Rev. Rul. 93-12, supra. How much exemption is allocated to each grandchild? Suppose Blackacre is left to one trust for five grandchildren, and the executor determines to divide the trust into separate trusts so the trusts will qualify as "S" corporation shareholders. Is the result different? See, Reg. 26.2654-1(b)(1)(ii)(C)(1) which permits funding on a non pro rata
basis if the funding is at date of distribution values or using Rev. Proc. 64-19 principles.

4. If the GST-exempt and nonexempt shares of a trust (and arguably an estate) severed from the whole are involved, Reg. §26.2654-1(b)(1)(ii)(C)(1) permits funding on a non pro rata basis if the funding is at date of distribution values or using Rev. Proc. 64-19 principles.

G. Pushing theory to the absurd.

1. Assume under state law or the governing instrument each 50% residual beneficiary is entitled to a pro rata distribution of each asset. If Beneficiary #1 receives distribution of 70% of an asset (and it is the kind of asset to which a control premium could be ascribed) and Beneficiary #2 receives only 30% of the asset (a minority interest), is Beneficiary #2's failure to enforce his or her rights to a 50% interest a gift from Beneficiary #2 to Beneficiary #1? What if each of the two residuary beneficiaries owned 49% of the stock in a closely held business and the 2% interest owned by the decedent is distributed to just one of the beneficiaries? See, TAMs 9403005 and 9436005.

2. Assume a variety of situations involving 51%/49% stock ownership. If a beneficiary owns 49% of a certain stock, and the executor distributes 2% to that shareholder, should there be a control premium attached? If each of two children already owns 49% of a company's stock, what about a distribution of 1% to each of them -- would that carry with it a premium based on ability to block action by each other? See, TAMs 9432001 and 9436005.

3. What happens if an estate is left 50% to a spouse and 50% to a charity, and the estate consists of one asset? In that case it could be argued that less than the full value of the decedent's assets passed to the shares, suggesting that an estate tax would be due. Carried to its logical extreme, any time a decedent owned a larger portion of an asset that was ultimately distributed to beneficiaries, and a marital or charitable deduction is involved, additional tax could be due. See TAM 9403005. See also, Coudell and Budgate, "New IRS Position on Valuation May Result in Reduced Marital Charitable Deduction", Journal of Taxation, September 1993, p. 176.

V. Post Death Administration Issues Involving Disclaimers.

A. It appears that property passing as a result of a disclaimer retains the character of the gift from which the disclaimer was made. In P.L.R. 9502007, a disclaimer of a portion of the residuary estate was required to
bear its share of debts and taxes because under the terms of the
governing instrument, debts and taxes were payable out of the residue.
The disclaimer did not convert a residuary gift to a preresiduary gift.
Accord, P.L.R.s 199924002; 9616001. Presumably, property passing as
a result of a disclaimer of a portion of a preresiduary gift would be treated
as a preresiduary gift. In P.L.R. 9247002, the Service (incorrectly?) ruled
that the disclaimant could not "gross up" the disclaimer so that after the
allocation of debts and taxes to the disclaimed property, the net amount
would be the amount that was intended to pass to the surviving spouse.

B. Assets must be allocated to a disclaimer of a pecuniary amount based on
fair market value at the time of allocation or on a "fairly representative"

C. Because income attributable to the disclaimed assets must be allocated
to that asset, even a disclaimer of a pecuniary amount takes on the
character of a fractional disclaimer. See, Reg. § 25.2518-3(d), examples
(17), (18) and (19). See also, P.L.R. 9513011.

D. If a pecuniary or fractional disclaimer is made, can the disclaimed
property be satisfied on a non-pro rata basis? For example, if a surviving
spouse disclaims an undivided one-half interest in the deceased spouse's
interest in the community property, can the disclaimer be satisfied with
both the deceased spouse's and the surviving spouse's property in a
jurisdiction in which the entire community property is subject to
administration. Non-pro rata funding should be permitted if state law or
the instrument permits it. See, P.L.R. 199944038. Even if non-pro rata
distribution is deemed to be an exchange, the stepped up basis at death
may prevent any significant gain recognition. See, P.L.R. 9707008.

E. A disclaimer may not be used to effect an exchange of property; it must
reduce the property passing to the disclaimant. See Estate of R. Nix, Sr.,

VI. Penalties for Incorrect Valuation

In recent years, the penalties for incorrect valuation of assets for income, estate
and gift tax purposes have become more stringent and more detailed.

A. For income tax purposes IRC §6662 provides penalties for
underpayments of income taxes arising from (a) a taxpayer's negligence
or disregard of rules and regulations, (b) "substantial" understatement of
income tax; and (c) substantial valuation misstatements.

B. If an underpayment of income tax results from a "substantial"
misstatement of value, the penalty is 20% of the underpayment
attributable to the incorrect value. The penalty for a gross misstatement
is 40% of the underpayment. A "substantial" misstatement occurs if the
value is 200% or more of the correct amount. A "gross" misstatement occurs if the value is 400% or more. In all cases, the penalty is imposed only if the misstatement results in an underpayment of tax of more than $5,000 ($10,000 in the case of a C corporation). Reg. §1.6662-5.

C. To constitute negligence, the taxpayer must fail to make a reasonable attempt to comply with the tax laws or to exercise ordinary and reasonable care in the preparation of a tax return; a taxpayer must fail to keep proper books and records or to properly substantiate items. Reg. §1.6662-3(b)(1).

D. A disregard of rules and regulations occurs when the taxpayer is careless, reckless, or intentionally disregards the provisions of the IRC, temporary or final regulations (not proposed regulations), published revenue rulings (not P.L.R.s) and certain notices. A taxpayer's conduct is reckless if the taxpayer makes "little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe." Reg. §1.6662-3(b)(2).

E. The penalty for negligence or disregard of rules or regulations is 20% of the underpayment attributable to the negligence or disregard. Reg. §1.6662-3(a).

F. A substantial understatement of income tax results if the understatement exceeds the greater of 10% of the tax required to be shown on the return and $5,000 ($10,000 in the case of a C corporation). The understatement is reduced by items that are supported by substantial authority and items that are adequately disclosed on the return (other than valuation misstatements and tax shelter items). Reg. §1.6662-4(a). The substantial understatement penalty is 20% of the understatement. Reg. §1.6662-4(a).

1. Reg. §1.6662-4(d)(3) provides guidance to determine whether substantial authority exists. Substantial authority includes the IRC, proposed, temporary and final regulations, published revenue rulings and procedures, treaties, cases, post 10/31/76 P.L.R.s, general counsel memos, official explanations, and the Blue Book (the Joint Committee Explanation of the tax laws). Reg. §1.6662-4(d)(3)(iii). Substantial authority exists if the weight of authority supporting the taxpayer's treatment is substantial in relationship to the weight of authorities supporting the contrary position. Reg. §1.6662-4(d)(3)(i). The regulations set forth a facts and circumstances test:
a. The weight of an authority depends upon its relevance and persuasiveness and the type of document providing the authority.

b. An authority that merely states a conclusion ordinarily is less persuasive than one that has a cogently reasoned analysis of the facts and the law.

c. If information has been deleted from an authority, the authority's value is diminished if the deleted information might have affected the authority's conclusions.

d. The type of document from which the authority comes is relevant.

e. It is recognized that substantial authority may exist despite the absence of "back-up" authority. For example, a well-reasoned argument relating to the construction a statute may be enough even if there are no authorities construing the statute. Reg. §1.6662-4(d)(3)(ii).

2. Reg. §1.6662-4(d)(3)(iii) states that treatises, legal periodical legal opinions or opinions rendered by tax professionals are not authority, although the underlying authorities cited in these publications may be substantial authority.

3. Reg. § 1.6662-4(d)(3)(ii) and (iii) provide a list of Service authorities and the weight to be accorded to each:

   a. P.L.R.s and technical advice memoranda are authority after they are made available to the public.

   b. A letter ruling is not authority if it is revoked or it is inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement in the Internal Revenue Bulletin.

   c. An older letter ruling or other "private" pronouncement is accorded less weight than a recent one, and such documents that are more than 10 years old generally are accorded little weight.

   d. The taxpayer's own P.L.R. and a prior year's revenue agent's report generally are per se substantial authority.

G. IRC §6662 also imposes penalties for negligence or disregard of rules or regulations in the filing of an estate tax return, and for substantial valuation understatements on a gift or estate tax return. Generation
skipping tax returns are included under IRC §2661. Unlike the income tax aspects of the penalties, no proposed regulations have been issued. However, it is anticipated that the same criteria will be applied for gift, estate and generation skipping transfer tax purposes as exist for income tax purposes. The penalty is 20% of the tax understatement, but the threshold for determining the penalty for transfer tax purposes is different from the penalty for income tax purposes. A substantial understatement exists if the value of any property is 50% or less of the amount determined to be correct (with a $5,000 threshold). The valuation misstatements should be evaluated on an item-by-item basis for purposes of the 50% test, but the aggregate underpayment of tax will be determinative of whether the $5,000 threshold has been met.

H. No accuracy-related penalty will imposed if there was reasonable cause for taxpayer’s action and the taxpayer acted in good faith. For example, if an underpayment occurs by reason of an honest mistake or reasonable reliance on others (including competent professionals), no accuracy penalty should be imposed. See, Reg. 1.6664-4. The fact that a taxpayer relied on a professional such as an appraiser, attorney or accountant is not per se reasonable or good faith unless under all of the circumstances, the reliance was reasonable and the taxpayer acted in good faith. See, Reg. 1.6664-4(b). The fact that a taxpayer relied on a professional such as an appraiser, attorney or accountant is not per se reasonable or good faith unless under all of the circumstances, the reliance was reasonable and the taxpayer acted in good faith. See, Reg. 1.6664-4(b). But see, Prop. Reg. §1.6664-4(c) re reliance on professional opinions in a transaction that must be disclosed under Reg. §1.6011-45. An appraisal does not per se establish reasonable cause and good faith if the appraisal is wrong. The appraisal must be analyzed to determine whether it was reasonable for the taxpayer to act upon the appraisal. For example, were the methodology and assumptions underlining the appraisal appropriate, what was the appraiser’s relationship to the taxpayer or to the properly; and what were the circumstances under which the appraisal was obtained? See, Reg. 1.6664-4(b). With respect to charitable contributions of property during lifetime, the reasonable cause and good faith exception is available if the value of the property is based upon a "qualified appraisal" by a "qualified appraiser" and if the taxpayer made a good faith investigation of the value of the property before claiming the deduction. See, Reg. §1.170A-13(c).

I. Adequate disclosure of the relevant facts affecting the tax treatment of an item is an exception to the substantial understatement penalty. IRC §6662(d)-1(B). Reg. §1.6662-3(c) also provides that adequate disclosure is an exception to the negligence or intentional disregard of rules and regulations penalty. Adequate disclosure is not an exception to any other aspect of IRC §6662. See, Rev. Proc. 94-74, updating Rev. Proc. 94-36, 1994-2 C.B. 823.

J. Form 8275 must be used to disclose a position inconsistent with a statute, regulation or revenue ruling. Disclosure on the tax return itself
may not be sufficient to avoid the negligence or intentional disregard penalties. Reg. §1.6662-4(f)(2).

K. Under IRC §6694, penalties may be imposed upon an income tax preparer, whether or not the preparer signs the return. See IRC §7701(a)(36); Reg. §1.6694-2.

VII. Basis Issues and Using Both Applicable Exclusion Amounts.

— Joint Settlor Revocable Trust

A. The step up to basis at the death of a first spouse to die without having to pay an estate tax may result in significant tax savings. In community property states there is a double step up in income tax basis.

B. In TAM 93080002 the taxpayer in a non community property state created a revocable trust with joint tenancy property, that was revocable by each spouse without the consent of the other. Each was granted a general power of appointment over the whole trust. The government rejected the taxpayer’s conclusion that a new basis was generated on the first death on the entire trust. The government took the view that the surviving spouse retained dominion and control over her shares and relied on the antiavoidance rule in IRC § 1014(e) (this precludes the taxpayer from gifting the property to a terminally ill third party and then receiving it back at death with a stepped up basis).

C. A similar result occurred in PLR 200101021. Again there was a joint trust with joint tenancy property that either spouse could revoke unilaterally. The first spouse to die was given a general testamentary power of appointment over all the trust property. If not exercised the property was allocated first to the bypass trust and the balance to the surviving spouse outright. The Service concluded that half of the property was included in the estate of the first spouse to die under IRS § 2038 and half under IRC § 2041, due to the power of appointment. However, the IRS concluded that there would be no double step up in income tax basis because of IRC § 1014(e). There was said to be a gift from the surviving spouse to the first spouse to die shortly before death.

D. This sort of trust can however be used to equalize estates to enable spouses to take advantage of the exemption available to each of the spouses. If the spouses created the trust more than one year before the death of the surviving spouse, it may be possible to argue that IRC § 1014(e) will not apply.

E. In PLR 200210051 the trust contained some separate property as well as joint tenancy property. Here the power of appointment was inter vivos but the result was the same with the Service applying IRC § 1014(e) to
the step up in basis issue. However, the unified credit planning was approved.

F. The double step up in basis may be achieved by transferring property to the spouse who is about to die more than one year before death. One could possibly also rely on the Alaska voluntary community property approach, if that is respected by the government.

G. This appears to be an area where the Service would challenge the double step up in basis but they would allow the double use of the applicable exclusion amount.

H. Cost segregation studies allow for the acceleration of depreciation at some expense. Taxpayers often have to weigh up the cost of doing this versus the time value of money resulting from the acceleration of depreciation. Between the death of the first spouse to die and the second death, because of the fact that the property gets a second step up in basis at the second death, the time value of money changes into a tax saving.

I. Neither spouse’s contribution to the trust is taxable because of the retained power of revocation. No gift tax occurs if a distribution is made to either spouse since the marital deduction will apply or the property is simply being returned to the donor spouse. At first death, all property is included in the estate of the first spouse to die under either IRS § 2038 or IRC § 2041. The transfer from the surviving spouse to the deceased spouse is a gift at death that will qualify for the marital deduction. Query whether the power of appointment needs to be an inter vivos power to achieve this. The credit shelter trust is regarded as entirely attributable to the first spouse to die and hence the surviving spouse does not have an IRC § 2036 power over the property.

J. It is also possible to limit the first spouse to die’s power to the amount that will fund the bypass trust.

K. In PLR 200413011 the wealthy spouse created a QTIPable trust revocable by the donor spouse. If the power to revoke was released the trust was QTIPable. If the donee spouse died first, the property would be includible in the donee’s gross estate under IRC § 2044. The risk here was that the donor spouse would not release the power in a timely manner but the benefit was that there was no change in the event of a divorce and the donor could retain control.

L. One should avoid the problem that arose in Estate of Whiting v. Commissioner, 87 T.C.M. 1097 (2004), despite the fact that the Court rebuffed the Service. The trust allowed for the diversion of income from the surviving spouse in the event of disability. This would defeat the all income requirement of the marital trust. The court however relied on the
intent language in the trust and held that the marital deduction was still available.

VIII. Paying Estate Tax at First Death

A. There are several reasons why it may or may not make sense to trigger a tax at the death of the first spouse to die.

1. In order to take advantage of a lower value on the alternate valuation date, a tax must be generated. If the value of the assets have dropped precipitously then it may make sense to trigger a tax and make the election to use the alternate valuation date and this may enable more assets to be placed in the bypass trust.

2. Where assets will appreciate significantly, and where the assets exceed the value of the bypass trust, it may be desirable to generate a tax at the first death. This has to be compared to the situation where the surviving spouse could use those assets to make a gift, the gift tax rate (if the donor survives for three years) has a lower effective rate than the estate tax because there is no tax on the tax.

3. What if there is a disconnect between the state estate tax and the federal tax. It may pay to use the full federal credit and pay some state estate tax in a decoupled state. More particularly, that the IRC § 2011 state death tax credit has been replaced by the IRC § 2058 state death tax deduction. The partial QTIP election or disclaimer may be used to create flexibility in the arena.

4. There are several other ways to add flexibility to a plan.

a. If the marital and non marital trusts are basically the same, assets may be shifted from one to the other without adverse consequences.

b. If there is a power to add charitable beneficiaries after death, the marital trust assets may be rolled into a foundation or a charitable lead trust that will zero out the estate tax at the second death.

c. The power to invade principal held by the surviving spouse will allow the surviving spouse to gift the property and to trigger a gift tax (at a lower effective rate) rather than the estate tax.

d. Mandatory income and only the surviving spouse as beneficiary of the credit shelter trust will allow for the previously taxed property credit with respect to that trust.
See IRC § 2013 which is discussed in detail below. However, this needs to be contrasted with the advantage of accumulating income in the credit shelter trust and the ability to pass credit shelter trust income to the kids at lower tax rates.

e. It is possible to divide the non marital trust into two separate trusts where the state in question allows a separate QTIP trust for the difference between the state QTIP and the federal QTIP. The non marital trust would have to comply with QTIP requirements.

f. Adding in a power to sever trusts has become essential with decoupling. This will also allow the credit shelter or the marital trust to be reshaped to allow for the optimum use of the generation skipping tax exemption.

IX. PTP Credit

Previously Taxed Property (PTP) Credit may result in savings where both spouses die in close proximity.

A. The surviving spouse (S) has an income interest in the estate of the first spouse to die (D) and this allows S’s estate to qualify for the PTP credit. See IRC § 2013. Revenue Ruling 80-80, 1980-1 C.B. 194, obsoleted by Revenue Ruling 96-3, 1996-1 C.B. 348 (effective Dec. 14, 1995, Revenue Ruling 80-80 was superceded by Regulation § 20. 75-20 – 3(b)(3)) precludes use of the tables where the measuring life (S) is terminally ill (is known to have an incurable illness or other condition and there is at least a 50% probability of death within one year.)

B. For this to work S has to have sufficient assets to fully utilize the credit.

C. Query whether the credit will be available in a trust that provides for S and others. In TAM 8608002 the Service ruled that the credit was available in such a trust. However, Regulation § 20. 7520-3(b)(2)(ii)(B) provides that the credit will not apply to such a trust. The TAM however, focused on language that the trust was primarily for S.

D. Granting S a five or five withdrawal power over a trust can significantly increase the value of S’s interest for IRC § 2013 purposes by an amount in excess of 10%. See Shapiro Estate v. Commissioner, T.C.M. 1993 – 483 where the withdrawal power increased the PTP credit by 13.5%.

E. What if the credit shelter trust does not qualify for PTP credit treatment but the marital trust does. All the tax is generated by the marital trust. However, a fair reading of IRC § 2013(b) suggests that the credit shelter
should bear a proportionate share of the tax. The proportion here is the size of the marital divided by the whole estate.

X. Graegin Loans

A. Interest on obligations incurred by the estate to pay the decedent’s debts and the debts of the estate must be necessarily incurred in the administration and not for the benefit of heirs, in order to be deductible. See IRC § 20.2053-3(a). *Health Care of Hibernia Bank v. U.S.*, 581 F.2d 741 (9th cir. 1978) aff’g 75-2 USTC ¶ 13, 102 (N.D. Calif. 1975) the estate incurred interest on a loan while the house was being sold. The interest was disallowed because the estate could have sold stock or distributed the house to the beneficiaries.

B. The payment of interest on estate taxes or on money borrowed to pay estate taxes is deductible as “actually and necessarily incurred.” The Tax Court has allowed deduction of interest expenses incurred on loans to avoid the sale of closely held stock. See *Todd Estate v. Commissioner*, 57 T.C. 288, acq., 1973-2 C.B. 4. The Tax Court also allowed the deduction of interest to pay estate taxes that could have been deferred under IRC § 6166 if the estate had so elected. See *McKee Estate v. Commissioner*, T.C.M. 1996-362. While penalties for late filing of a return are not deductible, the interest expenses on unpaid estate taxes is fully deductible where the interest has accrued.

C. Interest payable in the future on funds borrowed to pay estate tax may be deductible before it is paid. See *Graegin Estate v. Commissioner*, T.C.M. 1988-477. There was no prepayment of principal on the note in this case. The court reasoned that the interest was ascertainable with reasonable certainty and that it would be paid. In PLR 199952039 the IRS allowed the full deduction of 10 years of interest for a loan similar to the Graegin Loan. In TAM 2005 13028 the National Office looked at a Graegin note to the family partnership and ruled that this was not deductible because the note had no real economic impact since the same parties stood on both sides of the transaction. The liquid assets in the partnership were available to pay the estate tax and the loan was not necessary for the administration of the estate.

D. In the recent case of *Estate of Murphy vs. U.S.*, US Dist. Ct. W.D. October 2, 2009 dealing with partnership discounts there was a Graegin note issue. The estate borrowed approximately $11M from the family entity on a nine year Graegin note and it borrowed approximately $41.8M from a trust on a regular note. The latter permitted prepayment and the interest rate floated. The question arose as to the deductibility of these notes. The court cited the cases of *McKee*, 72 T.C.M. 324 and *Estate of Todd*, 57 T.C. 288 (1971) in support of the notion that interest that was “necessarily incurred” as an administrative expense was deductible. The
court went on to say that the amount of interest was certain and based on the Graegin case it was deductible. The Service tried to argue that the interest was not deductible for two reasons:

1. The lack of liquidity arose out of the estate planning transaction that drained the estate of liquidity. The court rejected this because of the conclusion that the partnership had a substantial non tax reason and because the decedent retained sufficient other assets at the time of creation of the entity to pay for living expenses and estate taxes.

2. The Service also argued that the partnership could have sold assets and made a distribution of cash to pay the estate taxes. This was a similar argument to the TAM referred to above. The court again rejected this and stated that if the Executor acted in the best interests of the estate then the courts will not second guess the Executor.

In the case of the regular note, the court only allowed the deduction of the interest paid to date because of the fact that the rest of the interest was not certain. This interest could be deducted when paid if the estate filed the requisite protective claim.

XI. Selecting a Formula Clause

A. The past couple of years have highlighted the possibility of the value of an estate dropping during administration but there was a time when estate values would increase during administration. Either way, this would have an impact on the choice of formula clauses.

1. Where there is a pecuniary marital bequest with funding based on date of distribution values and where the estate decreases subsequent to the date of death, then there will be a reduction in the size of the bypass trust. Obviously, if the opposite is true and the estate increases in value, this type of formula clause will result in an increase in the assets passing to the bypass trust.

2. A pecuniary bypass residual marital would push all the losses to the marital trust. Predicting whether the estate will be growing or shrinking is not generally part of the attorney’s job.

3. There are pecuniary clauses and fractional clauses. A pecuniary clause gives an amount of money. In the case of the fractional formula, the share is determined pursuant to a fraction or a percentage.
4. Pecuniary clauses utilize one of three funding options. Firstly, there is the true worth pecuniary gift where assets are valued at the date of distribution. Secondly, there is the fairly representative pecuniary gift where the assets are valued at the date of death. In this instance, there is a requirement under Rev. Proc. 64-19 that assets elected for distribution be fairly representative of the appreciation and depreciation between the decedent’s death and the date of funding. Finally, there is the minimum worth pecuniary gift where the assets are valued at the lesser of the date of distribution value or the federal estate tax value.

B. The true worth pecuniary marital formula clause (date of distribution pecuniary) is the one that is most commonly selected. This formula allows pick and choose flexibility but the funding will trigger gain or loss and it will accelerate income in respect of a decedent (“IRD”). Problems may arise where a particular asset is valued in the estate as a controlling interest and where, because of the flexibility available in allocation under this particular type of funding clause, the asset allocated to the marital trust is a minority interest. This may result in an underfunded bypass trust or a tax. See Ahmanson Foundation v. U.S. 674 F.2d 761 (Ninth Circuit 1981); Chenoweth Estate v. Commissioner, 88 T.C. 1577 (1987); DiSanto Estate v. Commissioner, T.C. Memo 1999-421. Appreciation or depreciation will be pushed into the credit shelter trust. However, in TAM 8746003 the Service took the view that if funding was delayed, the funding would be deemed to have taken place in a reasonable time. This formula is frozen and the amount will not change as a result of an audit or as a result of income earned during this period. While most marital bequests will carry out distributable net income (“DNI”), the Regulations under IRC § 663 allow for zero income allocation to this share.

As indicated above, separate share treatment determines whether DNI, distribution deductions and income carry out to beneficiaries. A separate share exists if a beneficiary has an identifiable economic interest. In the case of the true worth pecuniary marital formula, unless state law or the document requires income to be allocated, no DNI will carry out. If there are competing camps in the estate plan (like a surviving spouse and children from a prior marriage), the flexibility afforded by the formula may be problematic.

C. The fairly representative pecuniary marital avoids any gain or loss of funding. However it does cause acceleration of IRD. In theory at least there is still a need to revalue assets to comply with Rev. Proc. 64-19. Here the marital is a separate share and the assets are distributed using date of death values. DNI is limited to the lesser of basis or value. See IRC § 643(e). Furthermore, IRC § 643(e)(3) gives an election to trigger gain on a distribution. This formula requires revaluation of assets. It
restricts flexibility in that the appreciation and depreciation must be rateable.

D. The minimum worth pecuniary is a hybrid of the other two pecuniary clauses. The asset is distributed using the lesser of basis and the date of distribution value. Rev. Proc. 64-19 does not apply here and hence the inflexibility that comes with that section does not apply. This tends to overfund the marital. There is no gain or funding and the loss may be denied under IRC § 267. It does accelerate IRD. The marital is a separate share under the separate share rule. While it is more flexible, the flexibility creates the possibility of litigation between competing camps.

E. In the reverse pecuniary marital or the pecuniary credit shelter, the pecuniary passes to the credit shelter instead of the marital. In larger estates, the bulk of the assets will pass to the residual marital avoiding gain and acceleration of IRD. It has been suggested by some that the fiduciary be given the choice of a pecuniary marital or pecuniary credit shelter, but this raises questions of qualification of the marital trust. See TAM 9010001 where the Service argued that the language of the trust lacked the mechanism for determining how to fund the marital and they disallowed the marital deduction. But see the case of Smith Estate v. Commissioner, 66 T.C. 415 (1976), aff'd, 565 F.2d 455 (7th cir. 1977) where the government sought to attack the equalizer marital deduction formula. This is a formula that seeks to equalize the spouses’ tax brackets instead of opting for the maximum deferral. The court sided with the taxpayer In Revenue Ruling 90-3, 1990-1 C.B. 174 and in PLR 9143008, the government seems to be backing away from its tough position.

F. There are legal concerns involved in the reverse pecuniary funding. Query whether the fluctuating size of the marital will disqualify the marital deduction. Query further whether the allocation of the capital gain to the marital on funding the credit shelter, will disqualify the marital. In Revenue Ruling 90-3. 1990-1 C.B. 174 the government approved the funding of a reverse pecuniary marital using date of distribution values. To avoid problems in this area, the drafter should add language to the effect that the fiduciary should act in an impartial manner. A sharing of depreciation clause would also have the same positive impact. To solve the income tax problem, the tax could be specifically allocated to the credit shelter trust.

G. Fractional formulas avoid gain and IRD acceleration. In the case of a pro rata fractional there is lost flexibility. The separate share rule problems exist and the marital is not frozen in value. In the pro rata formula the marital gets a fraction of each and every asset. The marital gets under or overfunded, but there is little or no litigation potential. The pick and
choose fractional share uses date of distribution values to fund the fraction. This gives maximum flexibility and there are no Rev. Proc. 64-19 issues. The assets have to be revalued. The danger with this formula is that it will be recharacterized as a pecuniary formula with different tax results. However the Service placed emphasis on the fluctuation in value between death and funding as distinguishing this from the pecuniary formula. See TAM 8447003. This formula has DNI carryout issues and the separate share rule applies. However it is no more complex than the pecuniary formulas with significant tax advantages.

H. No single approach works in all cases. In very large estates, the frozen marital will push the administration appreciation into the credit shelter trust. But the opposite happens if there is depreciation. Many planners simply use what may be described as a fudge approach. See “Estate Tax Marital Deduction” BNA Tax management – Estate, Gifts, and Trusts Portfolios 843-2nd page A-27. This provides the objective which is to generate the smallest marital deduction necessary to reduce taxes as low as possible.

I. A drop in value during estate administration is no longer a vague possibility. The impact of this will be lowered by a double pecuniary and small residue clause. In this clause there is a pecuniary marital and a pecuniary to the credit shelter of say $3M and a small residue of the remaining assets which goes to the credit shelter trust. This residue will be first in line to absorb the reduction in value. A further reduction will be shared by the two pecuniary clauses ratably. The marital will share the reduction with the credit shelter.

XII. Converting the Credit Shelter Trust into a Grantor Trust

A. If the surviving spouse is the sole beneficiary of the credit shelter trust and if the trust is an all income trust, it is possible to convert this into an accumulation trust and a trust that is equivalent to a grantor trust with the surviving spouse as the grantor.

B. Place the assets in the trust in an S Corporation and make a QSST election (“Qualified Subchapter S Election”). This has the effect of accumulating income and the income tax is payable by the surviving spouse as beneficiary.

C. This planning also works to pass the income tax to the surviving spouse if the trust allows for the accumulation of income. To qualify as a QSST, all that is required is that the trust actually distribute all income and not that the trust has to provide for the distribution of all income. Income in this context is fiduciary income which means money distributed by the S Corporation.
D. Query whether the failure by the trustee of the trust to distribute income could be a breach of fiduciary duty and the failure of the spouse to sue the trustee may be a hidden gift.

XIII. Alternate Valuation Date Elections

A. If the estate increases in value, the beneficiary gets the benefit of 100% of the appreciation after the date of death. On the other hand, the beneficiary only has to bear 55% of the losses if the values go down during the first six months (because of the alternate valuation election). After that the estate bears 100% of the appreciation and depreciation.

B. If the title to an IRA is changed, does this amount to a sale or disposition of the asset which would peg the value for alternate valuation purposes. Clearly, distributing estate assets from the estate is treated as a disposition. However, re-titling IRA assets is the same as the re-titling of joint tenancy assets. This is not a “disposition” under the alternate valuation rules. See Revenue Ruling 59-213.

C. On the other hand, it is unclear whether the sale of assets inside the IRA will be treated as a disposition or whether the IRA is treated as a single asset.

XIV. Trigger IRC § 2519 **

A. Introduction

1. If the terms of a QTIP trust do not permit principal distributions or the trustee refuses to make principal distributions to a spouse to allow him or her to make gifts, the spouse is not without options. If the spouse can transfer or release his or her qualifying income interest in a QTIP trust, the spouse may be able to effectively trigger a gift of some or all of the QTIP trust assets without the trustee having to make a distribution to the spouse.

2. Under IRC § 2519, if a surviving spouse “disposes” of his or her income interest in property subject to a QTIP election, he or she is deemed to have disposed of all interests in that property other than the qualifying income interest.

   a. If the spouse makes a gift or releases his or her qualifying income interest in property, that gift is taxable to the spouse under IRC § 2511. In addition, under IRC § 2519 the spouse will be deemed to have disposed of all other interests in that particular property. Thus, if a spouse disposes of his or her income interest in a QTIP trust, the disposition will result in a taxable gift by him or her in an amount equal to the value of the QTIP trust assets less the...
value of the income interest. In other words, a disposition of an income interest results in a gift of the QTIP trust assets, though the gift is technically two gifts: one under IRC § 2511 and another one under IRC § 2519.

b. Assume, for example, a QTIP trust has assets of $10 million. If the surviving spouse is 80 years old and releases her income interest in November 2009, when the IRC § 7520 rate is 3.2%, she will be deemed to have made a gift under IRC § 2511 of $2,209,400. The spouse will also be deemed to have made a gift under IRC § 2519 in the notional amount of $7,790,600, which is the balance of the QTIP trust assets.

c. Congress enacted IRC § 2519 as a companion to IRC § 2044, which provides for the inclusion of property subject to a QTIP election in the estate of the surviving spouse. The general purpose of the marital deduction is to defer property held by a married couple until the earlier of a gift of that property by one of the spouses or the death of the last to die of the spouses. Before Congress enacted the QTIP legislation, a taxpayer could obtain a marital deduction by leaving property to a spouse outright or in a general power of appointment marital trust. If a taxpayer left property outright to the surviving spouse, he or she would be subject to a gift tax when he or she made a gift of the property during his or her lifetime under IRC § 2511 or would be subject to an estate tax if he or she held it on death under IRC § 2033. Similarly, if the spouse was the beneficiary of a general power of appointment marital trust, his or her release of the general power would trigger a gift tax under IRC § 2514. If the spouse died with property subject to his or her general power of appointment, that property would be included in his or her gross estate under IRC § 2041. In 1981, however, no statute existed that would include property in a surviving spouses estate over which he or she had a terminable interest. To fill this gap, Congress had to enact IRC § 2044. To be consistent with IRC § 2511 and IRC § 2514, Congress also enacted IRC § 2519 in order to impose a tax on the termination of the spouse’s now-qualifying terminable interest in property before his or her death. To this extent, IRC § 2519 is a cousin of IRC § 2511 and IRC § 2514 and is necessary for the government to collect tax on the termination of a terminable interest for which a marital deduction was allowed in the estate of the first spouse to die.
d. The now-familiar rule of IRC § 2519(a) bifurcating an assignment of a qualified income interest into two gifts actually came into the estate tax law as a technical correction. When Congress enacted the QTIP rules in 1981, IRC § 2519(a) provided that the disposition of a qualifying income interest in such property was “treated as a transfer of such property.” Congress enacted the language currently in IRC § 2519(a) that provides that the gift is of all interests in the property other than the qualifying income interest in a technical correction in 1982. See generally S. Rep. No. 592, 97th Cong., 1st Sess. 21 (1982)(reprinted in 1983-1 C.B. 475, 483) (the technical correction “clarifies” that IRC § 2519(a) “applies only to the remainder interest in the QTIP property”).

e. A spouse’s deemed gift under IRC § 2519 will be a “net gift” as long as the spouse does not waive his or her right to reimbursement from the donees of the gift taxes triggered by IRC § 2519.

(i) Under IRC § 2207A(b), when a spouse is treated as having transferred an interest in property by reason of IRC § 2519, the spouse has a right to recover the proportionate amount of gift tax from the holders of the remainder interests. See Treas. Reg. § 25.2207A-1(a). The donees’ obligation to pay their proportionate share of the gift taxes reduces the value of their gift – it is a “net” gift. See generally Rev. Rul. 75-72, 1975-1 C.B. 310 (if the donee must pay the federal gift tax on property given to him or her, the tax will be deducted from the value of the property given by the donor).

(ii) From the time that Congress enacted the QTIP rules, the IRS took the position that a deemed gift of a remainder interest under IRC § 2519 was a net gift for purposes of valuing the gift. The IRS tentatively adopted the net gift rule in the 1984 proposed QTIP regulations. See Prop. Treas. Reg. § 25.2207A-1(a) (reprinted in 1984-1 C.B. 598, 612). When the IRS promulgated the final QTIP regulations in 1994, it withdrew the proposed regulation on net gift treatment and reserved it for further consideration. T.D. 8522 (reprinted in 1994-1 C.B. 236, 239). Despite the withdrawal of the proposed regulation, between 1994 and 2003, the IRS routinely issued private letter rulings confirming net gift treatment

(iii) The effect of net gift treatment is to reduce the amount of the IRC § 2519 gift. In the example above, the spouse’s notional IRC § 2519 gift in a $10 million marital trust was $7,790,600. If the gift was a net gift, the actual taxable gift would be $5,383,172. The balance - $2,407,428 - would be the gift tax payable by the donees (assuming a flat 45% gift tax rate). In the case of *Kite v. Commissioner*, T.C. Memo 2013-43, Judge Paris of the Tax Court was asked to consider the application of Section 2519. In this case the QTIP assets were put into a Partnership. The Partnership was distributed to the surviving spouse and then the surviving spouse sold the Partnership for a 34% discount in exchange for a private annuity. The IRS did not try and argue that the transfer of assets to the Partnership was a trigger of Section 2519, but they did argue that the distribution and sale was part of an integrated transaction giving rise to a disposition of income interest. The Court concluded that no gift resulted because the wife received full consideration in the form of the annuity.

B. *Triggering an IRC § 2519 Disposition*

1. To trigger IRC § 2519 a spouse could simply release or transfer his or her income interest in the property for which a QTIP election was made.

   a. As long as the will or trust instrument does not have a spendthrift clause, the surviving spouse can simply release the income interest or transfer it to a third person. Doing so will trigger a gift of the income interest under IRC § 2511.
and a gift of the remaining interests in the property under IRC § 2519.

b. The difficulty with this apparently simple approach is that most wills and trusts will have spendthrift clauses that limit a beneficiary’s ability to assign or release an income interest. Courts have generally held that an income beneficiary of a spendthrift trust may not release his or her income interest after he or she has accepted that interest. See, e.g., Hartsfield v. Lescher, 721 F. Supp. 1052 (E.D. Ark. 1989); Preminger v. Union Bank and Trust Company, 220 N.W.2d 795 (Mich. App. 1974); Smith v. Bank of Delaware, 219 A.2d 576 (Del. 1966); In re Grote’s Estate, 135 A.2d 383 (Pa. 1957); Blackwell v. Virginia Trust Co., 14 S.E.2d 301 (Va. 1941).

c. Despite the consistency of these court decisions, the Restatement (Third) of Trusts takes the position that a beneficiary of a spendthrift trust can release his or her income interest:

A designated beneficiary of a spendthrift trust is not required to accept or retain an interest prescribed by the terms of the trust. Thus, an intended beneficiary may reject a beneficial interest or power of appointment by a proper disclaimer. Even the release of an interest in a spendthrift trust, including by purported disclaimer following expressed or implied acceptance, is permissible and serves to terminate the beneficiary’s interest even thought the release is treated for some other purposes as a transfer.

Restatement (Third) of Trusts § 58 comment c (2003). The position taken by the Restatement (Third) is different than the unsurprising position taken in the Restatement (Second) of Trusts that a beneficiary who has an accepted an interest in a spendthrift trust cannot later release that income interest. See Restatement (Second) of Trusts § 36 comment c (1959). See generally 3 Scott & Ascher on Trusts, § 15.2.9 (5th ed. 2007).

d. A number of IRS private letter rulings have involved releases of income interests by spouses in order to trigger IRC § 2511 and IRC § 2519. With one exception, the facts described in the rulings are consistent with the notion that state law will make it difficult for a surviving spouse to
simply release an income interest in a spendthrift trust to trigger IRC § 2519.

(i) In PLR 200328015, the taxpayer represented that a court modified a trust to remove a spendthrift clause before the spouse released the interest. In PLRs 200438028 and 200122025 the taxpayers appear to have obtained court orders allowing the spouse to release or transfer an income interest, though the facts are not entirely clear.

(ii) PLR 200334020 indirectly confirms the need for a court order. In this ruling, the spouse was persuaded to assign her income interest in a marital trust, thereby triggering IRC § 2519. The spouse apparently had a change of heart and obtained a court ruling that the attempted assignment was invalid because the trust was a spendthrift trust. The main issue in the ruling was whether the surviving spouse’s unified credit would be restored, but the ruling illustrates the state law uncertainties that come with attempted releases of qualified income interests in spendthrift trusts.

(iii) In only one ruling involving a release did the taxpayer represent that the spouse would release his or her income interest without any further discussion. PLR 200044034.

2. If the surviving spouse finds that he or she cannot release an income interest due to a spendthrift clause, it is possible that the spouse could disclaim the income interest under a state disclaimer statute.

   a. State disclaimer laws generally provide that a spendthrift clause does not preclude a trust beneficiary from disclaiming an interest in the trust provided that the disclaimer meets the requirements of the state statute. E.g., Cal. Prob. Code § 286; RCW 11.86.081.

   b. Estate planning lawyers are familiar with the use of qualified disclaimers under IRC § 2518, which allow a person to pass property received by gift or bequest to another person without the imposition of a second gift tax or estate tax. If, however, the surviving spouse wants to trigger IRC § 2511 and IRC § 2519, he or she must transfer his or her qualifying income interest in a QTIP trust in a way that
triggers gift tax, not in a way that avoids gift tax. To this extent, the spouse will be looking to make a disclaimer that is not qualified under IRC § 2518.

c. A disclaimer, however, can be effective under state law without being qualified under IRC § 2518 (a “nonqualified disclaimer”). If a surviving spouse can disclaim his or her income interest in a QTIP trust after the nine-month period of IRC § 2518 passes but within the time allowed by the relevant state statute, the spouse can use such a disclaimer to trigger IRC § 2519. So what is the time limit under state law for such a nonqualified disclaimer?

(i) Section 13 of the Uniform Disclaimer of Property Interest Act (1999) (“UDOPIA”), for example, does not put any time limit on disclaimers for state law purposes. In fact, the drafters of the Act deliberately eschewed a time limit because disclaimers may be useful in tax planning beyond nine months:

This Act specifically rejects a time requirement for making a disclaimer. Recognizing that disclaimers are used for purposes other than tax planning, a disclaimer can be made effectively under the Act so long as the disclaimant is not barred from disclaiming the property or interest or has not waived the right to disclaim. Persons seeking to make tax qualified disclaimers will continue to have to conform to the requirements of the Internal Revenue Code.

UDOPIA § 13, comment (reprinted in 8A Unif. Laws Ann. 163, 184).

(ii) Section 13(b)(1) of UDOPIA does bar a disclaimer when the disclaimant has accepted the property that he or she attempts to disclaim. If a surviving spouse receives income from a QTIP trust and later wishes to disclaim his or her income interest, however, the receipt of that income may constitute an acceptance and bar a disclaimer as a matter of state law. See, e.g., Leipham v. Adams, 894 P.2d 576, 581 (Wash. App. 1995) (noting the common law presumption of an acceptance of a gift beneficial to a donee); Matter of Will of Hall, 456 S.E.2d 439 (S.C. App. 1995) (donee’s acceptance of benefits of life estate in
property precludes later disclaimer of the life estate); *Jordan v. Trower*, 431 S.E.2d 160, 162 (Ga. App. 1993) (“Possession and use of the testator’s property has been held to constitute acceptance of the bequest so as to bar a later renunciation when the possession occurred over a long period of time and indicated an intent to claim rights in the property . . . .”).

(iii) In contrast to UDOPIA, the 1978 Uniform Disclaimer of Transfers by Will, Intestacy or Appointment Act and the 1978 Uniform Disclaimer of Transfers Under Nontestamentary Instruments Act both contain a suggested nine-month limitation on the time to disclaim.

(iv) The law of some states may differ in form from the three uniform acts, though not necessarily in practice.

(a) Under California law, for example, a disclaimant must disclaim an interest in property “within a reasonable time after the person able to disclaim acquires knowledge of the interest.” Cal. Prob. Code § 279(a). The California statute generally provides that nine months after a decedent’s date of death is a “reasonable time” for a disclaimer of an interest created by reason of a decedent’s death, but this is not conclusive. See generally Cal. Prob. Code §§ 279(b), 279(c). In the case of a surviving spouse with a QTIP trust, if he or she for some reason did not learn of his or her interest within nine months of the decedent’s date of death, it may be possible for the spouse to make a disclaimer of that income interest that is valid under California law, though the disclaimer would not be a qualified disclaimer under IRC § 2518.

(b) Under Washington law, a beneficiary of a trust may disclaim an interest in the trust no later than nine months after the date that the beneficiary is finally ascertained and the beneficiary’s interest is indefeasibly vested. RCW 11.86.031(2)(c). In the case of a
surviving spouse’s qualifying income interest in a QTIP trust, the operative date should be the decedent’s date of death for purposes of the Washington statute.

d. Many private letter rulings that address IRC § 2519 involve nonqualified disclaimers by the surviving spouse. In most of these rulings, however, the taxpayers appear to have represented to the IRS that state law permitted the disclaimer. *E.g.*, PLR 200122036; PLR 200224016; PLR 200116006; PLR 20002203; PLR 200022031. Two private letter rulings, PLR 200628007 and PLR 200801009, mention that the taxpayer obtained a court order authorizing the nonqualified disclaimer but do not otherwise discuss legal or factual issues related to the nonqualified disclaimer. The only ruling that I found that discusses law related to nonqualified disclaimer is PLR 200604006, which states that a court order allowed the disclaimer because it was within a reasonable time after the disclaimant acknowledged learning about the interest. The statute the IRS describes in the ruling sounds like the California disclaimer statute, but the state involved is not entirely clear.

e. Some IRC § 2519-related private letter rulings involve “renunciations” of income interests, which may be a synonym for nonqualified disclaimers, but you cannot really tell from the rulings. *E.g.*, PLR 200717016 (court decision appeared to have allowed spouse to release the spouse’s income interest; no discussion of particulars in the ruling); PLR 200530014 (ruling assumes spouse’s “renunciation” is permitted by state law); PLR 200324023 (“renunciation” of income interest pursuant to settlement agreement with no discussion of state law); PLR 200223047 (taxpayer represented that spouse’s renunciation of income interest was permitted by state law); PLR 199926019 (no discussion of whether state law involved “renunciation” of income interest).

3. Triggering IRC § 2519 through agreed-upon commutations and sales of interests.

a. It may be possible for a surviving spouse to trigger IRC § 2519 by entering into a transaction with the remainder beneficiaries, such as a sale of the spouse’s income interest, the purchase of a remainder interest, or the commutation of a marital trust.
b. In these situations, the spouse will probably not make a gift of his or her qualified income interest under IRC § 2511 because he or she will receive the actuarial value of his or her income interest in one way or another. On the other hand, a sale of an income interest or a remainder interest or the commutation of a QTIP trust does result in a gift of the remainder interest by the spouse under IRC § 2519. Treas. Reg. § 25.2519-1(g), Example 2 (involving a commutation); Estate of Novotny v. Commissioner, 93 T.C. 12 (1989); Rev. Rul. 98-8, 1998-1 C.B. 541 (involving the remainder beneficiaries' sale of their interests to the surviving spouse). In all of these situations, the IRS takes the view that such a transaction effects a disposition by the spouse of his or her income interest, which in turn triggers IRC § 2519. According to the IRS, the transaction terminates a trust for which a marital deduction was allowed with someone other than the spouse receiving some of the trust property, which is in effect a disposition by the spouse of his or her income interest. According to the IRS, the QTIP trust property must at some time be subject to an estate tax or a gift tax as the price for the marital deduction that the IRS allowed for the gift made to the trust:

The estate tax marital deduction provisions are intended to provide a special tax benefit that allows property to pass to the surviving spouse without the decedent’s estate paying tax on its value. Tax is deferred on the transfer until the surviving spouse either dies or makes a lifetime disposition of the property. Under either circumstance, a transfer (estate or gift) tax is paid.

The statutory scheme of the QTIP provisions is consistent with this congressional intent. Thus, a marital deduction is allowed under Section 2056(b)(7) for property passing from a decedent to a QTIP trust in which the surviving spouse possesses a lifetime income interest. Sections 2519 and 2044 act to defer the taxable event on the marital deduction property only so long as the surviving spouse continues to hold the lifetime income interest.


c. Transactions of this kind would appear to present issues when the trust in question has a spendthrift clause. The rulings in this area, however, suggest that dispositions of
this kind often result from the settlement of controversies between the spouse and the other trust beneficiaries. See, e.g., PLR 200844010 (settlement of litigation resulted in court-ordered termination of QTIP trust with payment to spouse of actuarial value of income interest; triggered IRC § 2519); PLR 200027001 (settlement of controversy results in spouse selling income interest in QTIP trust for its actuarial value; court approved settlement); PLR 200013015 (agreement between spouse and charitable remainder beneficiary to terminate trust; spouse receives actuarial value of income interest and charity gets rest of assets; IRC § 2519 applies with charitable deduction); PLR 200723014 (termination of QTIP trust by court order for changed circumstances, spouse receives actuarial value of income interest, IRC § 2159 applies); PLR 20030017 (controversy settled, resulting in spouse’s sale of income interest to remainder beneficiary for its actuarial value; triggers IRC § 2519). But see PLR 199936036 (spouse purchases remainder interest for its present actuarial value; no discussion of possible controversy). See generally Robin, Tax Results of Settling Trust Litigation Involving QTIP Trust, 36 Est. Plan. 23 (January 2009).

C. The “Transfer of All Interests” Rule

1. If a surviving spouse can get past the state law issues related to his or her proposed assignment or release of the qualified income interest, there is another issue to contend with before triggering IRC § 2519. Under IRC § 2519(a), the disposition of “all or part of a qualifying income interest for life in any property” for which a QTIP election was made is treated as a “transfer of all interests in such property other than the qualifying income interest.”

2. The legislative history to IRC § 2519 notes this rule but does not explain its purpose. For example, the House Committee Report on the 1981 tax legislation provides that:

If the property is subject to tax as a result of the spouse’s lifetime transfer of the qualifying income interest, the entire value of the property, less amounts received by the spouse upon disposition, will be treated as a taxable gift by the spouse under new Code Sec. 2519.

3. The statute also confused commentators. In 1982, for example, Dick Covey commented that although the legislative history of IRC § 2519 suggests that a spouse’s partial disposition of his or her qualified income interest is a gift of all the property of the QTIP trust, “the regulations should provide in such a case [that] the gift tax is imposed only on the QTIP in which the income interest is surrendered.” Richard B. Covey, Recent Developments Concerning Estate, Gift and Income Taxation – 1981, 16 Inst. Est. Plan. ¶ 102.2(1) at 1-43 (1982). Also in 1982 Malcolm Moore questioned the purpose of the rule:

It is unclear why such a partial disposition of an income interest should trigger a gift of the entire remainder (as opposed to a gift only of the corresponding portion of the principal), or why I.R.C. Section 2519 is necessary in the first place. Transfers of income interests by beneficiaries who also possess limited powers of appointment over trust principal are treated as taxable gifts and it should be possible to obtain similar results under the existing law and regulations.


4. When the IRS first proposed regulations under IRC § 2519, it parroted the rule set out by Congress that the disposition of all or part of a qualifying income interest for life was a disposition of all interests in the property other than the income interest:

If a person (“the donee spouse”) makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) or section 2523(f) for the transfer creating the qualifying income interest, the donee spouse shall be treated for purposes of chapters 11 and 12 of Subtitle B of the Code as transferring all interests in such property other than the qualifying income interest. For example, if the donee spouse makes a disposition of part of a qualifying income interest for life, such spouse will be treated for purposes of section 2036 as having transferred the portion of the property to which the retained income interest is attributable. The amount treated as a transfer under this section upon a disposition of all or part of a qualifying income interest for life in qualified terminable interest property is equal to the full value of the property subject to the qualifying income interest on the date of the disposition.
(including any accumulated income and unreduced by any section 2503(b) exclusion that may have been taken for the transfer creating the interest), less the value of the qualifying income interest in such property on the date of the disposition and less the amounts that the spouse is entitled to recover under section 2207A (relating to the right to recover taxes attributable to the remainder interest).


5. In the 10 years between its issuance of the proposed QTIP regulations and the finalization of the regulations, the IRS changed its mind and concluded that when Congress used the word “property” in IRC § 2519(a), it actually means “trust.” Under the IRS’s view of IRC § 2519 articulated in the final regulations, if a surviving spouse disposes of an income interest in any one item of property in a QTIP trust, he or she would be deemed to dispose of all the interests of all persons in the QTIP trust. This was not the view taken in the proposed regulations, which consistent with the language of the statute, limited the disposition to all interests in the “property,” not the “trust."

6. As finalized, Treas. Reg. § 25.2519-1(a) provides a harsh result for a surviving spouse when he or she partially disposes of an income interest in a QTIP trust:

If a donee spouse makes a disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under section 2056(b)(7) or section 2523(f) for the transfer creating the qualifying income interest, the donee spouse is treated for purposes of chapters 11 and 12 of subtitle B of the Internal Revenue Code as transferring all interests in property other than the qualifying income interest. For example, if the donee spouse makes a disposition of part of a qualifying income interest for life in trust corpus, the spouse is treated under section 2519 as making a transfer subject to chapters 11 and 12 of the entire trust other than the qualifying income interest for life. Therefore, the donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest, and is treated for purposes of section 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable. (emphasis added).
7. Under the regulation, if a surviving spouse disposes of some, but not all, of his or her income interest in a QTIP trust, the spouse will have retained an income interest in some of the assets that he or she is deemed to have given away. According to the IRS, the retained income interest in valued at zero under IRC § 2702. See Treas. Reg. § 25.2519-1(a); Treas. Reg. § 25.2519-1(g), Example 4. As a result, the spouse will not be able to reduce the value of the deemed gift under IRC § 2519 by the value of the retained income interest. See Casner & Pennell, supra, § 13.6.1.2.3 at 13-184 to 13-185 (the assignment of an income interest in a QTIP trust “produces such harsh tax consequences under [IRC] §§2519 and 2702 that a transfer of any portion of the income interest in a QTIP trust usually is an unmitigated disaster”).

8. To complicate matters, if the spouse makes a gift with a retained income interest under IRC § 2519, the property in which the spouse retained an income interest will be included in the surviving spouse’s estate under IRC § 2036. This raises the possibility that the value of the property that was subject to the IRC § 2519 deemed gift would be taxed again on the surviving spouse’s death. Congress attempted to avoid this result with the flush language of IRC § 2001(b), which provides that the decedent’s adjusted taxable gifts in this situation would not include the IRC § 2519 taxed property to which IRC § 2036 applied. If, however, the property in question has increased in value, the surviving spouse’s estate will pay tax on that higher value, so the mechanism to avoid double taxation does not work perfectly. Jeff Pennell generally points out that the way the IRC § 2001(b)(1)(B) adjustment, as well as the way Treas. Reg. § 25.2702-6 applies in this situation, are not entirely clear, nor is the interaction of these rules with IRC § 2207A(b). Casner & Pennell, supra, § 13.6.1.2.3 at 13-387 note 25 (commenting that the “operation of these double adjustments is not illustrated, nor is the effect of §2702 on the net gift concept flowing from §2207A(b)”).

9. The “dispose of some, dispose of all” regulation is questionable as applied to a trust over which a spouse partially relinquishes an income interest.

a. Under IRC § 2519(a), the disposition of “all or part of a qualifying income interest for life in any property” for which a QTIP election was made is treated as a “transfer of all interests in such property other than the qualifying income interest.” Congress did not mention “trust” in the legislation; it only mentioned property. The IRS came up with the notion that the disposition of part or all of an income interest
in a “trust” was a disposition of all the property of the “trust” when it finalized the regulations under IRC § 2519.

b. The preamble to the final IRC § 2519 regulation indicates that the only change from the proposed was to add references in certain examples to IRC § 2702. See T.D. 8522, 1994-1 C.B. 236. If you compare the regulation as proposed and as finalized, you will see that the preamble fails to mention the IRS in fact made a substantial change when it promulgated the final regulations by changing the wording of the regulation to expand the scope of IRC § 2519. The IRS gave no explanation for this change.

c. The change the IRS made to Treas. Reg. § 25.2519-1(a) is a questionable interpretation of IRC § 2519. Congress, when it enacted IRC § 2519, did not use the word “trust;” it used the word “property.” The use of the word “property” indicates that Congress intended for the IRS to apply IRC § 2519(a) on an asset-by-asset basis. Common sense suggests that Congress could not have intended for the deemed disposition rule to apply to all assets in a QTIP trust.

d. For example, IRC § 2056(b)(7) allows an estate to make a QTIP election for property in which a surviving spouse has a legal life estate. Assume for example that a surviving spouse had a legal life estate in five different assets. The IRS certainly would not suggest that the spouse’s disposition of his or her life estate in one of those assets resulted in a disposition of all the interests in the other assets. Yet the IRS suggests that such a result would occur if the five assets were held in a trust.

e. Congress could not have intended to treat life estates in assets differently than income interests in trusts that held multiple assets. If life estates are treated differently than trusts, no taxpayer would use a QTIP trust. Rather, taxpayers would give surviving spouses legal life estates in property. Congress wanted to simplify the tax laws and encourage the use of trusts when it enacted the QTIP rules. The IRS’s interpretation of IRC § 2519(a) discourages the use of QTIP trusts, standing Congressional intent on its head.

f. More generally, the “dispose of some, dispose of all” rule is not necessary to ensure taxation of the property for which the QTIP election was made over which the spouse
retrated an income interest. That property should be
included in the surviving spouse's gross estate under IRC §
2044 on his or her later death, or if the spouse later
releases the remaining income interest, the property would
be subject to gift tax under IRC § 2511 and IRC § 2519.

10. The IRS has implicitly recognized the unreasonableness of its

a. Over the last decade the IRS National Office has
consistently allowed taxpayers to sever QTIP trusts in
anticipation of the spouse disposing of his or her income
interest in some of a QTIP trust’s assets. E.g., PLRs
200438028, 200328015, 200324023, 200250033,
200230017, 200224016, 200223047, 200137022,
200122025, 200122036, 200116006, 200106029,
200044034, 200027001, 199926019, 9207023. In all of
these rulings the purpose of the severance was to avoid the
effect of the disposition of all interests rule when the spouse
disposed of an income interest in one particular asset of a
QTIP trust or in a fraction of the trust assets.

b. Jeff Pennell suggests that in light of the fact that the
interaction of IRC § 2519 and IRC § 2702, while harsh,
appears to be a “proper result,” one of these rulings, PLR
199926019, was “relatively unbelievable in that it blessed a
technique to minimize §2519 exposure.” Pennell, 843-2d
T.M. Estate Tax Marital Deduction at A-113 n. 718.

c. The large number of private letter rulings issued by the IRS
on the IRC § 2519 issue indicates that what may have been
relatively unbelievable 10 years ago is now routine. In
routinely allowing taxpayers to make these predisposition
severances, the IRS has created a de facto exception to the
disposition of all interests rule for taxpayers who plan in
advance; the “disposition of all interests” rule therefore
applies only to taxpayers who do not separate trusts before
making dispositions.

11. As noted above, IRC § 2519 is a counterpart to IRC § 2514, which
generally provides that the lapse or release of a general power of
appointment is a taxable gift. The general power of appointment
marital trust is the other principally used form of trust that qualifies
for the marital deduction. See generally IRC § 2056(b)(5). One
way to gauge the propriety of the “dispose of some, dispose of all”
rule of Treas. Reg. § 25.2519-1(a) is whether the same result
would happen with a partial exercise or release of a general power of appointment over a marital trust that qualified for the marital deduction under IRC § 2056(b)(5).

a. The Treasury Regulations under IRC § 2514 appear at first glance to take a similar position to IRC § 2519 for general power of appointment marital trusts. If a surviving spouse who is a beneficiary of a general power of appointment marital trust assigns or releases his or her income interest in the trust, he or she is deemed to have released his or her general power of appointment over the trust assets. See Treas. Reg. § 25.2514-1(b)(2)(the transfer of an income interest in a trust by a taxpayer pursuant to the exercise of a nongeneral power of appointment is a taxable gift under IRC § 2511(a) of the foregone income and also results in a taxable relinquishment of the taxpayer’s testamentary general power). This regulation is consistent with the general rule of Treas. Reg. § 2519-1(a) that the disposition of an income interest in trust property subject to a QTIP election is a disposition of the remainder in the trust property.

b. The real test, however, is whether a spouse’s disposition of an income interest over part of a general power of appointment marital trust would cause him or her to have released his or her general power of appointment over all the trust assets. If a spouse had a presently exercisable general power and exercised it as to 60% of the trust property by giving the trust property to someone else, he or she would be deemed to have made a gift of 60% of the trust property, but he or she will not be deemed to have exercised the power of appointment over the remaining trust property. See Treas. Reg. § 25.2514-2(e)(if a general power is exercised as to only a portion of the property subject to the power, “the exercise is considered to be a transfer only as to the value of that portion”). To this extent, the IRS’s application of IRC § 2519 and IRC § 2514 are not consistent.

c. But what if the spouse had a testamentary general power and released the income interest in 60% of the trust assets while retaining the general power of appointment over 100% of the assets and an income interest in 40% of the trust assets?

(i) As noted above, the IRS generally treats the release of the income interest as a deemed release of a
testamentary general power of appointment under Treas. Reg. § 25.2514-1(b)(2). The partial release, however, should not cause a disposition of 40% of the trust assets because those assets will remain subject to estate tax in the spouse’s estate under IRC § 2041 or will be subject to gift tax if the spouse later releases the power over those assets. No IRS ruling or court decision, however, appears to address this question.

(ii) In a somewhat analogous situation, the IRS decided that a taxable gift in connection with the lapse of a general power of appointment over a portion of trust property was a gift only over the portion of the trust property with respect to which the power lapsed. In PLR 9804047, a surviving spouse had the right to withdraw 10% of the value of the trust property on an annual basis. If the spouse did not exercise the power, it lapsed. The IRS ruled that to the extent the lapse exceeded the greater of $5,000 or 5% of the value of the trust assets, the spouse would be deemed to have made a taxable gift of the excess under IRC § 2514. This ruling suggests that IRC § 2514 should apply only with respect to property over which a general power of appointment lapses or is released, though admittedly in this ruling the spouse did not have a testamentary general power of appointment over all the trust property.

(iii) In Estate of Robinson v. Commissioner, 110 T.C. 499 (1993), the Tax Court held that the termination of a general power of appointment marital trust pursuant to a settlement agreement in which the surviving spouse received about one-half of the trust assets outright was not a release of the spouse’s general power over the entire trust. The court pointed out that the testamentary general power had been converted into a presently exercisable general power that the spouse exercised in favor of herself. The court took the view that the spouse’s exercise of a general power in favor of herself could not be a gift under IRC § 2514.

12. The lesson from Treas. Reg. § 25.2519-1(a) and the IRS-approved way of avoiding its application is for a client considering a partial release or disposition of an income interest in a QTIP trust to first divide the trust between assets over which the spouse will release
his or her income interest and the remaining assets of the trust. Clients may want to consider seeking an IRS private letter ruling confirming the nonapplication of IRC § 2519 in this situation; the IRS certainly appears willing to give such a ruling.

13. In planning for the QTIP trust there are certain suggestions that should be followed. The QTIP trust should contain a provision allowing for the distribution of principal to the surviving spouse in the sole discretion of an independent trustee. There should be a provision in the trust that allows the trust to be split without having to go to Court. Sale of assets should be entered into before the QTIP is funded. There should be a limited power of appointment over the QTIP Trust. The limited power should include charities. All of these suggestions may be inappropriate because of family considerations. However, they can be inserted in a manner that will limit the power of the surviving spouse to upset the plan. For example, the power may be subject to supervision of an independent trustee.

XV. Freeze Transactions with QTIP Trust Assets **

A. Introduction

1. As discussed above, the distribution of QTIP trust property and the triggering of IRC § 2519 can be useful ways for a surviving spouse to engage in lifetime wealth transfer planning for the trust property. In many instances, however, these strategies will not be available. The trust instrument, for example, may not permit principal distributions to the surviving spouse or the trustee will not be willing to make the distributions. Similarly, a spouse may not be able to release or disclaim an income interest to trigger IRC § 2519. Are there nevertheless other strategies that a family can use to engage in wealth transfer planning for QTIP trust assets?

2. The trustee of a QTIP trust cannot, of course, distribute trust property to a beneficiary other than the spouse, which rules out lifetime gift strategies that we might recommend to clients with significant individually owned property. One approach a family could consider in this situation is a freeze transaction that involves the transfer of QTIP trust property to family members in exchange for property of equivalent value and, if the transaction involves a deferred repayment schedule, a fixed return on the investment.

3. An individual client who wants to engage in wealth transfer planning but does not want to make gifts has a couple of very useful devices available to him or her for freeze planning: a grantor retained annuity trust or “GRAT” and sales of appreciated property
to grantor trusts. These devices, however, are not available for property held in QTIP trusts. This portion of the outline discusses ways in which the trustee of a QTIP trust can participate in freeze transactions and the tax and trust law issues these kinds of transactions raise.

B. Freeze Transactions for QTIP Trusts

1. The trustee of the QTIP trust could make a loan of cash held in the trust to a member of the spouse’s family.

   a. A trustee may be constrained by its fiduciary duties under the prudent investor rule to make the loan on commercially reasonable terms that might not apply to a situation in which an individual is loaning money to another individual. In the individual to individual situation, the lender is free to negotiate the terms of the loan as he or she sees fit. A trustee, however, must consider its fiduciary duties in making the loan, which may in turn cause the trustee to negotiate terms different than might otherwise be seen in an intrafamily loan. For example, a loan of cash by the trustee may involve greater security than an individual to individual loan, may have a shorter maturity date, and may bear a higher rate of interest. With respect to this point, our usual instinct might be to charge the IRC § 1274(d) rate of interest on a promissory note in order to avoid the application of the original issue discount rules. As a fiduciary matter, however, the IRC § 1274(d) rate may be too low based on the facts of the situation. Furthermore, a trustee may need to consider the effect of the loan on the diversification of the QTIP trust’s investments. A loan of too great a proportion of the trust’s assets could be an unreasonable assumption of risk.

   b. A loan by the trustee of a marital trust will, of course, be a taxable transaction. When the trustee receives interest payments from the borrower, the trustee must distribute those interest payments to the surviving spouse as part of the trust’s income. The surviving spouse will in turn pay income tax on that interest because it will be included in the surviving spouse’s income under IRC § 652 or IRC § 662. If the loan has original issue discount because it does not carry adequate stated interest under the OID rules, the resulting imputed interest will be taxable to the trust and not to the surviving spouse because the imputed interest will not be accounting income. See generally Treas. Reg. § 1.1273-1(c)(1)(i).
2. The trustee of the QTIP trust also could sell trust assets to family members or trusts for their benefit.

   a. As a fiduciary, the trustee must, of course, obtain a reasonable price for the property sold and secure reasonable payment terms. The trustee’s fiduciary duties constrain the trustee in a way that an individual seller would not be constrained.

   b. If the trustee of the QTIP sells appreciated property, the sale would generate capital gains tax, the payment of which would reduce the trust’s principal. If the trustee receives a promissory note in exchange for the property, the trustee can defer the capital gains tax by using the installment method to recover the trust’s basis and realize capital gain over the life of the installment obligation, effectively allowing some deferral of income tax on capital gain in the sale. See generally IRC § 453. Installment sale treatment is not available for sales of marketable securities. IRC § 453(k).

To this extent, the device is limited to sales of real estate and unmarketable securities, such as shares of stock in a family company. If the buyer is related to the seller and the seller disposes of the underlying property within two years of the original purchase, tax law deems the original seller to have disposed of the installment obligation. IRC § 453(e). The government charges interest on capital gains tax that is deferred with an installment obligation if the face amount of all outstanding obligations in a taxable year exceeds $5 million. IRC § 453A(b)(2).

   c. If the trustee sells trust property in exchange for an interest-bearing installment obligation, the interest payments from the purchaser would also be taxable, most likely to the surviving spouse, who would receive the interest payments as part of his or her distributions of accounting income.

   d. Another income tax issue will arise for the purchaser if he or she repays the principal in kind because such a repayment would cause the purchaser to recognize capital gain. This is a disadvantage if there is no actual sale of the property to generate the capital gains tax.

3. The trustee could form a preferred partnership with other family members or family trusts.

   a. One of the disadvantages of a sale or loan by a QTIP trust is that it generates income tax on the interest received and
capital gains tax on any realized capital gains. For example, if a trustee sells an appreciated asset to a member of the surviving spouse’s family or a trust, capital gains tax will be payable out of the trust assets, which reduces the trust principal without achieving any diversification of the family’s investments. Similarly, loaning cash held in a QTIP trust to a family member will generate taxable interest income that could have been avoided had the trustee retained the cash and invested it in tax-exempt bonds or in a bank account or money market fund that paid a lower rate of interest. If a trustee sells a dividend paying stock in exchange for an installment obligation, the trustee is essentially trading income taxable at 15% – the dividends – for income taxable at normal ordinary income rates – the interest. In these cases, the family has retained essentially the same assets as before the transaction but is now paying more tax. Is there a better solution for the trustee to pursue?

b. A freeze with a preferred partnership or a preferred limited liability company can accomplish many of the same goals as a loan or a sale without the accompanying income tax consequences.

(i) Although IRC § 2701 makes the use of partnership freezes more complicated, they are still possible. This section of the outline discusses a “preferred partnership.” For extensive background on these devices, see generally Hatcher, “Planning for Existing FLPs,” 2001 Inst. Est. Plan. ch. 3 ¶ 304 (2001) and Dees, “Using A Partnership To Freeze The Value Of Pre-IPO Shares,” 1999 Inst. Est. Plan. ch. 11 (1999).

(ii) A preferred partnership has two classes of interests - preferred and residual. The preferred interest holder is entitled to two kinds of distributions. First, the holder receives cumulative annual payments on the amount contributed to the partnership in exchange for the preferred units (at current rates, generally between 8% and 10% of the contribution). The annual “priority amount” payments are payable out of tax profits and are not guaranteed payments for federal income tax purposes. Second, the preferred interest holder will receive the fixed value of the preferred interests when the partnership liquidates. Otherwise, the preferred interest holder
does not share in the partnership’s income and appreciation. In effect, the preferred interests in the partnership are similar to preferred stock, and the partnership agreement “freezes” their growth rate at the preferred rate. The residual interest holders share all partnership income and appreciation in excess of the value of the preferred units and the annual preferred payments.

(iii) A preferred partnership has a number of income tax advantages over a sale or loan for a QTIP trust.

(a) In the QTIP trust context, the trust would generally receive the preferred interests in exchange for a contribution of assets, while other family members or trusts for their benefit would receive the residual interests. The partners’ contributions of appreciated assets to the preferred partnership should not have any income tax consequences. This is in contrast to a sale of appreciated assets by a QTIP trust, which will generate capital gains tax.

(b) In addition, the profits allocated to the QTIP trust by virtue of its preferred interests will be taxed based on the character of income earned by the preferred partnership. For example, if the preferred partnership owns only shares that pay qualified dividends, dividends allocated to the QTIP trust by virtue of its preferred interests will retain their character as qualified dividends and be taxable at the current preferable rate applicable to dividends. By contrast, in a sale the fixed return received by the QTIP trust – interest – will be taxable at ordinary income rates.

(c) Finally, the satisfaction of any preferred payments and the redemption of preferred units in kind by the preferred partnership with appreciated property is unlikely to generate capital gains tax. Rather, the QTIP trust will take the property received with a carry over basis, thereby deferring any income tax until the trustee sells the property. By contrast, if a
family member repays principal to a QTIP trust with appreciated property, that family member will realize a capital gain.

(iv) A perceived disadvantage of a preferred partnership is that the coupon rate on the preferred is likely to be much higher than the IRC § 1274(d) rate that an intrafamily loan may carry. While it is true that a preferred rate for a preferred partnership may exceed the IRC § 1274(d) rate, that is not necessarily the right comparison. As discussed above, a trustee must obtain a reasonable rate of interest when selling trust property in exchange for an installment obligation or loaning trust money. The IRC § 1274(d) rate may or may not be a reasonable interest rate for this purpose. Furthermore, the fact that the trustee of a QTIP trust receives a return greater than the IRC § 1274(d) rate will be good for the surviving spouse because it should augment his or her income. In addition, as discussed below, the fact that the surviving spouse's income increases as a result of the transaction will go a long way towards avoiding the imposition of gift tax in connection with the transaction.

C. Gift Tax Considerations

1. When clients who own assets in their own names engage in freeze transactions such as sales and freeze partnerships, they run the risk that the IRS may claim that the sales price or the value used to compute the frozen interest was less than the fair market value of the property that the client sold or exchanged for the preferred interest. See generally Treas. Reg. § 25.2512-8. Similarly, when a client loans money he or she owns individually to a family member, the client runs the risk that the IRS may recharacterize the loan as a gift. See, e.g., Hunt v. Commissioner, T.C. Memo. 1989-335 (1989)(even though an intrafamily loan is not arm’s length, the government must respect the loan as long as the loan is bona fide); PLR 9535026 (IRS will respect the IRC § 7872-compliant loan element of a sale transaction on the assumption that there are no facts present that indicated the notes would not be paid according to their terms). These risks are familiar to estate planners. But what if a QTIP engages in such a transaction? The participant in this situation is the trustee of the QTIP trust, not the surviving spouse. Trustees, of course, cannot make gifts. See IRC § 2501(a) (gift tax applies to gifts by any individual resident or nonresident of the United States). Are there any gift tax risks in
this situation for the surviving spouse or the remainder beneficiaries?

2. It is possible that the IRS might suggest IRC § 2519 may apply to such a situation under certain circumstances.

   a. As discussed above, the IRS takes the view that if a spouse disposes of an income interest in some of the assets of a QTIP trust, he or she will be deemed to dispose of all of the assets of the QTIP trust under IRC § 2519(a). Could a spouse be deemed to have disposed of his or her income interest if a trustee fails to obtain fair market value for QTIP trust property in a sale or freeze partnership transaction? For example, assume a trustee of a QTIP trust sells shares in a family company held in the trust to a family member based on an appraisal that uses a 15% discount for lack of control. If the proper discount was actually 10%, could the spouse be deemed to have disposed of a sliver of his or her income interest in the QTIP trust, which would in turn cause a deemed gift of all of the assets of the QTIP trust?

   b. Our first instinct would be no, that cannot be the rule, and the regulations would appear to confirm that instinct. Treasury Regulation § 25.2519-1(f) provides that “[t]he conversion of qualified terminable interest property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of this section, treated as a disposition of the qualifying income interest.” This regulation generally indicates that sales of QTIP trust assets in exchange for full and adequate consideration should not be deemed to be a disposition of an income interest that triggers IRC § 2519.

   c. But do not jump to hasty conclusions. Congress did not define “disposition” in IRC § 2519. The IRS also did not define “disposition” in the Treasury Regulations under IRC § 2519. In at least one Field Service Advice, FSA 199920016, the IRS suggested that an investment transaction might trigger an IRC § 2519 disposition if the conversion of the trust assets limited the spouse’s right to income. At least one IRS estate tax attorney has raised this issue more than once in gift tax and estate tax audits. The outline will return to that FSA shortly, but the important point is that some staff at the IRS believes that there may be some sort of “constructive disposition” rule implicit in IRC § 2519.
d. The regulations, however, do not suggest that there is such a rule. Each example used by the IRS in the regulations to illustrate how IRC § 2519 works involves a deliberate disposition of part or all of an income interest by sale or by gift by the surviving spouse. Nowhere in the regulations does the IRS suggest that a spouse could make a “constructive” disposition of an income interest.

e. In addition, the IRS National Office has never embraced or advocated a constructive disposition rule in the IRC § 2519 context in any public or private ruling. Almost every published ruling in which the IRS has considered the application of IRC § 2519 involved a direct transfer of an income interest by gift, sale, nonqualified disclaimer, or other deliberate action.

f. There are only two private letter rulings that address the relationship of investment decisions to IRC § 2519.

(i) In PLR 9523029, the National Office considered the effects of a division of a marital trust that also involved the marital trust’s purchase of shares in a closely held corporation. The National Office ruled that IRC § 2519 would not apply to the transaction assuming that the purchase price the marital trust paid was equal to the fair market value of the shares the trust purchased. The National Office, however, expressed no opinion on the valuation question, which meant that the National Office did not address the effect of a non-fair market value sale under IRC § 2519.

(ii) In the other ruling, PLR 9418013, the IRS privately ruled that a series of loans from a QTIP trust would not result in a disposition of the spouse’s qualifying income interest for life when the loans bore interest at the applicable federal rate. Although the loans in this ruling deferred the payment of interest, the trustee of the marital trust planned to make principal distributions to the spouse equal to the interest that would have been paid had it been paid annually. The National Office also noted that the notes would be includable in the surviving spouse’s estate. Accordingly, the IRS ruled that the spouse would not be deemed to have disposed of her income interests in the trust when the trust made the loans.
g. Even in FSA 199920016, in which the IRS suggested the existence of a constructive disposition rule under IRC § 2519, the National Office equivocated and ultimately advised the Examination Division to not pursue such an argument. In the FSA the National Office considered whether the IRS should treat a QTIP trust’s participation in the formation of a family partnership as a disposition of the spouse’s income interest under IRC § 2519. Under the facts of the FSA, the surviving spouse continued to receive income distributions in approximately the same amounts that she would have received had the partnership not been created. The surviving spouse was also a co-trustee of the trust, so there was no distinction between actions of the trustee and actions of the surviving spouse. In concluding that the matter was not suitable for litigation, the National Office raised the possibility of a constructive disposition rule:

By converting trust assets into FLP interests, [the spouse/co-trustee] has disposed of the corpus rather than the qualifying income interest. Facially this appears to be a permissible conversion. Thus, in order to invoke 2519, the conversion of the trust assets must work such a limitation on her right to the income as to amount to a disposition of that income. Although the conversion to partnership interests could yield this result, it does not necessarily follow. An investment in a partnership, despite possible restrictions on distribution, could be, under the right circumstances, a very lucrative investment.

The National Office did not cite any authority for this statement. The National Office recognized the futility of making such an argument given that it could not tell at the time of the “conversion” the extent to which the decision may have limited the spouse’s right to income.

h. The two private letter rulings mentioned above as well as the FSA, when combined with Treas. Reg. § 25.2519-1(f), indicate that the government probably would have a difficult time persuading a court that an IRC § 2519 disposition occurred when a trustee of a QTIP trust participated in a freeze transaction.

(i) In many of these transactions, the trust’s income – and therefore the spouse’s income – will increase. In the context of an installment sale, the spouse’s
income may increase because the buyer is paying interest to the trustee and that interest income may exceed what the spouse was previously receiving. A similar result could occur if the QTIP trust trustee participates in a preferred partnership; the preferred return, which should be accounting income, may well be higher than the income the trustee was previously receiving from the trust investments. Even in the case of a sale for cash, the trustee will be able to diversify investments and potentially invest the cash proceeds to obtain a higher yield for the spouse. Even if the trustee does not invest in income-producing property, the spouse will almost certainly have the power to compel the trustee to convert the trust investments to ones that produce income.

(ii) In addition, if the surviving spouse has a testamentary nongeneral power of appointment over the QTIP trust assets, any “constructive” IRC § 2519 gift would be incomplete. In such a situation, there would be no actual vesting of any of the trust property in the remainder beneficiaries of the trust. Because of the spouse’s testamentary nongeneral power of appointment, he or she will have retained control over the disposition of the property in question.

3. Although it appears that the IRS may have difficulties applying IRC § 2519 to such a transaction, there may be another avenue available to the IRS to argue that a taxable gift occurred when the trustee of a QTIP trust participates in a freeze transaction.

a. As discussed above, there is authority for the proposition that if a taxpayer fails to enforce a valuable right, he or she will be deemed to have made a gift. See, e.g., Nelson v. United States, 89-2 U.S.T.C. ¶ 13,823 (DND 1989)(spouse’s failure to claim full elective share to which she was entitled in a family settlement context was a gift); TAM 8723007 (shareholder did not insist on payment of preferred dividends); TAM 8403010 (controlling shareholder’s failure to pay himself dividends was a gift); TAM 9301001 (controlling shareholder made gift when he did not cause the company to pay a large enough dividend on his preferred shares).

b. If a trustee makes an imprudent investment decision, such as selling property for a bargain price, each trust beneficiary
should have a claim against the trustee for breach of fiduciary duty. If a beneficiary fails to pursue such a claim, he or she may be deemed to have made a taxable gift when the time for pursuing the claim expires. E.g., Rev. Rul. 84-105, 1984-2 C.B. 197 (spouse’s failure to require executor to fully fund pecuniary gift was a gift of the foregone funding amount). See also Bergeron v. Commissioner, T.C. Memo. 1986-587 (1986) (taxpayer did not make a completed gift in connection with the underfunding of a marital trust during a particular year when the taxpayer’s ability to correct the underfunding through a court action continued into the following year). A gift is more obvious if the beneficiary consents to the transaction. E.g., Rev. Rul. 86-39, 1986-1 C.B. 301 (trust beneficiary released a general power of appointment when beneficiary consented to a recapitalization that resulted in the trust receiving a reduced allocation of shares).

c. As noted above, however, a freeze transaction may in fact increase the surviving spouse's income. In such a situation, it may be hard for the government to argue that the spouse made a gift. The government, however, might suggest that the remainder beneficiaries have made a gift if they allowed the trustee to enter into a transaction that resulted in a disproportionately large benefit to the income beneficiary. See, e.g., Cerf v. Commissioner, 141 F.2d 564 (3d Cir. 1944) (trust beneficiary consents to rearrangement of income rights to her disadvantage).

XVI. IRC Section 6166 deferral is a useful Post-Death Estate Planning Tool

A. Introduction

1. The closely held business must be valued at more than 35% of the adjusted gross estate. You may defer the portion of the estate tax that is generated by the closely held business (§6166(a)(1)).

2. What if the stock in questions is legally bound to be redeemed over a 10-year period following the death. These were the facts in CCA 200141015 when the IRS Chief Counsel determined that the Company qualified for IRC § 6166 deferral. The stock would not immediately be redeemed but it would be redeemed during the 10-year period. Any stock not immediately redeemed would remain stock owned by the estate until it was redeemed. According to the CCA, the determination for the qualification takes into account the ownership at the date of death. Sales entered into after death may cause an acceleration but they do not impact the qualification.
3. A sale to an intentionally defective grantor trust converting a business interest into a note may significantly impact the qualification for IRS § 6166.

4. The election under IRC § 6166 must be made no later than the date prescribed by IRC § 6075(a) for the filing of the 706, including extensions. However, where there is no election under IRC § 6166 and there is no protective election and a deficiency is then assessed, the estate may then make an election with respect to the portion of the deficiency attributable to the closely held business interest. See Reg. § 20.6166-1(c)(1). This election must be made within 60 days of notice and demand for payment from the IRS.

5. It is possible to make a protective IRC § 6166 election. If an IRC § 6166 election is rejected, this issue may be taken up on appeal.

6. Prior to the 1997 Taxpayer Relief Act, the Tax Court had no jurisdiction to resolve disputes regarding an IRC § 6166 election. A declaratory judgment remedy was added under IRC § 7479 by the 1997 Act. This section allows the Tax Court to determine eligibility disputes without the taxpayer having to pay the tax. The 1998 Act contained a technical correction allowing the court to determine whether certain property qualified for the IRC § 6166 deferral.

7. IRC § 6166(b)(1) deals with what is a closely held business interest. This is defined as follows:
   a. An interest in a trade or business carried on as a proprietorship.
   b. An interest in a partnership carrying on a trade or business if either the partnership has 45 or fewer partners, or 20% or more of the partnership is included in the decedent’s gross estate.
   c. An interest in a corporation carrying on a trade or business if either the corporation has 45 or fewer shareholders, or 20% or more in value of the corporation’s voting stock is included in the gross estate of the decedent.

8. If the business is a sole proprietorship, then only assets used in the business will be taken into account. IRC § 6166(b)(8) and (9).

9. This issue of what is a trade or business is critical to the deferral question. The basic rule followed by the IRS in its rulings was that real estate used primarily for investments was not a trade or business.
10. Triple net property was not considered an active trade or business. See TAM 8451014.

11. In 2006, the IRS published Revenue Ruling 2006-34, 26 IRB 1172. In this Ruling, the IRS backed off its former position and said that it would consider the following non-exclusive factors in determining whether real estate is an active trade or business under IRC § 6166:

   a. The amount of time devoted to the real estate.

   b. Whether an office was maintained during regular business hours.

   c. Involvement in finding new tenants and negotiating leases.

   d. The provision of ground care, landscaping and other services.

   e. Involvement in repairs and maintenance.

   f. Handling tenant repairs and complaints

12. In looking at these factors the IRS will look at the decedent’s involvement as well as agents and employees of the decedent. An independent management company would be a negative factor.

13. In the Revenue Ruling there are five hypotheticals. In the second hypothetical the service determined that there was no active trade or business primarily because of the management entity in which the decedent had no ownership interest. In the other four situations, the decedent was carrying on a trade or business because the management was provided by the decedent or by employees and agent entities in which he or she had 20% or more of an ownership interest.

14. Under IRC § 6166, the term interest in a closely held business could include stock in a publicly traded corporation if the decedent owned more than 19% of the company.

15. The Service’s stated position that other sections of the Code that define “active trade or business” are not relevant is not necessarily correct.

16. IRC § 6166(b)(7) allows for some deferral of Partnership Interests and Non-Readily Tradable Securities. The Taxpayer loses the five years of interest free and the lower 2% rate for a portion of the tax. “Non Readily Tradable Stock” means stock for which there is no
ready market. In satisfying the 20% limitation, stock attributed to the decedent will be taken into account.

17. There is no form for making an election under IRC § 6166. There is however certain information that should be contained in the notice to the IRS and the election should also contain a protective request under IRC § 6166. The BNA Portfolio 832-2nd contains a sample letter.

18. Part of the interest under the Section is at a 2% rate and part is at 45% of the underpayment rate. The 2% rate also adjusts with an inflation factor and the increase in the applicable exclusion amount. The income tax and the estate tax deduction was eliminated by the introduction of the lower rates.

19. IRC § 6166(g) sets out rules for losing the deferral where:
   a. The business is sold or funds are withdrawn from the business;
   b. There is a distribution of insufficient income by the estate;
   c. There is a default in the installment payments to the IRS; or
   d. There is a violation of a lien condition under IRC § 6324A

20. The distribution, sale, exchange or withdrawal of money from the business amounting to more than 50% of the business, will cause the unpaid portion of the tax to be payable after notice and demand from the IRS. There are certain § 303 redemptions that are not taken into account. See IRC § 6166(g)(1)(B). Section 368 reorganizations are not treated as a sale. A like kind exchange and a sale to pay down debt is not treated as a disposition. Where the estate made a IRC § 6166(b)(8)(A) holding company election, any disposition of an interest in the stock owned by the holding company will be taken into account for purposes of this section. Earnings accumulated before death will also be taken into account but not those after death. Rev. Rule 75-401, 1975-2 C.B. 473.

21. A distribution to the first heir under the decedent’s plan, will not be considered a distribution.

22. All withdrawals or disbursements must be disclosed to the IRS in writing within 30 days of the event occurring. The Executor must also notify the IRS of such events when the installment is paid.

23. The IRS can demand that the taxpayer furnish a bond under IRC § 6165 when the deferral is granted.
PLANNING WITH CHARITABLE TRUSTS

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I. Charitable Lead Trusts

A. Charitable Lead Trusts (CLTs) created during lifetime or as a Testamentary Lead Trust, offer significant deferral opportunities. For example, if you put $10M into a 20 year Charitable Lead Annuity Trust and you zero out the remainder which will cause there to be no transfer tax, the annual payment to charity will, as of today, be 611,600. This is approximately 6.11% of the underlying $10M of assets. If the $10M of assets is a discounted value, with a discount of 50% (the author recognizes that this is a high percentage), then the rate of return on the underlying asset that would be needed to zero out the transfer tax is 3.05%.

B. In 2007, by way of Rev. Proc. 2007-45, 2007-29, I.R.B. 89, the Service came out with sample Charitable Lead Trusts. Similarly, in Rev. Proc. 2007-46, 2007-29 I.R.B. 102, the Service came out with a Testamentary Charitable Lead Annuity Trust for a term of years. In 2008, the IRS came out with sample forms for an Inter Vivos Grantor and NonGrantor Charitable Lead Unitrust and a Testamentary Charitable Lead Unitrust. See Rev.Proc. 2008-45, 2008-30 I.R.B. 224. In Rev. Proc 2008-46, 2008-30 I.R.B. 238, the IRS provided sample forms for a Testamentary Charitable Lead Unitrust for a term of years. In the Rev. Proc’s, the IRS indicated that it would not issue a Letter Ruling on whether an Inter Vivos Charitable Lead Annuity Trust or Charitable Lead Unitrust satisfied the requirements for a charitable deduction. However, it indicated that it would issue rulings on any substantive trust provisions other than those contained in the sample forms. The provision in the trust instrument which provides that if the trust does not qualify as a CLT, then the assets will be returned to the donor, would, in the opinion of the IRS, disqualify the trust. See Rev. Ruling 76-309, 1976-2CB 196. However, in Rev. Ruling 60-276, 1960-2CB 150, obsoleted by Rev. Ruling 91-4, 1991-1CB 57, the IRS took a different position. The IRS may permit a conditional return provision in a Charitable Remainder Trust where the return of the assets is contingent on the receipt of a favorable Private Letter Ruling and not the approval of the grantor’s income tax deduction. It would appear that this should apply to Charitable Lead Trusts as well. A better way of dealing with all of this is to provide that the trustee can amend the document to make it qualify as a CLT. The Code expressly permits such an amendment in Section 1022(a).

C. In order to qualify as a CLT, the grantor must provide for an annual payment to charity in the form of a guaranteed annuity or a guaranteed Unitrust interest. These can be for a term of years or life. In contrast to the Charitable Remainder Trust, there is no 20 year limitation on Charitable Lead Trusts established for a term of years. The payment must be paid periodically (but at least annually).
D. The guaranteed annuity amount must be determinable upon the establishment of the Charitable Lead Trust. One of the big advantages of a Charitable Lead Trust is that you can set the payments up as a fixed percentage of the assets that are being transferred into the Trust. This allows for a formula Charitable Lead Trust. For example, if the service increased the value on audit, there would be no tax generated by the transfer. All that would happen, is that the payments to the charity would increase. The key to qualification of a guaranteed annuity is that the amount of the Charitable Lead interest must be a sum certain that is readily determinable at the outset. The Regulations state that the amount of the stated sum may be changed by a specified amount at the expiration of the term but may not be re-determined by reference to any fluctuating rates like the Cost of Living Index. See Reg. § 1.170A-6(c)(2)(i)(A) and Reg. § 20.2055-2(e)(2)(6)(a). It is possible to have a shark fin annuity amount or an annual increasing annuity amount. See the discussion below. This may impact the desire to of the IRS to audit an estate that uses a formula Charitable Lead Trust.

E. The excess income that accrues in the annuity trust can either be retained in the trust or distributed to the charitable beneficiaries. However, the deduction is based on the guaranteed annuity payment to the charity. Where you provide for excess income to be paid to the non-charitable beneficiary, care must be taken to include language prohibiting transactions taxable under § § 4943 and 4944. See Rev. Ruling 88-82, 1988-2CB336.

F. The Private Foundation excise taxes under IRC §§ 4941-4945 apply to Charitable Lead Trusts. The governing instrument of the Charitable Lead Trust must contain certain prohibitions with respect to certain private foundation rules. However, in the case where the present value of the charitable lead interest does not exceed 60% of the assets of the trust computed on the valuation date, the governing instrument of the Charitable Lead Trust is not required to prohibit acquisition and retention of IRC § 4943 Excess Business Holdings and IRC § 4944 Jeopardy Investments.

G. If there is provision in the CLT for private purposes before the expiration of all charitable lead interests, then the lead interest will not be considered a guaranteed annuity interest. See Regulations § 1.170A-6(c)(2)(i)(E) and Regulations § 20.2055-2(e)(2)(iv)(f). There are two exceptions to this general rule. Firstly, an amount may be paid for a private purpose if the amount is in the form of a guaranteed annuity interest and the trust governing instrument does not provide any preference or priority for the private annuity over the charitable annuity. Secondly, an amount may be paid for a private purpose if the governing instrument provides that such amount is payable only from assets
devoted exclusively to private purposes and to which IRC § 4947(a)(2) does not apply.

H. The annual amount payable to charity may provide for any dollar or percentage amount. There is no 5% minimum annual payout requirements nor is there any 5% exhaustion requirement that applies to Charitable Remainder Annuity Trusts. If the income in the trust falls short of what is needed to be paid out, the trustee must use principal to pay to charity.

I. Unlike Charitable Remainder Annuity Trusts where additional contributions made after the initial contribution are prohibited, there is no such similar prohibition in the case of the CLT. However, one cannot get a deduction for additional contributions since the amount of the annual guaranteed annuity payment must be determinable at inception. These additional contributions may be useful where the trust has insufficient income to pay the annuity amount. In PLR 200149016, the IRS ruled that an additional contribution to a CLT would qualify for the gift tax charitable deduction where the earnings from the additional contribution were kept in a separate account. In this Private Letter Ruling, each of the accounts was a separate Charitable Lead Annuity Trust that complied with the determinable amount requirements of a CLT.

J. In the case of the Unitrust, a fixed percentage of the net fair market value of the trust is determined annually and paid to charity. The trustee again has the obligation to pay the Unitrust amount even if the trust income in a given year falls below the amount of the payment. Once again, the Unitrust payments may be for a term of years or for the life or lives of one or more of the individuals. In the case of lives of individuals, each individual has to be living at the date of the transfer to the trust. See Reg § 20.2055-2(e)(2)(vii)(a). Once again there is no 20 year limit on the term of years alternative. You can also have a life plus a term of years.

K. If you have a qualified contingency described in § 664(f), a Charitable Remainder Trust is not disqualified. A qualified contingency in the case of a CLT will disqualify the trust.

L. For the purposes of valuing the Unitrust amount, one may use the value on any one day during the trust’s taxable year or by taking the average of valuations made on more than one day during the year. You do, however, have to use the same method of valuation year after year. If the trust is silent on this issue, then the trustee must select the date or dates and indicate the selection on the trust’s first income tax return. See Reg §§1.170 A-6(c)(2)(ii)(A) and 20.2055-2(e)(2)(vii)(a).

M. If the charitable beneficiary is to receive the lesser of a sum certain or a fixed percentage of the assets, this will not qualify as a Charitable Lead
UniTrust. For the purposes of calculating the annual payment to charity, one may use the cash or accrual method of accounting. Regardless of which one you use, one must be consistent.

N. You can have a provision in the governing instrument of the CLT Unitrust which provides that excess income can or must be paid to the charitable beneficiary. See Reg §§1.170 A-6(c)(2)(ii)(C) and 20.2055-2(e)(2)(vii)(b) and 25.25522(c)-3(c)(2)(vii)(d). This excess amount which is paid to charity will not avail the grantor of an additional deduction. However, if the CLT is a grantor trust, then the grantor would be permitted an annual income tax deduction for the amounts paid to charity to the extent that they exceed the Unitrust amount. In the case of a Non Grantor Lead Trust, the trust is entitled to an IRC § 642(c) income tax set aside deduction.

O. One cannot have the Unitrust percentage varying over the term of the trust. See Reg §§1.170 A-6(c)(2)(ii)(A) and 20.2055-2(e)(2)(vii)(a).

P. Once again a CLT will not be considered a Unitrust interest if any amount may be paid by the trust for private purposes during the lead period. As in the case of the Charitable Lead Annuity Trust, there are two exceptions. Firstly, you can provide for a private purpose as long as the governing instrument does not provide any preference or priority for the private Unitrust interest over the Charitable Unitrust interest. Secondly, you may have a governing instrument which provides that an amount may be paid for private purposes out of assets devoted exclusively to private purposes and to which IRC § 4947(a)(2) does not apply by reason of IRC § 4947(a)(2)(B). The 2003 amendments (which reflect the Tax Court decision in Boeshore Estate v. Commissioner, 78 T.C. 523 (1982), Acq., 1987-1 C.B.1.) permit a seriatim Non-Charitable and Charitable Unitrust interest. As in the case of an Annuity Charitable Lead Trust, payments for legal services and trustee fees are for consideration and are not paid for private purposes.

Q. There is no minimum 5% payout requirement for a Charitable Lead Annuity Trust and the 5% exhaustion requirement applicable to certain Charitable Remainder Unitrust does not apply.

R. You may make additional contributions to a Charitable Lead Unitrust. You also get an additional gift tax contribution for additional contributions. Compare the Annuity Lead Trust where no deductions are allowed for additional contributions.

S. The Annuity Lead Trust works better where the income is increasing over time and the Uni Lead Trust where the income is expected to decline over time.
T. There is no completed gift where the donor retains the power to select the identity of the charitable recipient. See Reg § 25.2511-2(b), (c) and PLR 200328030. Similarly, where the grantor holds a fiduciary position with the charitable beneficiary, then the gift is incomplete. However, in PLR 8130033, the IRS ruled that a completed gift of the annuity interest had been made where the grantor was a director of the charitable organization. Where the family members are in control of the charity, there is still a completed gift. See PLR 200030014. By keeping the grantor out of the control of the portion of the funds that come from the Lead Trust, one would be able to have the gift be complete. See PLR 200138018 and 200108032 and 199908002.

U. The Internal Revenue Code does not define the permissible term of Charitable Lead Trust. The Regulations prescribe that the term may be a term of years or the life of the individual (or individuals who are living at the date of transfer).

V. The Charitable Lead Trust must have one or more charitable income beneficiaries and one or more non-charitable beneficiaries. The trust does not fail to qualify under IRC 2522(c)(2)(B) where the grantor does not designate specific charitable beneficiaries. The trustee may have the power to select new charitable beneficiaries each year. If the grantor has the power to change the charitable beneficiary or the remainder beneficiaries, then the corpus of the trust will be included in his or her estate for estate tax purposes. See PLR 200328030.

W. If the grantor of an Inter Vivos CLT is a member or director or officer of the charity, then the corpus will be included in his or her estate under IRC § 2036(a)(2) with a charitable deduction permitted for the present value of the income interest. See *Rifkind v. U.S.*, 5 CL.Ct. 362 (1984). The same will not occur if the spouse or children act as officers or directors of the charity.

X. Under IRC § 170(f)(8), a taxpayer who claims a deduction to charity of $250 or more is responsible for obtaining from the donee a contemporaneous written acknowledgement of the contribution. The Regulations provide that this substantiation requirements will not apply to a Grantor Charitable Lead Trust. See Reg § 1.170(a)-13(f)(13). You also do not need the substantiation requirements for a non-Grantor Charitable Lead Trust because the deduction arises by virtue of IRC § 622(c) and there are no substantiation requirements under that Section.

Y. A Non-Grantor CLT is taxed as a complex trust. Any income in excess of the allowable deduction is taxed to the trust. The trust receives an IRC § 642(c) income tax deduction for income paid to charity. There is no statutory tier system for the payments to charity. The governing instrument will prevail and if it is silent, then payments to the charitable
beneficiaries will be considered to consist of a pro rata portion of all items of the trust income. Effective April 16, 2012 the IRS amended the IRC § 642(c) Regulations to provide that a provision in a trust, will or local law specifically indicating the source out of which amounts of income are to be paid, permanently set aside or used for an IRC § 642(c) purpose, must have an economic effect independent of the income tax consequences in order to be respected for federal tax purposes. If the governing instrument has no such provisions, the amount to which § 642(c) applies is deemed to consist of the same proportion of each class of the items of the trust’s income as the total of each class bears to the total of all classes. It is still desirable, however, to allocate all depreciation, amortization, and depletion deductions to the trust. See Regulations § § 1.642(e)-1, 1.611-1(c)(4) and 1.167(h)-1(b).

Z. If a Charitable Lead Trust has unrelated business taxable income, this may result in a portion of the Charitable Lead Trusts IRC § 642(c) charitable deduction being disallowed.

AA. The trustee of a Charitable Lead Trust must prepare and file an income tax return each year. (A Form 1041). The trustee must also prepare a K-1 indicating the beneficiaries of all items of income, deductions and credits.

BB. In Revenue Ruling 88-27, 1988-1C.B. 331, the IRS ruled that a trust with a prepayment provision did not qualify as a CLT. The reason for this was the exact amount of the annuity interest would not be determinable at the time of the gift. Many of the private foundation rules contained in IRC § § 4940 to 4948 apply also to Charitable Lead Trusts.

CC. A generation skipping transfer tax occurs when the income or corpus is transferred from the CLT to a skip person. One may only apply the GST Exemption to the value of the assets that emerge from the Lead Trust at the end of the lead period. A Charitable Unitrust is not subject to IRC § 2642(e) and an exemption allocation made at the time of funding will be effective for the date of funding value. If one is using a Charitable Lead Annuity Trust, skip persons should not become beneficiaries in the event of the death of the remainder beneficiary. The generation skipping tax may also be reduced by purchasing assets into a generation skipping trust at a discounted value and by funding the CLAT with a note. The note is generally funded into an LLC before contribution to avoid any self-dealing issues. See the attached Ruling.

DD. Another way to deal with the generation skipping tax consequences is to provide that if the child who is the beneficiary of the Charitable Lead Trust, dies before the end of the term, then the child’s share will go to the child’s estate. See PLR 9533017 and 9534004. It is also possible to give the child a general power of appointment over the remainder interest. See § 2652(a)(1) and Regulation § 26.2652-1(a)(2) and PLR 200043039.
In this private letter ruling, the remainder interest of an Inter Vivos Charitable Lead Unitrust was to pass into separate trusts for the grantor’s children after a 30 year term. Each child was to have a lifetime general power of appointment over his or her share after reaching age 35. The IRS ruled that the child would become the transferor for GST purposes after that time. However, the IRS also ruled that the grantor would be the transferor for GST purposes if the child died before age 35. The IRS therefore concluded that the grantor could allocate GST exemption to the trust at the end of the 30 year term.

EE. There is an interesting Private Letter Ruling 200107015 where there was a 25 year Charitable Lead Annuity Trust and the trustees had certain powers to amend the trust beneficiaries at termination. The trustees were planning on amending the trust so that 1/6 of the remainder would vest in one child of the grantor. The trustees were then going to release their power to change the disposition at termination. The child was planning to assign his remaining interest to his own children and file a gift tax return. The IRS ruled that the child would become the transferor of a portion of the trust equal to the present value of 1/6th of the remainder on the date of the assignment. The grantor remained the transferor of the balance of the trust. However, the IRS warned that the form of the transaction might be disregarded since it appeared that this was an end run around the GST leveraging that IRC § 2642(e) was designed to prevent.

FF. An independent trustee of a Non-Grantor Charitable Lead Trust is not prohibited from having the power to sprinkle the annuity or Unitrust payments among a class of charities. The same would apply to an independent trustee having the power to sprinkle the assets among a class of beneficiaries at the end of the term.

GG. The grantor may transfer mortgage property to a Charitable Lead Trust. If the mortgage was acquired immediately prior to transfer, there could be unrelated business taxable income problems. If the indebtedness exceeds the grantor’s basis in the property, then there could be gain recognition. See Regulation § 1.1001-2.

HH. The Charitable Lead Trust is a form of a freeze and freezes work very well where there are significant valuation discounts in play or where the property in question has significant income or appreciation. If non income producing properties transfer to the Charitable Lead Trust, this should be balanced with high-yielding securities or income producing properties or cash.

II. Because gifting results in a carryover of basis and because income tax rates have gone up precipitously, Inter Vivos Charitable Lead Trusts should be funded with high basis assets. This problem does not occur
with the testamentary Charitable Lead Trust where one receives a step-up in basis at death.

JJ. A distribution of corpus from a Non-Grantor Charitable Lead Trust to the charitable beneficiary in satisfaction of the fixed dollar obligation is a sale or exchange by the trust and could result in capital gains. See Regulations § 1.661(a)-2(f) and Revenue Ruling 83-75, 1983-1.C.B.114. This gain may be offset by the charitable deduction arising from the payment to the charity.

KK. Borrowing by the trust may avoid the adverse tax and economic consequences associated with the sale or distribution of assets to the charity. This may be a method of providing funds in a year where there were insufficient funds to make the charitable payment.

LL. It is possible to have a varying annuity amount as long as it is determinable at inception. The Regulations also provide that the amount of the annuity may be changed at the end of the term by a specified amount so long as the redefined annuity amount is not determined using a fluctuating index or the principal valuation of the trust at the time of the change. See Regulation §§ 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a). Charitable Lead Trusts are not subject to any minimum or maximum payout requirements. One possibility is the so-called “Step” Charitable Lead Annuity Trust where the annuity gradually increases. For example, the annuity amount may increase by 120% of the fixed fraction or percentage payable in the preceding year. See Regulation § 25.2702-3(b)(2)(ii)(B) where the payment increased by 120%. Therefore, it may be assumed that increasing the payment by 120% would not be considered abusive by the IRS, since this is the figure contained in the Regulation. Then there is the shark fin or balloon payment trust which starts off with a very low annuity amount and then in the final year has this large increase in the annuity amount. This type of planning allows the growth assets to remain in the trust for a long period of time and maximizes the amount that would pass on to the remainder beneficiaries. This is definitely more aggressive than the gradually increasing rates. At this point in time, there is no clear authority from the IRS as to whether this type of planning is considered abusive. On the other hand there is no authority that it is abusive.

MM. Charitable Lead planning is dependent on the 7520 rate. Charitable Lead Trusts function significantly better in an environment where the 7520 rate is low. Some practitioners who provide for testamentary Charitable Lead Trusts in their documents, will in fact provide for a phase out of the Charitable Lead Trust as a planning device if the 7520 rate should exceed a certain percentage.
Besides creating a Qualifying Non-Charitable Grantor Lead Trust, it is also possible to create a Non Qualifying Non-Grantor Charitable Lead Trust. In this instance, the charitable income interest is not stated; and there is a guaranteed annuity or Unitrust amount. The settlor does not usually make a completed gift of the income interest to the charitable beneficiary when the trust is created and is not entitled to any gift tax charitable income tax deduction at that time. On the other hand, a gift of the trust income to charity is made annually at which time the settlor receives a gift tax deduction. The income of this trust is not taxed to the grantor. This trust is used to avoid the private foundation rules and to ensure that the trust charitable deduction will equal its income.

It is possible with a Testamentary Charitable Lead Trust to completely eliminate the estate tax on the assets passing to the trust. For example, if the asset that passes to the Charitable Lead Trust is an asset that yields income at a 7% rate of return, and if the asset is discounted for valuation purposes at a 40% discount, then using a 20 year Charitable Lead Annuity Trust and the interest rates in December 2013, it will take approximately 60% of the income from the transferred property to completely eliminate the estate tax on the assets in question. In the case of a Testamentary Charitable Lead Trust, the property in question will receive a step-up in basis. The Testamentary Charitable Lead Trust is taxed as a complex trust under the general rules set forth in Subchapter J and will be entitled to an IRC § 642(c) income tax charitable deduction for amounts paid to charity. What is in effect happening, is that the payments to charity are being made with pretax dollars. In the case of real estate assets, where the income will be partly sheltered by depreciation deductions, most of the remaining income after paying the 60% to the charity will be free of income tax.

It is generally not desirable to have the business assets (whether they are real estate or a manufacturing company) pass into the charity. The Charitable Lead Trust is subject to all of the private foundation rules. The family is therefore precluded from buying the business assets out of the Charitable Lead Trust. There is however an exception. During the administration of the estate, assets may be purchased from the estate with court approval. If the assets given in exchange for the business assets that are in the estate are less liquid, then a Private Letter Ruling is required. If there is an option agreement in place, then there is once again no Private Letter Ruling required.

The self-dealing restrictions that apply to Private Foundations also apply to CLTs. A disqualified person may enter into a purchase of assets that are bequeathed to the CLT in certain circumstances set out in the Code. This only applies where the property is unreservedly destined to be transferred to the foundation. See Reg. §§ 53.4941(d)-1(b)(8), Ex (3) and PLR 9014063 and PL 200003051. There are certain exceptions to the
self-dealing rules. One of these exceptions exists where the executor is required to sell the property under the terms of a valid option agreement. See PLR 199930048 (May 6, 1999). See Reg. § 53.4941(d)-1(b)(8), Ex(4). The transaction has to be approved by the probate court and the transaction must be completed during the reasonable administration period. See Reg. § 1.641(b)-3. The estate or trust must receive an amount that equals or exceeds the fair market value of the foundation’s interest or expectancy, taking into account the terms of the option agreement. The foundation must receive an interest or expectancy as liquid as the one it gave up. Alternatively, the foundation must receive an asset that it uses for its exempt purpose or the transaction is required under the terms of the option agreement. See PLR 9320041 and PLR 200207028 and 200207029. See also Reg. § 53.4941(d)-1(b)(3). See also PLR 8942054 dealing specifically with a Lead Trust. See also PLR 200232033 (May 16, 2002), PLR 200124029( March 22, 2001), PLR 9501038 (October 6, 1994), PLR 8006029 (April 3, 1980). In three identical rulings (200625015, 200635016 and 200635017 dated June 8, 2006) the taxpayer created single member LLCs and contributed notes to the LLCs. The LLCs were engaged solely in passive investment activities. The nonvoting units were allocated to the CLATs. The taxpayer then granted option agreements to the children to purchase the nonvoting units at fair market value after death. The IRS ruled that this was not impermissible self-dealing under the Regulation. The retention of the LLC by the CLAT was held not to be an act of indirect self-dealing because of the fact that the CLAT would not have control over the LLC (it only owned the non-voting units on a note). Furthermore, the LLC would be excluded from the definition of “business enterprise” under IRC § 4943(d)(3)(B) and Regulation § 53.4943-10(c)(1) and the non-voting units will not constitute “excess business holdings” under §4943. In PLR 20092704, the decedent’s son owned corporation that exercised an option (cash option) to purchase timber properties from the estate where the properties were bequeathed to the foundation. The son and daughter were the executors of the estate and the son was the director of the foundation. The IRS held that the facts here met the requirements of the estate administration exception and are therefore not subject to the self-dealing rules. See also the PLR attached to this outline.

RR. The IRS will rule on the more liquid than issue. See PLR 9320041 when the IRS ruled that a note secured by real estate is more liquid than the real estate itself.

SS. The Internal Revenue Code also imposes a punitive excise tax on excess business holdings in a private foundation (or a CLT). See IRC § 4943. “Excess business holdings” is the amount of stock which the foundation would have to dispose of to a non-disqualified person in order for the remaining holdings of the foundation to be permitted holdings. “Permitted holdings” are 20% of the voting interests reduced by the percentage of
voting interests owned by all disqualified persons. However, if all disqualified persons together own 20% or less of voting interests, non-voting interests will also be treated as permitted holding. Permitted holdings, increase to 35% if the private foundation and all disqualified persons together own 35% or less of the voting interests and effective control is held by persons other than disqualified persons. Where there is a gift or bequest in a business holding to a private foundation, the foundation has five years to dispose of the interests. Note that the term “business enterprise” does not include a business that earns more than 95% of its income from passive sources. The sale of the business enterprise will avoid the violation of the excess business holdings rule.

TT. When a foundation (or a CLT) makes an investment that jeopardizes the carrying on of the exempt purposes, penalty taxes are imposed. This is when the managers of the foundation fail to exercise ordinary business care and prudence in making an investment. This rule does not apply to an investment that is gratuitously transferred to the foundation. See IRC § 4944 and Regulation § 53.4944-1(a)(2). In PLR 200024052 the IRS concluded that the lead trust receipt by gift of notes from a disqualified person, is not a jeopardizing investment under the Regulations.

UU. Where a taxpayer has an interest in charitable giving, a portion of a large gift may never be deductible for income tax purposes. This problem arises because of the percentage limitations on annual deductions and the five year carryover period. See IRC § 170(b)(1)(A) to (E). A nongrantor CLT is allowed as unlimited fiduciary income tax charitable deduction for payments out of income that it makes to charity. See IRC § 642(c). The income from the property that is transferred to the CLT accrues to the trust and the trust gets an offsetting charitable deduction (no limit on the amount of the deduction).

VV. To achieve an income tax deduction for a charitable gift made using a CLT, the donor must be treated as the owner of the CLT for income tax purposes. There are a number of ways to achieve the grantor status. These include the following:

(a) retention by the grantor to substitute property with property of the trust for equal value. See IRC § 675(4)(C)

(b) the trust making a loan to the grantor that is not repaid by year end. See IRC § 675(3)

(c) a non-adverse party adding beneficiaries (individual or charitable or both). IRC § 674(a) and 674(b)(5)

WW. Where there is a grantor CLT, the trust is not recognized as a taxpaying entity. In 2009 the IRS in PLR 2009 20031 concluded that a grantor CLT could not distribute appreciated assets to the charity without tax.
incidence. The IRS cited Reverse Ruling 83-75. 1983 CB 114 (in which taxable gain results on a nongrantor trust’s distribution of appreciated property in payment of a charitable annuity) as authority for its position. It also cited Kenan v. Commissioner, 114 Fed 217 (2nd Cir. 1940) as authority for this position (here the estate funded a specific bequest with appreciated property). The IRS seems to be ignoring its policy of treating a grantor trust as being owned by the owner of the CLT. Neither of the two authorities relied on in the private letter ruling involved a grantor trust.

XX. A gift to a CLT results in a tradeoff of future income versus a current deduction. This is the time value of money. On the other hand, the benefits of doing this may be enhanced where the taxpayer avoids adding more income in a year where he or she is paying tax at marginal rates.

YY. Comparing the CLAT to IRC § 6166 is an interesting exercise. Generally speaking the 6166 deferral will push more assets down to the family than the CLAT. However, this does not take into account the following:

(a) The 6166 deferral has a variable interest rate.

(b) The T-CLAT may be less likely to be audited than the 6166 deferral.

(c) The T-CLAT may be extended beyond that of 6166 deferral which is limited to a fifteen year deferral.

(d) The advantage of the charitable entity cannot be quantified in dollars.

(e) The 6166 deferral precludes the sale of the property subject to deferral without the loss of the deferral.

(f) The taxpayer has to qualify for the 6166 deferral and the IRS may challenge the qualification.

ZZ. There are several articles that have discussed the benefit of the CLAT:

(a) Matthew J. Madsen, Funding a CLAT with a Note Can Accelerate the Transfer of Wealth to Heirs, 30 Est. Pl. 495 (2003)

(b) Donald Tescher and Barry A. Nelson, The Frozen T-CLAT, 143 TR. & EST 33 (July 2004).

(c) Daniel L. Daniels and Dave T. Leibell, Planning for the Closely Held Business Owner: The Charitable Options, 40 Philip E. Heckerling Institute on Estate Planning § 1402 et. seq. (2006)
(d) Donald R. Tescher, Testamentary Charitable Lead Trusts: When They Should Be Used in Estate Planning, and Don’t Overlook the Income Tax Planning Opportunities, 48 Tax Management Memo 411 (October 27, 2008).
XVIII. Section 645 Election

Background

Many of our clients establish revocable living trusts during their lifetimes. Revocable living trusts are generally designed to (1) avoid probate with respect to assets which have been transferred to them and (2) provide detailed guidance regarding how their assets should be administered and who should administer them. These are grantor trusts [see Internal Revenue Code ("IRC") Sections 671-679] and they become irrevocable upon the death of the grantor.

A decedent who funded a revocable living trust during his lifetime will frequently have other assets which have not been transferred to the trust. Those assets will comprise the decedent's estate. Both the estate and the now irrevocable trust will separately be required to file fiduciary income tax returns assuming they have sufficient income to meet the filing requirement.

The Election

Under these facts, the trustee and the executor must consider whether to file an election under Section 645. If the election is made, the trust will be treated for income tax purposes as a part of the decedent's estate for all tax years of the estate ending after the decedent's date of death and before the "applicable date" (see below). A Section 645 election, once made, is irrevocable.

Why should this election be seriously considered? If the election is made only one annual fiduciary income tax return will be required combining both the trust and the estate. Further, the return will utilize the rules applicable to estates rather than trusts.

Advantages

Estates have several income tax advantages not available to a trusts, including:

- The option to adopt a fiscal year for income tax purposes and thereby permit an executor to defer the reporting of income and plan for the use of deductible expenses. Under the right circumstances, this can provide a full year of income tax deferral.
- The ability to take advantage of the charitable set aside deduction under Section 642(c).
- Recognition of loss upon the satisfaction of a pecuniary bequest with assets having a fair market value less than basis under Section 267(b).
- Not being subject to the active participation requirements of the passive loss rules for tax years ending less than two years after decedent's date
of death.

Absent the election, the trust will be required to have a calendar tax year. The first taxable year of the trust will be a short year beginning from the grantor's date of death through December 31. The trust will likely be considered a complex trust since the trustee will not typically be required to make immediate distributions. As such, there is the potential for the income earned by the trust to be taxed at the high income tax brackets applicable to trusts unless the trustee is able to do post-mortem planning and make timely distributions. Such distributions will carry out the trust's distributable net income to the beneficiaries. See also the Separate Share Rule below.

While distributions to beneficiaries may solve the problem of high tax rates at the trust level, it will result in the beneficiaries reporting more income than they anticipated and could result in underpayment penalties. Thus, even though the trust functions as an administrative vehicle for the estate, without additional planning it does not offer the same post-mortem income tax planning opportunities that are available to a decedent's estate.

**Qualified Revocable Trusts Only**

A Section 645 election is effective only if made with respect to a "qualified revocable trust" ("QRT").

- A QRT is any trust (or portion thereof) "owned" for income tax purposes by the decedent under Section 676 because of a power held by the decedent, determined without regard to Section 672(e) (which treats a grantor as holding any power or interest held by his or her spouse)
- A trust is not a QRT if it is treated as owned by the decedent because his or her spouse is granted the power of revocation. However, a trust is a QRT if it is treated as owned by the decedent because he or she had the power to revoke with the consent of the decedent's spouse.

**Applicable Date**

- For estates not filing an estate tax return, the "applicable date" is the date that is two years after decedent's date of death.
- If an estate tax return is filed, the applicable date is the date that is six months after the date of the final determination of estate tax liability. This date can be based on a number of possible events including the issuance of an estate tax closing letter, the execution of a settlement agreement fixing the estate tax liability or a court decree resolving the estate tax liability.
- Note that since the Internal Revenue Service is no longer automatically
issuing estate tax closing letters, extra care must be taken in determining the applicable date.

How to Make the Election

- The straightforward election procedures are set forth in IRC Reg. §1.645.
- If there will be no executor appointed, the QRT Trustee files the election. In this event, the election must include the QRT Trustee's representation that there is no executor and to the trustee's knowledge and belief, one will not be appointed.
- If there is an executor, the election is made on Form 8855 attached to the timely filed (including extensions) initial Form 1041 of the estate. If there is no executor, the election is attached to the timely filed Form 1041 for the first tax year of the QRT taking into account the trustee's election to treat the trust as an estate under Section 645.
- If there is an executor, one Form 1041 is filed for the combined QRT and related estate under the name and TIN of the estate (the QRT does not need to file a Form 1041 for the balance of the tax year after decedent's death). One $600 personal exemption is permitted and all items of income, deduction and credit are combined, except as required under the separate share rule. If there is no executor, the QRT trustee files Form 1041 treating the trust as an estate.

Separate Share Rule

- The QRT and related estate are treated as separate shares for purposes of calculating distributable net income ("DNI"). Accordingly, if distributions are made from the QRT and/or the related estate, the DNI of the entity making the distribution will have to be calculated.
- Distributions between the QRT and related estate shares will affect the computation of DNI

Termination of Election Period

At the close of the election period (the applicable date), a distribution is deemed to be made by the combined QRT and related estate, if there is an executor, or, if there is no executor, from the QRT. The deemed distribution is to a new trust and consists of the QRT share, as determined under the separate share rule discussed above. The combined related estate and QRT, or the QRT, as the case may be, is entitled to a distribution deduction with respect to the deemed distribution. The new trust will include the distribution in gross income to the extent required under the inclusion rules of Section 662.
Portability Elections in 2015:
Utilizing the Deceased Spousal Unused Exclusion Amount

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1.

Introduction

Portability elections, namely the election to make available to the surviving spouse some, or all, of the deceased spousal unused exclusion amount ("DSUE amount" or "DSUEA" depending on your preference with acronyms) has become the growing colossus in estate planning, generally, and estate tax practice, in particular. This presentation and outline address issues beyond the basics with portability elections and reviews several refined issues of significance to estate planning and/or compliance with portability elections, namely:

+ Establishing proof of income tax basis after the death of the first spouse with estates filing the Form 706 solely for portability elections (i.e., the return is not mandated under general filing requirements).

1Copyright © Keith Schiller. August 2014, revised September, 2014, December, 2014, April, 2015, and October 2015. All rights reserved. These materials may not be reproduced, in whole or part, without the prior written permission of Keith Schiller and Bloomberg BNA, the publisher of the Second Edition Estate Planning At The Movie® — Art of the Estate Tax Return ("706 Art"). Estate Planning At The Movies® is the registered trademark of Keith Schiller. Some portions of these materials have been adapted from 706 Art. References to motion pictures are intended for educational benefit to assist the recall of the reader of significant estate planning or tax considerations or to otherwise aid professionals in their communication with clients for greater awareness and more effective estate and tax planning. The author thanks John Schooler, Esq., IRS Estate and Gift Tax Group Appeal Manager Retired, for his review of the Second Edition of 706 Art.
Portability returns and its relationship to income tax basis.

Communication with clients.

Must trusts be amended?

Basics for the Form 706 preparation with portability.

Does simplified reporting really help?

Transmission expenses ... where to report?

How should the estate handle contingent liabilities with portability elections?

Problems created by the extended audit period provided to the IRS to review portability elections or the amount used.

Protecting the marital deduction.

Checklist for planning: include chart/tool for client.

The author references the following previous articles and materials addressing portability elections:

- **Estate Planning At The Movies® — Back to the Future Dangers or When Direct Transfers to a Grantor’s Trust Are Confused with Outright Distributions to a Surviving Spouse**, Leimberg Information Services Newsletter, Archive Message #2262, (December 17, 2014): Special focus on drafting problems when the decedent leaves bequests to the Survivor’s Trust, since it is not the same as outright. Mr. Schiller co-authored this article with Paula Leibovitz Goodwin, Esq., partner with Schiff Hardin, San Francisco, California.


- **Estate Planning At The Movies® — Art of the Estate Tax Return (“706 Art”), Second Edition**, published October 2014 by Bloomberg BNA. The Second Edition includes extensive new and refined coverage on portability elections. (Contact mstone@slg41law.com for additional information or visit http://bna.com/bnabooks/aetr.)

- **Estate Planning At The Movies® — Quicksand and Portability**, Leimberg Information Services Newsletter, Archive Message #2190 (January 30, 2014): basis issues and reporting unresolved claims. Content from this paper is drawn, in part, from said article including with substantial replication. Inclusion is with the consent of Leimberg Information Services, Inc.


2. Portability Returns and Their Relationship with Income Tax Basis

Whatever allowance exists for income tax basis change on the death of an individual continues on the death of the first spouse irrespective of whether a portability election is made. Internal Revenue Code §1014(a) provides:

"Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be-

(1) the fair market value of the property at the date of the decedent's death,
(2) in the case of an election under section 2032 (...), its value at the applicable valuation date prescribed by those sections,
(3) in the case of an election under section 2032A its value determined under such section, or
(4) to the extent of the applicability of the exclusion described in section 2031(c) the basis in the hands of the decedent."

Items (2) through (4), above, reference alternate valuation date, special-use, and conservation easement elections, respectively. Income in respect to a decedent (under Code §691 and referenced as "IRD") represents the most significant, but not the exclusive, exception to basis adjustments arising from death.

Reg. §1.1014-3 sets forth the central connection between estate tax valuation and income tax value. That section states, "The value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax ... shall be deemed to be its fair market value." The regulation does not require that any estate tax must be paid. Similarly, the regulation (which has not been updated since December 31, 1960) makes no reference to an estate tax return filed solely to make the portability election. On the other hand, this regulation states that in the event, "no estate tax return is required under Code §6018, the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value."

Aside: Code §6018 requires an estate tax return to be filed when the combination of the gross estate plus adjusted taxable gifts exceeds the basic exclusion amount ($5,340,000 for each in 2014 and $5,430,000 for deaths in 2015) in the year of death. (Gifts made after September 8, 1976 and before
January 1, 1977 that used any of the decedent's specific exemption reduce the basic exclusion amount. Thus, the threshold test has three parts: (1) gross estate + (2) adjusted taxable gifts + (3) use of the specific exemption to compare against the un-reduced basis exclusion amount.)

The test under Reg. §1.1014-3 to evidence basis has been clouded in the portability context. On the one hand, a complete, properly prepared and timely filed estate tax return is required under Code §2010(c) to make a portability election. (See, §3, infra, for discussion of the requirements of "complete and properly prepared"). The portability section requires that the estate tax return be filed within the time prescribed by law. That deadline is established under Code §§6018 and 6075 for this filing requirement. Code §6075 establishes the nine-month due date and cross references Code §6018 which establishes a requirement described in the Aside above. On the other hand, no estate tax may ever be payable and the return may have no relevance in determining the amount of estate tax, if any, that is ever payable. This would be the case in estates in which the total of both estates is below the basic exclusion amount in the year of death of the surviving spouse.

Presumption of Value

Accordingly, Reg. §1.1014-3(a) provides that the value of property as of the date of the decedent's death, as appraised for the purpose of the federal estate tax, shall be "deemed" to be its fair market value. For the purpose of determining the basis at death (for determining gain or loss on the sale thereof or the new base to establish the deduction for depreciation), the value of the property as determined for the purpose of the federal estate tax shall be deemed to be its fair market value at the time of acquisition. Thus, in the ordinary course of events, income tax basis arising from death is consistent with the reported estate tax value. TAM 199933001 observes that except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value, which may be rebutted by clear and convincing evidence.

In McMillan v. U.S., 64-2 U.S.T.C. 9720 (S.D. W.V. 1964), the court applied a duty of consistency and found that the taxpayer had sufficiently participated in the estate tax valuation of foreign stock. The decision adds language that may be helpful to taxpayers, particularly after a return is reviewed, to estop the IRS from arguing for a valuation that is less than reported on the estate tax return. The court states:

"So if a taxpayer who acquired gain in an exchange of property sets up as its measure a value of what he received in which the Commissioner acquiesces, that value is the basis to be taken in measuring a further gain on a sale of the property in a later year. The taxpayer cannot say: 'I was mistaken. The value was many times what I said it was. I therefore realized less gain on the last sale,' without doing justice all around in correcting his mistake. The reverse principle is also true if the Commissioner, in reviewing the return, should correct the first valuation and the taxpayer should acquiesce. The Commissioner could not repudiate his action when that value again became a determining factor"

A duty of consistency has also been applied with special-use valuation property in Van A/en v. Commissioner, T.C. Memo 2013-235. In that case, the court declined to follow Rev. Rul. 54-97, which allows the taxpayer, who did not participate in the estate tax return, to overcome the estate tax value by clear and convincing evidence. The enabling language in Code §1014 respecting special-use value applying for income taxes differs for assets generally in the gross
estate. Thus, the duty of consistency in *Van A/en* may not be presumed to apply to assets generally.

**The Estate Tax Return Must Be Required**

The estate tax return does not establish a presumed valuation for income tax purposes unless a return is required. Moreover, the taxpayer has the burden of establishing basis. Establishing basis is a factual matter. If the taxpayer is unable to establish basis, the basis may be deemed to be zero.

Decades ago, the IRS determined that an estate tax return that was filed despite the fact that no return was required under the threshold of Code §6018(a) was ineffective for purposes of making the alternate valuation (AV) date election. Rev. Rul. 56-60. (As a historic note, the IRS had previously ruled that AV date elections could be made even if the impact was to increase value and not reduce estate tax. This old rule was reversed by statutory change to Code §2032. Current law allows the AV date election to be made only to reduce the estate tax liability.) While the AV date discussion reflects the core of Rev. Rul. 56-60, the ruling concludes with the following statement of broader application:

"Accordingly, it is held that where the value of the decedent's gross estate at the date of death does not exceed the statutory exemption of $60,000, a Federal estate tax return, Form 706, filed with respect to the estate is not a return as contemplated by section 26 USC 6018(a)(1) of the Code. [Typo in the ruling which stated 6918.] Because the return will not be recognized for Federal estate tax purposes, it follows that any material contained therein would have no force or effect with respect to its application in the determination of any other Federal tax liability. (Emphasis added.)"

**Is a Portability Return a Required Return to Deem the New Income Tax Basis?**

Code §2010(c)(5) and Reg. §20.2010-T(a)(1) each require a timely filed federal estate tax return in order to make a portability election. The statutory requirement indirectly references returns required under Code §6018. This spawned debate regarding whether a Form 706 filed solely to make a portability election must be filed within the time and in the manner required for estate tax returns generally. Reg. §20.2010-2(a)(1)-(7) establishes particular rules for making portability elections and creates a regulatory requirement for a timely filed and properly prepared estate tax return.

**Distinction:** Portability elections may be made on estate tax returns in which filing is required under general filing rules or with returns below the filing threshold.

**Example 1:** Abe dies in 2014 with a gross estate of $6 million and secured or general debts on Schedule K of $5 million, a portability election of as much as $4,340,000 ($5,340,000 less $1 million taxable estate) may be available. Abe's estate tax return is required under the statutory mandate of Code §6018. **Result:** The presumption of income tax basis equal to the federal estate tax value for assets subject to Code§1014(a) applies.
Example 2: Betty dies in 2014 with a gross estate of $2 million and little or no material debt. Her DSUEA may be as great as $5,340,000 on this return filed solely to make the portability election. Betty’s estate is not subject to any state death tax. Betty’s estate tax return is required under the statutory mandate of Code §6018 solely. Result: The presumption of income tax basis equal to the federal estate tax value for assets subject to Code §1014(a) may not apply. This is an open issue, at least under Reg. §1.1014-3(a).

Example 3: Carla dies in 2014 with the identical estate values and debts as Betty though her estate is subject to some state death tax. Although no estate tax return is due under the federal filing requirements, Reg. §1.1014-3(a) extends presumptive value to the valuation reported on the state death tax return to apply for purposes of establishing date of death value for income tax basis under Reg. §1.1014-1.

As a basic rule, portability elections are available only with the timely filing of a “complete and properly-prepared estate tax return.” Estates qualifying for “simplified reporting” may use good faith estimates of value rather than fair market value for the reporting of assets that receive the estate tax marital deduction or charitable deduction when the estate tax return is not required under the general rules (i.e., when the return is filed solely for the portability election) and certain other tests are met.

(See, 706 Art, Second edition, §7A.9 for discussion of requirements and practical commentary with simplified reporting.)

Estate tax returns filed solely for portability election purposes have entered unchartered waters relative to the impact, or “deeming” of value for purposes of income tax basis adjustment. The ability to file a return with simplified reporting while hoping to apply a good faith estimate of value may have been undermined by two references in the simplified reporting regulations:

1. The general rules established for simplified reporting under Reg. §20.2010-2(a)(7)(ii)(A) provide in relevant part, “an executor is not required to report a value for such property on the estate tax return” (except to the extent of the good faith estimate of value later described in the regulation with rounding up to the next $250,000 increment. Thus, the general rule states that the reporting of value in the traditional manner on the return is not required, but it does not expressly state that traditional reporting of fair market value cannot be indicated in some manner on the return.

2. Example #1 under subparagraph (B) in the regulation considers real property, bank accounts and life insurance passing outright to the surviving spouse and reported in the simplified manner. In applying simplified reporting, the example applies the facts so that the executor "files an estate tax return on which these assets are identified on the proper schedule, but ... provides no information on the return with regard to the date of death value."

One approach toward simplified reporting would be to report assets without values on the schedules, indicate the rounded up good faith estimates of value on lines 10 and 23 of the
Recapitulation and attach an appendix to the return with the executor stating fair market value with actual valuations and attaching appraisals to support those valuations of fair market value.

Nevertheless, it would appear safest when trying to fall within the framework of a "required return" in light of Rev. Rul. 56-60, for purposes of establishing an evidentiary basis and greater stability for income tax reporting to file the Form 706 for portability-only purposes using a regime that replicates traditional estate tax return practice. In other words, traditional reporting of value and forsaking use of simplified reporting provides the best position to assert the presumption that the reported value on the Form 706 applies for income tax basis for date of death value under Reg. §1.1014-1.

Evidencing Fair Market Value Versus Simplified Reporting

Where then should the return preparer, if at all, indicate a statement of fair market value? There appear to be three choices:

1. Forgo use of simplified reporting. Value and report assets in the traditional manner. Attach appraisals of the decedent's interest as of the date of death as would be done with a return required under general filing requirements. This is the approach most likely to support income tax basis yet presents the downside of filing a properly prepared and complete return with respect to valuation.

2. If simplified reporting is made on the return, then attach a schedule of the assets with fair market values indicated, and attach a copy of the reports or appraisals that support the good faith estimate. This approach may help and is better than doing nothing if simplified reporting is adopted. This amounts to a "fat" simplified return.

3. Report in the simplified manner, and retain evidence of fair market value (or the basis for the good faith determination) in files that are part of permanent records. This creates the least likely foundation to establish a presumption of value, yet the appraisals or valuation reports would be used in the similar manner currently for small estates that do not file the Form 706. The nature of the asset mix may also influence the use or eschewing of simplified reporting.

The following are some examples:

IRD items receive no basis adjustment as a result of death. Thus, simplified reporting works well with IRD assets, if the portability election will otherwise be made. A good faith estimate of value is used. If the IRD item has basis (such as a promissory note arising from an installment sale), the recipient of that item will need to know the income tax basis. Simplified reporting can still apply to that item if simplified reporting is elected. The executor should communicate the income tax basis to the recipient of the item.

The valuation of interests in closely held businesses (corporations, partnerships, and LLC interests are among the most expensive). Until the appraisal industry or reputable appraisers develop a method to provide less expensive estimates of fair market value (with caveats on the limitations of the report), taxpayers may find the cost of traditional appraisals to be cost prohibitive. If the valuation is needed for a non-tax purpose, then the valuation serves other purposes and traditional fair market value may be needed.

**Possible Solution:** Some practitioners may feel sufficiently comfortable providing a good faith estimate. For example, real estate holding companies are often valued using adjusted book value. A CPA or attorney may feel sufficiently suited to determine an estimated fair market value using an adjusted book value.
financial statement and applying a "comfort zone" discount for a minority interest for a lack of control or lack of marketability. Granted, there are no official comfort zones for discounts, many practitioners will have experience with discounts in modest ranges to provide support for a good faith estimate. Similarly, some accountants have extensive experience with valuations in particular industry groups and may feel sufficiently capable providing a good faith estimate based on generally applied factors and ranges of capitalization rates or other measures.

- The simplified rules provide some safety from the requirement of a properly prepared return while still making portability elections for those practitioners or taxpayers who do not adhere to the use of qualified appraisals as of the date of death.

If state death taxes are payable, simplified reporting on the federal return may not be available. If state death taxes are payable and the federal estate tax return is not used as a reference point to determine the state death taxes, then reporting in the simplified manner under the federal return while reporting traditional value for state death tax purposes provides an approved regulatory reference to presume that the value reported to the state establishes the federal income tax basis under Reg. §1.1014-3.

See, 706 Art, Second Edition, §7A.10.1-§7A.10.4 for discussion of issues relating to the establishment of income tax basis and estate tax returns electing portability.

3. Communication with Clients

Communication with clients on issues pertaining to portability elections can arise during the estate planning process, post-death compliance and use of the exclusion amount "ported" (i.e., transferred over) to the surviving spouse. The following are significant points to make with respect to portability planning in each of these settings:

3.1 Estate Planning

1. Focus first on non-tax reasons for the use or non-use of a trust when leaving property to loved ones.

2. A trust is not required to be used in order to achieve estate tax savings.

3. However, when estate tax is a significant possibility (or actual concern), a trust for the benefit of a surviving spouse saves greater estate tax than will be available with outright gifts/bequests to a surviving spouse.

4. Most estate tax savings strategies carry offsetting income tax consequences. Generally, there is "no free lunch" on matters of estate tax savings. For example, valuation discounts saving estate/gift/GST tax mean a reduced income tax basis than otherwise available. Exemption trusts can be excluded from the gross estate of the beneficiary. However, there is no income tax basis adjustment when the beneficiary dies.

5. Congress may alter, amend or even eliminate the estate tax. Cynics (or the politically aware) observe that estate tax debates in Congress provide outstanding revenue generators for the campaign coffers of elected officials.
6. Build flexibility into the estate plan to the extent the client feels comfortable to facilitate changes to the estate planning paperwork to address potential later tax savings. The goal is to render the estate/trust assets subject to the least amount of anticipated tax liability... whether that is income tax (plus the 3.8% federal medical insurance tax), on the one hand, or gift/estate/GST tax on the other hand. Potential strategies to achieve flexibility include: (i) appointment of a trust protector with the power to modify, terminate or create powers sufficient to exclude, or include, a trust in the gross estate of the beneficiary; (ii) include formula provisions in which general powers of appointment are granted under certain conditions and with priority of application of the general power to certain assets; (iii) authorizing the relocation of the trust to a state with less damaging income taxes; (iv) authorizing the trust protector to remove a trustee and appoint a successor trustee in a state with less onerous state income tax; (v) as an alternative to a trust protector, include language in the trust that can be used to support the termination or modification of trusts for tax savings without court approval with reference to a variety of potential changes in law or circumstances that the court may consider changes in circumstances.²

7. Appoint a fiduciary who will properly implement the estate plan and not act out of self-interest contrary to the desires of the client. The trustee has a lot of power and discretion, for better or worse. A surviving spouse with his or her own loved ones can hijack (i.e., make available the deceased spouse’s basis exclusion amount for his or her own loved ones rather than the loved ones of the deceased spouse). Encourage clients to look realistically at the motivations and appoint trustees/executors who will faithfully carry out their duties. Experienced independent fiduciaries can provide objective oversight and strive to do their best rather than the conflicted family member working to do their worse.

**Hijacking the Basic Exclusion Amount:** Husband has two children from a prior marriage and Wife-2 has children from her prior marriage. Husband has a $4 million estate and Wife-2 has a $9 million estate. Husband leaves his estate in trust in which Wife receives all net income and the trust passes to Husband's children on her later death (or on his death if Wife-2 dies first). Wife is appointed the trustee. Wife timely files the Form 706 following Husband’s death and makes a portability election. The following illustrate two examples of the portability amount and allocation of the federal estate tax when Wife dies based on different elections made on Husband’s estate tax return. We assume that Husband has a basic exclusion amount of $5.6 million when he dies and that Wife has a basic exclusion amount of $6.4 million at the time of her death. Assume asset values remain the same. The following results:

(i) Honest dealing: No QTIP election is made on the trust left for the surviving spouse. A portability election is made on Husband's estate tax return, reflecting a DSUEA of $1.6 million ($5.6 million less $4 million credit shelter trust). The $1.6 million DSUEA is added to the $6.4 million basic exclusion amount of Wife, creating an applicable exclusion amount of $8 million. Wife's $9 million estate value is reduced by the $8 million

² See, California Probate Code §15403 and (vi) include provision for a disclaimer trust by which asset pass to a surviving spouse in trust rather than outright as a result of a qualified disclaimer.
applicable exclusion amount, leaving $1 million in value subject to federal estate tax. Wife’s estate pays $400,000 of federal estate tax.

(ii) Hijacking husband’s basic exclusion amount: Same as Honest dealing except that a QTIP election is made by Wife, as Trustee, on the $4 million trust left by husband. A portability election of $5.6 million is made, creating an applicable exclusion amount of $11 million ($5.6 million DSUEA from Husband plus $6.4 million basic exclusion amount of Wife). A federal estate tax liability of $400,000 arises—the same amount as in the example of Honest dealing. However, Husband’s trust pays 100% of this estate tax because Wife’s share estate receives the benefits of the applicable exclusion amount until exhausted until any of this tax-free allowance can be applied to the QT/P trust left by Husband. IRC §2207 compels this result under tax law. (Cue the trust litigation attorneys, stage left to enter the post-death administration drama.)

8. Professional fees will be incurred to make portability elections. Moreover, the estate tax return of the deceased spouse, plus supporting documents and work papers may be needed to verify the DSUEA when the surviving spouse uses any DSUEA on life or upon death. While this may not be a problem with most one-marriage families, concerns may arise when the children (or a surviving spouse) want the election made but the other side of the family does not want funds spent for filing an estate tax return that is not generally required under federal law and is only being filed to make a portability election.

**Sample language for a living trust:**

In addition to the powers otherwise granted to the Trustee with respect to tax elections, the Trustee shall have the following authority:

(i) As used herein, the term "portability election" shall refer to the election provided under Internal Revenue Code §201O(c)(5), as amended, and applicable regulations, to make available to the surviving spouse the unused basic exclusion amount ("DSUEA") of the deceased spouse. The executor (as herein defined) shall have the authority to file the estate tax return in order to make a portability election even if the filing of a federal estate tax return is not required under Internal Revenue Code §6018, as amended.

(ii) As used in this section, the term "executor" is defined to refer to (A) an executor or administrator of the estate of the deceased spouse (survived by a spouse) that is appointed, qualified, and acting within the United States, within the meaning of Internal Revenue Code §2203 (appointed executor); or (B) if there is no appointed executor, any person in actual or constructive possession of any property of the deceased spouse (a non-
appointed executor) the estate of the deceased spouse. Accordingly, the term "Trustee" includes the term "executor" for the purposes of this section when there is no appointed executor for the estate or Will or the deceased spouse. The executor shall make the portability election, to the extent available after considering all other elections and factors applicable to the estate tax return of the deceased settlor. (Optional: The portability election shall be made by the executor to the extent determined appropriate by the executor.) No non-appointed executor shall take any action contrary to the Trustee with respect to the filing of the estate tax return or any election with respect to said return, or any supplement or amendment thereto.

(iii) (Provided that a portability election is effectively made on the federal estate tax return of the deceased spouse), the Trustee shall have the authority to elect qualified terminable interest property (QTIP) under Internal Revenue Code §2056(b)(7), as amended, and applicable regulations, in whole or part, with respect to any property or interest left by the deceased spouse for the benefit of the surviving spouse, including but not limited to (i) the trust designated as the (fill in name of the exemption/by-pass/Trust B/ or whatever other name is used to reference the trust which by formula would otherwise receive basic exclusion amount of the deceased spouse) under Section _____ of this instrument. [Optional: ; and (ii) any other interests or property in the gross estate of the deceased spouse which are left to or pass for the benefit of the surviving spouse in a manner that could qualify for the estate tax marital deduction upon the making of a QTIP election]. The foregoing provision shall supersede direction otherwise stated in this trust to establish the trust estate of the deceased spouse as estate tax exempt if the Trustee, in the reasonable discretion of the Trustee determines that the prospects for overall tax savings of making the QTIP election may be greater than not making the election.

(iv) The authority of the Trustee to make a QTIP election, or not, with respect to the Marital Trust, or any part thereof, under Section _____ of this instrument is not conditioned upon a portability election being made, in whole or part.

(v) (Optional): The term "Portability Return" in this item (v) shall refer to a federal estate tax return that is both (i) not required to be filed under Internal Revenue Code §6018, as amended, and (ii) not required to be filed in order to comply with the applicable estate tax, death tax or inheritance tax requirements of any state or local government authority. The Trustee shall file a Portability Return if the surviving spouse
provides the funds to pay the professional fees and costs associated with the preparation and filing of the Portability Return.

(vi) By virtue of Internal Revenue Code §2010, the surviving spouse is considered to have a material interest that is affected by the return information of the deceased spouse within the meaning of Internal Revenue Code §6103(e)(3). Accordingly, the Trustee shall provide information that is reasonably requested by the surviving spouse, or executor of the surviving spouse relating to the portability election made on the estate tax return of the deceased settlor to enable the surviving spouse (and estate of the surviving spouse) to use such information on any subsequent gift tax return filed by the surviving spouse or estate tax return of the surviving spouse on which any DSUEA transferred to the surviving spouse is used as part of the applicable exclusion amount of the surviving spouse and/or to defend its use in connection with an audit by the Internal Revenue Service of any such return(s). (Optional): The professional fees and costs associated with the Trustee responding to such information requests shall be advanced by the surviving spouse (or executor of the estate of the surviving spouse) or reimbursed by the surviving spouse (or executor of the estate of the surviving spouse) as the Trustee determines reasonable.

(vii) (Optional: If the trust instrument does not include satisfactory language of discretion and liability protection with respect to tax elections or other actions of the Trustee, then include desired language in this section. Similarly, consider language to absolve the Trustee from making adjustments among beneficiaries for tax elections where appropriate. Such language is beyond the scope of these illustrated terms.)

3.2 Compliance

1. Portability elections are a type of "estate tax insurance" only without annual premiums. If as of the death of the surviving spouse the taxable estate may be greater than one basic exclusion amount, the portability election saves estate tax. A portion of the sample letter at Appendix 1 provides assistance for clients on this point. Consider the following unknown risks of eventual estate tax:

😊 Inheritances left outright or with a general power of appointment.
😊 Growth and liquidity with investments or real estate.
😊 Liquidity event or appreciation with value of a closely-held business.
😊 The relative youth of the couple and the prospects for growth.
😊 Portability elections are not ali-or-nothing. (A credit shelter trust can be used leaving a smaller DSUEA.)
😊 Changes in law that reduce the applicable exclusion amount. What are the odds that the basic exclusion amount will be reduced???,??,??,?? to $5 million, $3.5 million or something lower?
Spending/savings anticipated by the surviving spouse (will retentions exceed cost of living?)

Inflation.

Alert: 1% of term life insurance policies pay off... and they have annual premiums. If the cost of a portability return is $5,000 and the potential estate tax savings is $500,000, or more, the investment beats term life insurance. Moreover, term life insurance requires annual premium payments and annual payments soar when the insured reaches advanced age! If the surviving spouse has a 20-year life expectancy, the amortized cost of a portability return costing $5,000 is $250/year.

2. ☺☺☺ A QTIP election cannot be made except as part of a federal estate tax return. If the QTIP election is desired (such as to obtain income tax basis adjustment on the death of the surviving spouse for property left in trust for the benefit of the surviving spouse) then an estate tax return must be filed anyway. Therefore, a portability election is almost a freebee once the decision is made to make the QTIP election. (Rev. Proc. 2001-38 issue has been raised with making QTIP elections when the 706 is not required under general rules and is not needed to reduce or eliminate federal estate tax. Author views this as a mentionable point but a non-issue; and, expects favorable IRS guidance soon.)

3. Determine the extent to which the portability election should be made. Making (or not) a QTIP election for property left in trust which could qualify for the marital deduction if elected is commonly the most significant planning decision. This involves the interplay between estate tax liability and income tax planning.


Some of the major factors:
1. Federal and state income tax rates versus federal and state death taxes.
2. Types of assets that do not receive basis increase (such as IRD or passive foreign investment company shares)... death of the beneficiary or owner does not change basis to date of death.
3. Zero basis assets (such as copyrights, trademarks, patents, works of art of the creator) can be changed from ordinary income to long-term gain.
4. Assets that decline in basis (such as real estate or partnership/LLC interests that may even have negative basis).
5. Low basis assets.
6. Consider turn-over rates after the death of the first spouse and before death of the surviving spouse. (Frequent turnover lessens impact of basis change from death of beneficiary.)

4. Extend the time to file and pay estate tax in order to increase available planning time. An estate tax return, including QTIP and portability elections can be changed or revoked within the period for timely filing, including extension.
See the chart at Appendix 2 to these materials for an illustration of an assumed inflation or increase in asset value versus a lower cost-of-living adjustment on the surviving spouse’s basic exclusion amount with a portability election.

5. Uber-large estates (greater than two exclusion amounts) will benefit generally from traditional exemption trust (credit shelter trusts) using the basic exclusion amount of the deceased spouse with a QTIP marital deduction trust to defer estate tax until the death of the surviving spouse. The greater problem arises when the eventual value of the surviving spouse’s estate is unknown. The factors listed under point #1 of this §3.2 provide examples of factors that may contribute to these unknowns.

- The DSUEA does not increase with inflation.
- No GST exemption with portability election (except to the extent a reverse QTIP election is made).

3.3 Use of the DSUEA by the Surviving Spouse

The surviving spouse can use DSUEA for lifetime gifts (provided it is used before the surviving spouse is predeceased by a later spouse) or on death, provided in each instance that the DSUEA used is from the last deceased spouse. A different rule applies when the surviving spouse is the beneficiary of a qualified domestic trust (QDOT). See, §6, infra, for discussion of the ordering rule in the QDOT situation.

Use of the DSUEA by the surviving spouse on a gift tax return will be reported on Schedule C (page 4). The preparer indicates that DSUEA is being applied by checking the box "yes" on line 19 of the Form 709, completing Schedule C, and carrying over the DSUEA on to line 7 of page 1 of the gift tax return with the applicable credit amount reported on line 8 of that return.

The IRS Has a Sense of Humor: Schedule C of the Form 709 has lines for the use of DSUEAs from six (6) pre-deceased spouses. That's one amazingly generous donor-spouse with a unique sense of timing and history of spouses who do not believe in omens. Had they left eight blank lines, we might be singing, *I'm Henrietta the Eighth I Am.*

Use of the DSUEA by the executor on the estate tax return of the surviving spouse will be included on Schedule D, Part 6 (Page 4) of the Form 706 and the inclusion of the DSUEA as part of the applicable exclusion amount will be included on lines 9b and 9c of the Tax Computation (page 1). The applicable credit amount arising from the DSUEA-enhanced applicable exclusion amount is reported on line 9d and is derived from the amount on line 9c, (see Table A in the instructions to Form 706). The allowable applicable credit equals the amount of tax attributable to the applicable exclusion amount, with any adjustment on line 10.

The surviving spouse’s estate is limited to the DSUEA of the last deceased spouse. The last deceased spouse is the most recently deceased individual who, at that individual’s death after December 31, 2010, was married to the surviving spouse. In general, the surviving spouse receives only the DSUEA left by the last deceased spouse. The "last deceased spouse" rule presents two significant consequences. First, if the surviving spouse remarries and is predeceased by another spouse, any unused DSUEA from the prior deceased spouse is lost.
Second, the surviving spouse can use as many DSUEAs from prior deceased spouses as long as the order of gifting and of death of prior spouses is correctly timed.

**Example of General Rule:** If W was predeceased by H-1 in 2011, who left a DSUEA of $5 million, and she is predeceased by H-2 in 2012, W will lose the ability to use any DSUEA from H-1 because H-2 has become W's last deceased spouse. The loss of unused DSUEA from H-1 applies regardless of whether H-2's estate has any particular value or distribution plan or any other variable. If, instead, the marriage between W and H-2 ends by divorce or annulment, H-1 will remain W's last deceased spouse.

The following examples illustrate the basic rule and the importance of good timing.

**Example 1A:** H-1 dies in 2011, survived by W, a U.S. citizen. H-1 leaves a DSUEA of $5 million to W. W marries H-2 in 2012 and survives H-2, who dies in 2013. H-2 thus becomes W's last deceased spouse. H-2's executor elects out of the DSUEA or otherwise leaves no DSUEA to W. W never made taxable gifts. W's applicable exclusion amount in 2014 is $5,340,000 and the DSUEA is $0 (The DSUEA from H-1 was lost upon the death of H-2 when H-2 predeceased W leaving no DSUEA).

**Example 1B:** The conditions are the same as in Example 1A, except H-2 survives W. W's applicable exclusion amount with her death in 2014 is $10,340,000. W could use $10,340,000 to make taxable transfers without paying estate tax and may leave up to $5,340,000 in DSUEA to H-2, assuming unused basic exclusion amount in that sum and a timely filed estate tax return with an effective portability election. Taxable transfers by W will first reduce the DSUEA before reducing her basic exclusion amount.

**Factors Encouraging Use of the DSUEA by the Surviving Spouse in the General Case:**

No clawback arises from the use of the DSUEA received from the last deceased spouse. Thus, gifts can be made using DSUEA without risk that a later death of a subsequent spouse will cause DSUEA used prior to that death to be forfeited.

Gifting, as a general principle, is normally preferred sooner than later in order to remove post-gift growth from the taxable base (adjusted taxable gifts) when the donor dies.

Use of the DSUEA on a gift tax return starts the statute of limitations for the IRS to challenge the effectiveness of the portability election or amount of the DSUEA to the extent applied against taxable gifts.


4. **Does Simplified Reporting Really Help?**

Several factors will enter into the decision regarding whether to employ the simplified method of reporting assets to the treatment of value on an estate tax return filed solely to make
the portability election. One of the variables will be the easing of disclosure requirements under the instructions to Form 706 with respect to the reporting of valuation. A "complete and properly-prepared" estate tax return remains required to make a portability election. Simplified reporting eases the requirements when reporting valuation and providing information related to valuation.

Reg. §20.2010-2(a)(7)(i) defines a "complete and properly-prepared" estate tax return for purposes of the portability election to be one filed in accordance with the instructions issued for the estate tax return (instructions for Form 706) and satisfying the requirements of Reg. §§20.6018-2, 20.6018-3, and 20.6018-4. The simplified valuation regime provides easier disclosure and valuation requirements on the issue of valuation. The reference to regulations under §20.6018 incorporates extensive reporting requirements as a result of the incorporation and cross references to (i) identity of other persons holding property of the decedent if assets are not fully known to the executor filing the return; (ii) the value of the gross estate (for which Reg. §§20.2031-1 through 20.2044.2- are referenced; (2) reporting deductions in accordance with regulations §§20.2052-1 through 20.2056(e)-3), (iii) computation of credits and computation of the estate tax. In particular, "In listing upon the return the property constituting the gross estate (other than household and personal effects for which see §20.2031-6), the description of it shall be such that the property may be readily identified for the purpose of verifying the value placed on it by the executor."

The instructions to Form 706 have their own disclosure requirements. Documentation with respect to closely held corporate stock, partnerships and sole proprietorship interests are particularly extensive. Qualified appraisal reports normally include this information. If the report is truncated or the accountant or other tax preparer seeks to lessen the expense of reporting value, the return may run afoul of the compliance requirements under the instructions. As a result, the return may be deemed by the IRS to not be complete and properly prepared. This could cause loss of the portability election.

The following are pros and cons with simplified reporting in estates qualifying for simplified reporting:

<table>
<thead>
<tr>
<th>Factors Favoring Traditional Valuation</th>
<th>Factors Favoring Simplified Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Better evidence and possibly a presumption of consistency to establish income tax basis.</td>
<td>Lower potential valuation expense.</td>
</tr>
<tr>
<td>May need traditional values for state death tax returns.</td>
<td>Client more willing to file the Form 706 for &quot;estate tax insurance&quot; when investment reduced.</td>
</tr>
<tr>
<td>If simplified reporting is employed and some asset should not have been valued in that manner, a &quot;properly&quot; prepared estate tax return has not been filed. Will this disqualify the portability election?</td>
<td>Easier to file a complete and properly prepared return, particularly if all attachments or reports required under Reg. §§20.6018-2, 20.6018-3, and 20.6018-4, and the instructions to Form 706 (see, for example, Schedule A regarding information to determine value of real property, Schedule B regarding financial statements for 5 years on closely held stock and similar requirements on the valuation of partnership and proprietorship interests) Reg. §20.2031-3 (regarding partnerships and proprietorships) and §20.2031-6(b) (regarding collectibles and certain items of personal effects).</td>
</tr>
<tr>
<td>Must be mindful of unique descriptive information and attachments for simplified reporting.</td>
<td></td>
</tr>
<tr>
<td>If simplified reporting is employed and the combination of adjusted taxable gifts + gross estate</td>
<td></td>
</tr>
</tbody>
</table>

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is near the basic exclusion amount, the estate risks not being in compliance if any adjustment is made to the estate tax return that would cause the estate to have been required to file the Form 706 under general filing requirements of Code §6018(a).

If the executor believes that simplified reporting of values is allowed but that later events might cause simplified reporting to not be allowed, then electing simplified reporting might lead to a return that is not properly prepared. Examples of such events include the after-discovered gifts, audit changes, or other changes in value or an incorrect determination that 100% value in the gross estate of a given asset also generates a marital or charitable deduction equal to that 100% valuation.

Appraisals are highly recommended to establish value, particularly to avoid valuation-related penalties, or provide a defense for the executor against such liability in reliance on a qualified appraisal report. However, appraisals are not generally required by the estate tax regulations or the instructions to Form 706. Reg. §20.2031-3 calls for “fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including goodwill” in the context of a “business, whether a partnership or a proprietorship.” The instructions to Schedule B direct the executor to attach the following to Schedule B:

"Complete financial and other data used to determine value, including balance sheets (particularly the one nearest to the valuation date) and statements of the net earnings or operating results and dividends paid for each of the 5 years immediately before the valuation date."

Consider the following situation that can easily arise if the decedent owns a small interest in a partnership or LLC, each of which is subject to the disclosure of the 5-year financial statement requirement among others under the instructions to Form 706. Let's say the decedent owns a 3% limited partnership interest in an operating partnership with many partners. The interest may have very low value, yet a qualified appraisal report would cost many thousands of dollars, perhaps more than the value of the interest. Will state law, or the partnership agreement, permit the copying of the financial records? If the decedent's interest is only an assignee/economic interest holder, inspection rights may not be available. (See, California Corporations Code §15903.04(1) as a case in point.) In the normal situation, the return preparer would have information from the K-1, know the capital account as of the date of death, the history of distributions, and may be able to obtain a letter from the general partner regarding recent transactions or an indication of value that does reach the character of an appraisal. With normal return preparation, reporting in this practical manner for an asset of immaterial value may be the norm, or at least common enough from the purely tax-reporting standpoint to be considered sufficiently complying with the requirements in the audit of an estate tax return outside of the portability context. The author has experienced numerous audits in which full-blown appraisals of assets of minor significance were not required (though obtaining qualified appraisals remains the best practice). However, in the portability setting such shortcuts might doom, or threaten to doom the portability election if the IRS takes a strict approach to the complete and properly prepared standard.

**Pros and Cons with By-Pass Trusts from the Perspective of Portability Compliance:** Trusts that use some part of the deceased spouse's applicable
exclusion amount for the benefit of the surviving spouse (often called a "By-Pass Trust," "Credit Shelter Trust," "Trust B," "Trust C," or "Family Trust" or some other name) utilize the basic exclusion amount of the deceased spouse, thus reducing the DSUEA (assuming no marital deduction is elected). As a result, the impact of non-compliance with portability compliance rules jeopardizes less DSUEA than a return that minimizes use of the decedent’s exclusion allowances (whether basic exclusion amount only or the applicable exclusion amount). However, simplified reporting is not available for trusts that utilize exclusion amounts. Thus, the potential for non-compliance is greater even if the DSUEA at risk is less.

**Example:** H and W have a $9 million community property estate when H dies. The surviving spouse has a substantial life expectancy and growth may be material even with turnover of assets after the death of the deceased spouse. The executor timely files the estate tax return and reports a DSUEA of $840,000 ($5,340,000 less $4,500,000). If the return is not complete and properly prepared and the IRS takes a hard line on the issue, then $840,000 of DSUEA is at risk, not $5.34 million. The latter/larger sum would be at risk if the executor filed a QTIP election on the by-pass trust.

Are these concerns merely paranoia? After all, Blanche Dubois (portrayed by Vivian Leigh) in *A Streetcar Named Desire* could be counted on to "have always depended on the kindness of strangers." Hopefully, lack of materiality will save the day with matters of compliance when situations of non-compliance for a complete and properly prepared estate tax return do not alter the DSUEA. However, the surviving spouse (or executor of the surviving spouse) may have given the IRS an opportunity to challenge the portability election (i.e., created an audit risk) by having this type of issue raised in the first place.


5. **Problems Created by the Extended Audit Period Provided to the IRS to Review Portability Elections or the Amount Used**

Internal Revenue Code §2010(c)(5)(B) establishes with somewhat ambiguous language the right of the IRS to audit "with respect to a deceased spousal unused exclusion amount" notwithstanding any period of statute of limitations in Code §6501. On its face, the audit period does not expire. Fortunately, the portability regulations clarify that the audit period is extended with respect to a particular usage of a DSUEA only through the limitations period on the estate or gift tax return on which DSUEA is used by the surviving spouse. Reg. §20.2010-3T(d), which construes the authority of the IRS to examine returns of the deceased spouse, states in its clarifying language:

"For the purpose of determining the DSUE amount to be included in the applicable exclusion amount of the surviving spouse, the Internal Revenue Service (IRS) may examine 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 any such return. The IRS's authority to examine

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1 *A Streetcar Named Desire.* Charles K. Feldman Group, Warner Bros.© 1951 All rights reserved.
returns of a deceased spouse applies with respect to each transfer by the surviving spouse to which a DSUE amount is or has been applied. Upon examination, the IRS may adjust or eliminate the DSUE amount reported on such a return; however, the IRS may assess additional tax on that return only if that tax is assessed within the period of limitations on assessment under section 6501 applicable to the tax shown on that return. See also section 7602 for the IRS’s authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry. For purposes of these examinations to determine the DSUE amount, the surviving spouse is considered to have a material interest that is affected by the return information of the deceased spouse within the meaning of section 6103(e)(3).” (Emphasis added.)

Companion language appears in Reg. §25.2505-2(e).

This extended audit right of the IRS has several apparent and subtle implications:

1. The IRS can sit back and disregard the decedent's estate tax return in which portability is reported and audit the amount, and presumptively the effectiveness, of the portability election in the estate of the deceased spouse. As a result, the surviving spouse cannot use DSUEA in gifting with assurance that passage of the normal statute of limitations provides a reliable assumption that all is well.

2. An examination "with respect to a deceased spousal unused exclusion amount" need not be limited to the computation of the portability amount but includes (expressly or implicitly) whether any DSUEA exists at all. If the estate tax return of the deceased spouse is not "complete and properly prepared” the IRS may determine that no DSUEA exists because the election was not effectively made. Will the following cause a portability election to be held invalid?

   (1) Failing to obtain an appraisal report from an appraiser qualified with respect to any work of item or items with collectible value and details supported by an appraisal report of items with a value of $3,000 or more under Reg. §20.2031-6(b).

   (2) Listing real property in a revocable living trust on Schedule A and not on Schedule G. The instructions on Schedule A tell the preparer to report real property subject to revocable powers on Schedule G.

   (3) Failing to include the extensive documents required to support the reported value of an interest in a business, whether a partnership or proprietorship. These requirements are recited in the instructions to Form 706 and Reg. §20.2031-3. Thorough appraisal reports will include this required information, thus satisfying this requirement by disclosure.

   (4) Failing to provide with respect to a closely held corporate stock (Schedule B) complete financial and other data used to determine value, including balance sheets (particularly the one nearest to the valuation date) and statements of the net earnings or operating results and dividends paid for each of the 5 years immediately before the valuation date.
(5) Failing to attach an existing appraisal for real property to the estate tax return. (The instructions direct that explanation of the analysis of fair market value be indicated on the return and that if an appraisal has been obtained that a copy must be attached.)

Comment: If the IRS takes literally "complete and properly prepared" it could likely find some nit to pick on virtually all estate tax returns. Will materiality become a test? Will the issue rest on whether the failure to comply with some instruction or to include an asset has any bearing on the amount elected for portability? Hopefully, there will be some practical application to this test. However, such is by no means assured nor is it the case with how the IRS approaches other matters. For example, gifts are considered reported and the statute of limitations commences when the gift is "adequately" disclosed. Certainly, that standard is a lot lower than "complete and properly prepared." Yet, if a donor makes a $6 million gift of an interest in a closely held business while applying a 45% discount for lack of marketability and minority interest, the IRS will not concede that the gift was adequately disclosed. One would imagine that a gift of that value, or of any material value, in a hard-to-value asset would alert the IRS to the fact that revenue potential exists with that gift, and it is worth taking a closer look (i.e., to audit). Yet, the IRS will argue (and is certainly encouraged to argue) that the gift is treated as non-reported for gift-tax purposes and that no statute of limitations commences. Yet, the same reporting on an estate tax return in a non-portability context would commence the statute of limitations.

(6) The following are additional adverse implications created by the extended audit period:

(i) The surviving spouse (and his or her estate) has a "material interest" in the estate tax return of the deceased spouse. As a result, information, at least sufficient to support the portability election and its calculation will be needed from the deceased spouse. In the event that the remainder beneficiaries are not cooperative with the surviving spouse or his/her estate, the cost of compliance and loss of privacy to the survivor's of the deceased spouse may become a point of resistance. Making the portability election would appear to provide the agreement of the estate of the deceased spouse to cooperate with the surviving spouse (and his/her estate). Clarification of the responsibility to provide information and how expenses/fees for cooperation will be paid should be considered as part of the estate planning documents. In any event, the estate or successors of the deceased spouse will need to keep records and support for the DSUEA for a long time. This factor may favor a very "fat estate tax return by the executor of the deceased spouse for portability purposes in order to reduce later document requests. In other words, attach with the return information that the surviving spouse's estate may later need to prove the availability of DSUEA.

(ii) Use of traditional credit shelter trusts reduces the DSUEA and avoids exposing the use of the decedent's basic exclusion amount to the uncertainties and gamesmanship that may later arise with authenticating and proving the DSUEA. Whether estate tax exemption (or a QTIP election) will be applied to a given trust for the benefit of the surviving spouse will likely turn on issues balancing expectations for later estate tax
versus income tax liabilities (income tax basis issues versus estate tax avoidance). Allowing a trust to follow traditional exemption character (i.e., no QTIP election or use of a general power of appointment) preserves estate tax exemption and reduces the importance of cooperation from a prior deceased spouse or whatever hurdles the IRS may impose with non-compliance with some aspect or stress among estranged families.

(iii) The extended audit period is a benefit to the IRS, not the taxpayer in determining matters with respect to the DSUEA. If the taxpayer wishes to achieve a particular DSUEA and values or deductions change, then a formula should be used. The regulations do not provide for a protective portability election. Yet, formulas are a common part of estate planning (such as with GRATs, formula gifts, marital deduction gifts and GST exemption allocations with reverse QTIP elections or generally in reciting priority for use of the GST exemption). A formula may be helpful when traditional valuation is used in reporting the gross estate with portability elections. However, the regulations do not expressly embrace formula clauses.

See, 706 Art §§2.1, 7A.3.3, 7A.8.4, 7A.8.4.1, 7A.8.4.4, 7.9, 7A.10.2 and 7A.10.4 for additional information.

6. Application of DSUEA When the Surviving Spouse is a QDOT Beneficiary.

When property passes for the benefit of a surviving spouse in a qualified domestic trust (QDOT), the DSUEA is computed on the decedent's estate tax return for the purpose of electing portability in the same manner as this amount is computed generally, except the DSUEA is subject to subsequent adjustments. The DSUEA of the decedent must be re-determined upon the occurrence of the final distribution or other events (generally the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which estate tax is imposed under Code §2056A. This redetermination logically applies because as of the filing of the estate tax return for the death of the creator of the QDOT, the ultimate value of the QDOT is not known and will not be known until final distribution or earlier termination of the QDOT. Thus, the determination of the DSUEA must be held in abeyance. As a result, the surviving spouse's basic exclusion amount is applied before the DSUEA of the prior spouse can be used in the QDOT context.

Reg. §25.2505-2(c)(3) includes the following example for the application of the DSUEA on the death of the surviving spouse in the QDOT setting:

(i) Facts. Husband 1 (H1) dies in 2011, survived by Wife (W). Neither has made any taxable gifts during H1's lifetime. H1's executor elects portability of H1's deceased spousal unused exclusion (DSUE) amount. The DSUE amount of H1 as computed on the estate tax return filed on behalf of H1's estate is $5,000,000. In 2012, W makes taxable gifts to her children valued at $2,000,000. W reports the gifts on a timely filed gift tax return. W is considered to have applied $2,000,000 of H1's DSUE amount to the 2012 taxable gifts, in accordance with paragraph (b) of this section, and, therefore, W owes no gift tax. W is considered to have an applicable exclusion amount remaining in the amount of $3,000,000 ($8,120,000 of H1's remaining DSUE amount plus W's own $5,120,000 basic exclusion amount). In 2013, W marries Husband 2 (H2). H2 dies on June 30,
2015. H2's executor elects portability of H2's DSUE amount, which is properly computed on H2's estate tax return to be $2,000,000.

(ii) Application. The DSUE amount to be included in determining the applicable exclusion amount available to W for gifts during the second half of 2015 is $4,000,000, determined by adding the $2,000,000 DSUE amount of H2 and the $2,000,000 DSUE amount of H1 that was applied by W to W's 2012 taxable gifts. Thus, W's applicable exclusion amount during the balance of 2015 is $9,430,000 ($4,000,000 DSUE plus $5,430,000 basic exclusion amount for 2015).

Comment: The application of DSUEA in the QDOT setting creates a limitation for use of the DSUEA, which may make the "QTIPing" of an otherwise estate tax exempt trust less attractive. The surviving spouse will be using his or her basic exclusion amount before the QDOT termination event occurs. As a result, the availability of the DSUEA for the surviving spouse will remain vulnerable to the initial QDOT-widow(er) losing the original DSUEA because of the death of a subsequent deceased spouse. Electing no OTIP in the first place exploits the decedent's basic exclusion amount to that extent thereby leaving a smaller DSUEA subject to unique application rules of the QDOT and general vulnerability to forfeiture of the unused DSUEA prior to the death of a subsequent deceased spouse.

See, 706 Art §7A.8.3.1 and §7A.14.1 (portability) and §21.20 regarding QDOT requirements for the marital deduction.

7. Relief to Make Late Portability Elections and Actions to Take Now in Your Practice

As above noted, a portability election of the DSUEA can only be made on a timely filed estate tax return per Code §2010(c). Estates that are required to file a Form 706 under the general filing requirements are not granted any relief from the timeliness requirement since that mandate is statutory. Estates filing for portability elections, however, often fall under the general filing requirement. The general filing requirements mandate the filing of a Form 706 if a combination of the gross estate plus adjusted taxable gifts exceeds the basic exclusion amount in the year of death.

Estates not required to file an estate tax return under the general filing requirements (i.e., not mandated under Code §6018(a)) can apply for relief to file a late portability election under Reg. §§301.9100-1 through 3 with the latter section being the most common. This relief is also the most expensive for the taxpayer and least certain in result (i.e., a request for a private letter ruling). Generally, relief under Reg. §301.9100-3 is granted if the IRS determines that the taxpayer acted reasonably, in good faith, and can establish that relief will not prejudice the IRS. However, as in the case of a late filed Form 706 and loss of the deferral election to pay estate tax under Code §6166, when the return is required under general rules, receipt of an extension of time to file would be a surprising result.

Rev. Proc. 2014-18 afforded inexpensive relief to file an estate tax return with an otherwise late portability election for deaths after December 31, 2010 and before January 1, 2014. However, that procedure terminated on December 31, 2014 and is no longer available.

If the decedent died after December 31, 2013, the estate may request an extension of time to make the portability election by requesting a letter ruling under Reg. §301.9100-3. (That means more expensive PLR protocol with higher professional fees, the IRS use fee, and uncertainty on the outcome.)
**Practice Hint:** Extend the time to file the estate tax return if you are uncertain whether a portability election will be made and believe additional time will assist making that decision or being able to file a return that is complete and properly prepared. If the estate is required to file the return under general filing requirements and any potential exists for estate tax to be payable (if a marital deduction is not made in whole or part) then also extend the time to pay estate tax. Chapter 2 of 706 Art discusses the importance of extensions of time and includes sample language when an extension of time to pay estate tax is included with the application to extend the time to file the estate tax return.

See 706 Art §§2.1, 4.5A, 7A.8.4.1, 7A.8.4.4 (extensive), 13.3A.

8. **Protecting the Marital Deduction**

The increase in the basic exclusion amount has made two approaches to planning more attractive, namely: (i) outright bequests/gifts to the surviving spouse when the use of a trust is not desired for non-tax reasons and (ii) Qualified Terminable Interest Property ("QTIP") trusts when trusts serve a non-tax purpose and income tax basis increase is desired on the death of the second spouse (also referred to as the "surviving spouse"). The primary reason to prefer a marital deduction trust rather than a credit shelter (i.e., a trust that uses a part of the deceased spouse’s applicable exclusion amount and is not subject to estate tax when the surviving spouse dies) is to obtain basis adjustment (hopefully an increase in basis) for income tax purposes on the death of the surviving spouse. See, Code §1014.

Accordingly, two issues are in play. First, does the trust qualify for the federal estate tax marital deduction? Second, is the trust one in which the surviving spouse has a power with respect to which an election (i.e., QTIP election, made on Schedule M of the Form 706) is made to include the trust in the gross estate of the surviving spouse? Each of these questions must be separately addressed and considered.

The easiest way for the deceased spouse to qualify a bequest for the federal estate tax marital deduction is to leave the property outright (i.e., free from trust) to the surviving spouse (assuming the surviving spouse is a U.S. citizen). Once property is left in a trust – any trust - for the benefit of the surviving spouse, the marital deduction requirements must be considered if it is important to qualify the transfer from the deceased spouse to the surviving spouse for the estate tax marital deduction.

It is possible to have a trust that does not meet all the marital deduction requirements set forth in the Code still included in the gross estate of the surviving spouse through the use of a general power of appointment. The following is an example of a bequest with the use of a general power of appointment.

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*The author wishes to thank Paula Leibovitz Goodwin, Partner with Schiff Hardin, San Francisco, California, and John Hartog, Hartog & Baer, LLP, Orinda, California for their contributions to this section. Ms. Leibovitz and Mr. Schiller co-authored the article referenced in section 1, page 2 of these materials. © Keith Schiller November, 2014. All rights reserved.*
Example: Husband leaves a trust for the benefit of Wife by which Wife receives income for need, and on death the trust shall be distributed to such persons consisting of the issue of Husband or the creditors of the estate of Wife as Wife may appointment by Will.

Result: The interest does not meet all of the marital deduction rules because of the limitation on income distribution to the surviving spouse. However, Wife holds a general power of appointment within the reach of Code §2041(b). The trust is included in Wife's estate and the assets in the trust receive basis adjustment to the extent allowed under Code §1014 on Wife's death.

A QTIP trust must be crafted in compliance with Code §2056(b)(7) and the regulations thereunder. One, of among many requirements, is reporting the QTIP election on Schedule M of Form 706. There are other requirements for a QTIP trust to qualify under the code. This presentation does not review all the mandates. However, among the other requirements is the right of the surviving spouse to receive all net income for life without forfeiture or cessation of benefits and as the sole beneficiary during the lifetime of the surviving spouse. In other words, distribution to the surviving spouse cannot be limited or contingent as a basic rule.

Qualification for the federal estate tax marital deduction with a QTIP trust is an approach that practitioners have been working with since 1982. The general power of appointment marital deduction trust, on the other hand, has not received extensive use (at least in community property states) with the advent of the QTIP trust. The primary drawback with the general power of appointment marital trust lies with the requirement that the surviving spouse be able to appoint the trust to him/herself or to his or her own estate. Code §2056(b)(5), Reg. §20.2056(b)(5)(a) item(3). Thus, the loved ones of the deceased spouse under a Code §2056(b)(5) general power of appointment marital deduction trust receive no protection from disinherance. A general power of appointment under Code §2041(b) also includes the creditors of the estate of the surviving spouse or creditors of the surviving spouse that an estate may be appointed. The existence of a power to appoint an irrevocable trust to creditors of the estate of the holder of the power of appointment renders the trust subject to creditor claims of the power holder to the extent provided by state law. State law varies. In California, the trust is generally subject to creditor claims and administrative expenses of the powerholder's (donee's) estate if the powerholder's estate is otherwise inadequate. Probate Code §682. Clients are better served with marital deduction trusts that include no general powers of appointment, or which limit special powers of appointment to acceptable limits or include no power of appointment if the goal is to protect the loved ones of the deceased spouse (such as “Cinderella”). In that setting, the QTIP trust provides the best protection for the remainder beneficiaries of the settlor/deceased spouse.

Alert: The scope of permitted appointees from the exercise of a power of appointment under a general power of appointment marital deduction trust is broader (and less protective of the loved ones of the deceased spouse) than is the case with a general power of appointment for purposes of estate tax inclusion in the estate of the beneficiary.

*Planet of the Apes* and Bequests to Survivor's Trust

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*Planet of the Apes*. APJAC Productions, Twentieth Century Fox Film Corporation. © 1968. All rights reserved.
Do the requirements for marital deduction qualification apply when property is left to a Survivor's Trust (i.e., a trust that benefits the surviving spouse and over which he or she has a broad general power of appointment)\(^6\) and no part of the inheritance goes into an irrevocable trust for the surviving spouse? The Survivor's Trust for our purposes represents the surviving spouse's one-half share of the community property, all of his or her separate property, and all property directed to the Survivor's Trust by the deceased spouse. The surviving spouse holds the following powers and rights in a Survivor's Trust: (1) the power to amend or revoke the Survivor's Trust; (2) the power to appointment to his or her spouse on death or anyone else desired by the surviving spouse; and (3) the rights of income and principal. Thus, does the convenience of directly distributing the deceased spouse's share of community property and separate property to the Survivor's Trust rather than outright to the surviving spouse create marital deduction qualification issues for the property left to the surviving spouse?

Yes, even though common sense might lead one to the conclusion that the unfettered right of the surviving spouse to amend or revoke the trust would trump any limitation that might exist at some later point in time during the lifetime of the surviving spouse for marital deduction qualification of the Survivor's Trust, these broad powers of great significance do not remove the trust from marital deduction qualification requirements relative to the property left by the deceased spouse. In other words, a terminal interest exists and the marital deduction may be lost (if the limitations are inconsistent with marital deduction requirements as though placed into an irrevocable trust by the deceased spouse.) Thus, if a restriction on income might exist at some point in time during the lifetime of the surviving spouse, i.e. limited distributions of income to the surviving spouse upon his or her incapacity, or some third-party beneficiary might become a permitted distributee under trustee discretion, the marital deduction appears lost under existing authority. A brief journey though space and law will make the point.

In this respect, what appears to be a logical conclusion is not the actual result. We liken decedent-spouse distributions directly to the Survivor's Trust as an estate planning version of Planet of the Apes. Planet of the Apes stars Charlton Heston as an American astronaut who lands on a planet ruled by apes following a prolonged journey through space. For all intents and purposes, he appears to have landed on an alien planet from a distant galaxy. In fact, he has merely returned to the United States. Thus, reality and appearances differ. Similarly, a decedent's bequest to a Survivor's Trust for what appears to be a transfer to the surviving spouse (funneled directly into the Survivor's Trust for convenience) is, in fact, a transfer into the domain of marital deduction trust law. As a consequence, terminable interest requirements, in general, and general power of appointment rules, in particular, become relevant.

One of the requirements is that the transfer to the spouse cannot be a non-qualified "terminable interest." Code§ 2056(b)(1) states in part:

"Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest--

\(^6\) General powers exercisable in favor of the power holder or his/her estate are referred to as a "broad" general power of appointment in this article. This contrasts with the less encompassing general power allowable within Code §2041, which includes the "broad" permitted recipients but also the creditors of the power holder or creditors of the estate of the power holder.
(A) if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse);"

The test can be satisfied most cleanly with outright bequests if the transfer is made directly to the spouse (assuming the survivorship condition does not exceed six months). Code §2056(b)(3)(A). Outright distribution from a trust to the surviving spouse, however, will make the property received by the surviving spouse subject to probate upon the death of the surviving spouse in most states. The extent to which that expense may be relevant would be a determination made relative to state law and the value of the assets received by the surviving spouse otherwise subject to probate.

If the potential exposure to probate is unattractive, the surviving spouse can then contribute (transfer, assign, grant, or deliver) the outright inheritance to the trustee of a trust over which the surviving spouse has the power of revocation plus a general power of appointment to appoint to the estate of the surviving spouse, among others, in all instances. See, Reg. §20.2056(b)-5(f)(6). In this way, the deceased spouse is not the contributor to the recipient trust. The surviving spouse is the contributor. Thus, any limitations on the right of the surviving spouse to receive or to have applied for his or her benefit will be self-imposed. They would not have arising as a condition of the bequest in the first instance. The marital deduction is preserved.

However, the surviving spouse may forget to make the transfer into his or her revocable living trust and be unwilling to pay for costs of transfer. The subsequent transfer also places the burden on the practitioner to follow up with the client to encourage the transfer. This poses another action step that may be missed or that the client will not address even if reminded.

In the alternative, the transfer may be made to the surviving spouse's Survivor's Trust (often referred to as the "Trust A" in estate planning forms). The name is not important. The key qualities of the Survivor's Trust (by whatever name) are typically the right of the surviving spouse to revoke and amend the trust and/or to have a general power of appointment with respect to the trust with no loss of benefits in the event of incapacity, no third-party beneficiaries and no terms inconsistent with marital deduction principles. The inclusion of both features (right to amend and revoke and retention of a broad general power of appointment) are most common and consistent with Code §2056(b)(5).

Alert: General power of appointment trusts are receiving increased use as a result of portability. Practitioners will need to review the unique qualification provisions, limitations, broad-scope of the required general power and how general power of appointment law may arise. Code §2056(b)(5) and regulations thereunder provide the starting point.

One might think that a bequest by the deceased spouse into a trust that the surviving spouse can revoke and wholly withdraw for any reason, wish, or purpose and at any time would be constitute a trust in which the surviving spouse is the sole owner and transferor for all tax purposes. Such is, however, not necessarily the case. If these unfettered rights terminate during the lifetime of the surviving spouse or someone else is also a beneficiary of the trust, the estate tax marital deduction may be unavailable. Moreover, the trust may be excluded from the gross estate of the surviving spouse (i.e., lose basis change under Code §1014 on death of the
surviving spouse) unless the surviving spouse holds a general power of appointment exercisable on death. \(^7\) Yes, the trust is a grantor trust and the surviving spouse has a power to revoke or withdraw. The fact that the deceased spouse created the trust in the first place creates problems under the terminal interest rule for the estate tax marital deduction. Thus, if these unfettered rights may become un-exercisable at some time or if there is a beneficiary in addition to the surviving spouse, the trust may not be eligible for the unlimited federal marital deduction as the trust would not meet the all-net-income requirement for a qualified terminable interest property trust.

Now we address the nuance: Is a transfer to the revocable trust of the surviving spouse from the deceased spouse's share of the revocable trust the same as though the transfer from the deceased spouse was made outright to the surviving spouse and then the surviving spouse directly transferred the bequest to the Survivor’s trust?

So often practitioners view a revocable living trust the same as the individual who holds the power of revocation and a general power of appointment. After all, the trust is a grantor trust with the powerholder treated as the taxpayer under Subchapter J. However, the revocable trust is treated as distinct from its settlor (or the person holding the power to revoke and appoint to himself or herself). For example, in California old policies of title insurance may become unenforceable on the transfer of title to a revocable living trust. Lenders may be more hesitant to loan on property held in trust. However, probate is not needed on property held and properly titled in the name of a revocable trust.

In this context, the marital deduction may be jeopardized for the surviving spouse if the surviving spouse loses income distribution rights or withdrawal rights terminate in the event of incapacity of the surviving spouse, or in the event that anyone other than the surviving spouse becomes a beneficiary, or in the event that general power of appointment marital deduction requirements are not satisfied.

Rev. Rul. 85-35, 1985-1 G.B. 328 both reminds practitioners of the importance of not conditioning income rights while providing a practical solution to protect the marital deduction. The ruling addresses the question whether the marital deduction requirements of a general power of appointment trust under Code §2056(b)(5) are satisfied if, with respect to an incapacitated spouse, the trustee under state law has the power to distribute trust income to a relative or a court-appointed representative for the benefit of the spouse, or the trustee may spend trust income directly for the benefit of the spouse, if the spouse becomes legally disabled. In the facts of that ruling, state law provided that the trustee has the discretion to pay any sum distributable to a beneficiary under legal disability, without liability to the trustee, by paying the sum to the beneficiary or by paying the sum for the use of the beneficiary either to a legal representative appointed by the court, or if none, to relative. The similar provision was included in the testamentary trust.

\(^7\)Unless the surviving spouse makes the transfer to the Survivor’s Trust, the termination of a withdrawal right or other power subject to Code §§2036 or 2038 within three years of death will not cause estate tax inclusion. Property that was contributed by a third party (such as the decedent) was excluded from falling within the scope of Code §2038 because the property was not “from the decedent's own property.” Estate of Halpern v. Commissioner, T.C. Memo 1995-352 (discussion in Section II (§2038) of the opinion.) Also, releasing a power of appointment within three years of death granted by a third party is not within the three-year rule under Code §2035(b). See, Estate of Halpern, ibid.
Among several requirements, the IRS cites Reg. §20.2056(b)-5(f)(7) for the proposition that an interest passing in trust fails to satisfy the condition that the surviving spouse be entitled to all the income from the property, to the extent that the income may be accumulated in the discretion of any person other than the surviving spouse. The ruling cites Estate of Tingley v. Commissioner, 22 T.C. 402 (1954), aff’d sub. nom., Starrett v. Commissioner, 223 F.2d 163 (1st Cir. 1955), which held that a trust did not satisfy the marital deduction requirements under Code §2056(b)(5) where, under the terms of the trust instrument, the spouse's right to trust income and to demand corpus terminated if the spouse became legally incapacitated. The IRS noted that the limitations on the spouse's beneficial interest in the event of incapacity went beyond those imposed under state law and actually terminated the spouse's interest.

On a point of distinction, the ruling observes:

"However, the prohibition against restrictions on enjoyment and control of trust income and corpus contained in Code §2056(b)(5) does not refer to reasonable restrictions imposed by state law or by will that provide for the protection of the beneficiary and for payments for the benefit of the beneficiar during a period of legal disability. See Rev. Rul. 75-350, 1975-2 G.B. 366."

Under this standard, the IRS concluded the surviving spouse had the right to all trust income and has the power to appoint the entire trust under state law or by will that provide for the protection of the beneficiary and for payments for the benefit of the surviving spouse in the event of incapacity. See Estate of Smith v. Commissioner, 79 T.C. 974 (1982). The ruling then held that a marital deduction trust satisfies the requirements of Code §2056(b)(5), if under state law the trustee has the power to distribute trust income to a relative or a court-appointed representative for the benefit of the spouse, or the trustee may spend trust income directly for the benefit of the spouse, if the spouse becomes legally disabled.

Estate of Walsh v. Commissioner, 110 T.C. 393 (1998), in an opinion by Tax Court Judge David Laro, concluded that a trust in which the surviving spouse received all net income, principal under a broad distribution standard and could withdraw the trust (Trust A) which received the marital deduction amount to an unlimited extent, did not qualify for the estate tax marital deduction under Code §2056(a) because the spouse ceased to be a beneficiary in the event of incapacity. The surviving spouse also held a broad general power of appointment. Upon becoming incapacitated, the surviving spouse would be deemed to have predeceased the deceased spouse. As a result of the language to terminate distribution on the incapacity of the surviving spouse, the marital deduction was lost despite the unfettered right of the surviving spouse to demand, and thus receive, the entirety of Trust A before incapacity. Moreover, no third party can be a beneficiary of a marital deduction trust (regardless of form).

Accordingly, a provision in a trust to direct distribution to a trust that the surviving spouse can revoke rather than directing the distribution directly to the surviving spouse could jeopardize the marital deduction if language in the trust would cause the surviving spouse to be unable to receive all net income or be demanded by a conservator or guardian for the benefit of the spouse. Rev. Rul. 85-35. In the portability context for moderate estates, the loss of marital deduction treatment would often mean no income tax basis adjustment when the surviving spouse dies. For large estates, the cost would mean estate tax liability on the death of the deceased spouse. Estate of Walsh v. Commissioner, supra. Thus, from the standpoint of action steps:
1. Distribution outright to the surviving spouse followed by a transfer by the surviving spouse into the revocable trust of the surviving spouse is the safest way to protect the marital deduction. The surviving spouse actually receiving distribution provides the cleanest evidence of complete real and equitable ownership by the surviving spouse and severs the identity of the decedent as the transferor to whatever trust the surviving spouse may thereafter elect to transfer ownership. Should the interest of the surviving spouse be lost in the event of incapacity (i.e., “Should I become incapacitated, the trust estate shall be distributed to X”) a gift would arise by the surviving spouse. To avoid a gift, distributions would remain subject to trustee discretion and paid to responsible payees. If other people become beneficiaries as a result, the gifts will arise at least to the extent of value transferred.

2. Another approach is to establish a separate marital deduction survivor’s trust. This form of trust is illustrated in CEB® Drafting California Trusts 4h Edition, §12.9. The marital deduction survivor’s trust initially receives direct distribution from the surviving spouse (i.e., sourced initially to the deceased spouse). The surviving spouse can then direct distribution from the marital deduction survivor’s trust to the traditional Survivor’s Trust (property sourced to the surviving spouse). Unless and until such distribution is made from the Marital Deduction Survivor’s Trust to the Survivor’s Trust, no transfers to third parties (other than solely for the benefit of the surviving spouse) could be made. The marital deduction survivor's trust could remain subject to allowances under Rev. Rul. 85-35 in the event of incapacity. While CEB® states that the surviving spouse may merely “instruct” the trustee, the cleaner approach would be to make transfers of record, or at a minimum with sufficient gravitas (assignment, grant, delivery, transfer, etc) to constitute a conveyance within the principles of Estate of Heggstad 16 CA app. 4th 943 (1993). Heggstad arises in the context of a settlor’s declaration in which the settlor is the trustee. If the trustee is a third party, an agreement signed by the trustee is needed to accept the property.

3. Simply do not include a forfeiture provision. Additionally, avoid any limitation inconsistent with state law and the allowance of the third party (such as the conservator) to demand receipt of at least all net income, or other acceptable benefits, from the trustee for the benefit of the spouse. In any event, there would be no other beneficiaries while the spouse is living. Whatever gifting is made would be subject to withdrawal by an attorney-in-fact under authority granted in the trust and durable power of attorney or under supervision of a conservatorship proceeding.

4. A final alternative would be to include a provision that the decedent’s assets are given to the surviving spouse who is then deemed to have distributed the inherited assets to the Survivor’s Trust, or if the surviving spouse is the trustee, that acceptance of the office of trustee also evidences the transfer of these assets to the trust and acceptance by the trustee. While this approach may work to avoid the deceased spouse as constituting the transferor to the marital deduction purposes, it is not as clean of an approach as any of the three alternatives indicated. The essential underlying fact is to effectively sever under state law the surviving spouse from the deceased spouse as the actor of subjection events. This fourth alternative has qualities more akin to a
savings provision. In other words, it reinforces intent and may be helpful but does not necessarily prevail.

In any event, the increased use of outright bequests to the surviving spouse (or virtually so with the use of some form of Survivor's Trust to receive distribution) creates considerations for marital deduction treatment that were neither common to the vast estates of the reasonably wealthy (i.e., before the estate tax filing requirement) or as common before the era of portability elections. One might reason that since the surviving spouse can revoke and amend a Survivor's Trust freely and at will, a later limitation should be irrelevant. After all, the surviving spouse had not been bound by any limitations between the death of the deceased spouse and the death of the surviving spouse. *Estate of Halpern v. Commissioner*, T.C. Memo 1995-352, however, infers and *Estate of Walsh* shows that is not the case. Those prior unfettered rights do not sever a later limitation over distribution benefits than would have existed had the revocation and amendment right never existed.

9. **Transmission Expenses ... Where to Report?**

A DSUEA election that equals exactly 100% of the basic unused exclusion amount of the deceased spouse is likely a pipedream, or at least it will be a rarity. Achieving this precise DSUEA would require no transmission expenses on the decedent's death being reported for income tax purposes.

Transmission expenses are expenses that would not have been incurred but for the decedent's death and the consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it. Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, or maintenance of the assets), probate fees, expenses incurred in construction proceedings, and defending against Will contests, and appraisal fees. The Regulations distinguish transmission expenses from management expenses. 706 Art §§7A.2, 7A.8.4.6, 7A.9 and §20.15 discuss the impact on the funding of the residue when transmission expenses are deducted on the income tax return. The illustrated portability-elected estate tax return in Chapter 40 or the Second Edition illustrates the use of a portion of the basic exclusion amount when these expenses are deducted on the income tax return. When transmission expenses are deducted on the income tax return, a non-deductible amount arises against the residue of the estate, which burns basic exclusion amount to that extent. Since deductions at the income-tax level provide some immediate benefit while estate tax arises down the road with a non-taxable estate, the typical decision under Code §642(g) is to deduct these "swing-items" on the income tax return. There is no free lunch. Thus, if you are deducting transmission expenses on the income tax return and reporting a DSUEA equal to 100% of the basic exclusion amount, the DSUEA has been overstated.

**AMT Alert:** Whether a deduction will provide any income tax deduction benefit will also depend upon the limitations on deductions, application of alternative minimum tax (AMT), and impact of the 2% limitation under Code §67(a) and the exception under Code §67(e)(1) (when the expenses would not have been incurred had the property not been held in an estate or trust). Regulations under Code §67(e) have not yet been finalized. Practitioners will need to run the numbers to determine the relevant benefits, if any, with reporting administrative expenses — particularly transmission expenses — on the income tax return. This practical recommendation applies with even greater vigor to estates subject
to estate tax. We are in a new day, one in which practice-by-historic assumptions may not lead to optimum results.

**Illustration:** The decedent's estate, valued in the normal manner, would report a gross estate of $1,279,350. In summary, real property is valued for $360,000, securities $60,000, cash $100,000 among several accounts (one of which holds $31,000), life insurance $200,000, qualified joint tenancies $300,000 and miscellaneous $259,350 ($257,000 of which is left outright to the surviving spouse). Deductions apart from the marital deduction are $5,000 funeral expenses and $1 in general debts. In addition, the estate incurred $15,000 of transmission expenses for death in 2013, which are deducted on the income tax return(s).

<table>
<thead>
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<th>Summary of Significant Reporting Differences with Selective Return Entries with DSUEA-Eicted Returns</th>
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<td>Column A: Regular Reporting: QTIP w/ Reverse QTIP Election portion, simple on outright</td>
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<td>Schedule R (based on facts. $0 if no reverse QTIP)</td>
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<td>DSUEA (DSUE amount)</td>
</tr>
</tbody>
</table>

Portability elections are discussed in Chapter 7A of 706 Art and demonstrated in a sample estate tax return in Chapter 40 of 706 Art.

10. **How Should the Practitioner Address Issues of Uncertainty as of the Filing of the Form 706?**

What if the amount of the taxable estate is not known when the federal estate tax return is filed? What does the statute mean when it states "such amount may be taken into account"?
The existence and procedure regarding how to handle unknown liabilities at the time the estate tax return is filed presents unique considerations in the portability context. The following issues and considerations exist:

Protective refund claims and refund claims exist to abate tax or obtain a refund of tax paid. However, portability returns generally have no estate tax payable and therefore, nothing to refund.

The portability regulations direct that the amount of the DSUEA be computed on the estate tax return. How should that amount be shown when it is unknown?

The IRS has an extended time to audit the correct amount of the DSUEA. The relevant statute of limitations period is based on the gift tax return(s) or estate tax return on which the surviving spouse applies the DSUEA. Will the decedent's estate be extended a similar time to adjust the DSUEA in the event deductions arise after the estate tax return is filed?

Given the uncertainty with respect to the treatment of unknowns and current lack of guidance from the IRS, should taxpayers report contingent liabilities to the extent believed reasonably deductible and disclose non-compliance with the regulations governing the deduction of administrative expenses and claims? Generally, these items are not deductible until paid unless an exception applies.

10.1 Use of Protective Refund Claims

Although most administrative expenses and claims cannot be deducted until paid, there are exceptions. Certain administrative expenses may be deducted even if not paid. See Reg. §20.2053-1(d)(4)(i) (amount determined with reasonable certainty and will be paid, such as legal fees and executor commissions by way of example). The estate may deduct claims subject to the 2009 Regulations on Form 706 in two instances when they have not yet been paid. (See Reg. §§20.2053-4(b) and 20.2053-4(c), which apply respectively to claims related to property, the value of which is at least 10% of the gross estate, and miscellaneous claims that do not exceed $500,000.)

Practice Point: Taxpayers should use, to the fullest extent possible, the allowance for the deduction of miscellaneous claims within the $500,000 allowance above noted. This enables the estate upfront deductions to the extent allowed under the foregoing regulations. Similarly, if administrative expenses are going to be deducted on the estate tax return, include these expenses on Form 706 to the fullest extent desired and with reasonable certainty that they will be paid. Of course, most estates will likely prefer to deduct the administrative expenses on the income tax return. In other words, try to minimize the unknown estate tax deductions to the extent possible when an estate tax return with a portability election is filed.

Accordingly, situations may exist in which the amount of the taxable estate will not be known until some time after the estate tax return is filed. Typically, the estate will file either a Schedule PC with the estate tax return or a Form 843 (protective or actual claim) after the estate tax return is filed, or both. See, Rev. Proc. 2011-48. However, refund claims exist to
abate or refund tax. If no tax is payable in the first place, the refund claim is moot from the standpoint of obtaining a refund on the particular return under which the claim is filed. Whether the refund claim will generate an increase in the portability amount remains an open issue. In view of the fact that the portability amount will eventually become integrated with the estate tax liability of the surviving spouse (i.e., as part of the computation of the applicable exclusion amount of the surviving spouse) will a Schedule PC still remain moot?

10.2 Problems with Computation of Portability Amount and Possible Use of Formula Clauses

Reg. §20.2010-2(b) directs that the DSUEA be computed on Form 706.

This section states:

"In addition to the requirements described in paragraph (a) of this section, an executor of a decedent's estate must include a computation of the DSUE amount on the estate tax return to elect portability and thereby allow the decedent's surviving spouse to take into account that decedent's DSUE amount. See paragraph (b)(2) of this section for a transitional rule when the estate tax return form prescribed by the Internal Revenue Service (IRS) does not show expressly the computation of the DSUE amount."

Aside: The transitional rule referred to above, applied for deaths in 2011 when the IRS had not published a schedule on which the portability election would be indicated and the amount computed.

The regulations do not clearly address how to indicate the DSUEA when unknown factors exist by the time the estate tax return is required to be filed, including extensions. There is no protective portability election. Thus, once made, it is final.

This author believes that in situations in which all facts determining the final taxable estate are not known by the time the Form 706 is due, including extensions, a formula can be stated to indicate the potential adjustment to the DSUEA. Essentially, the estate would indicate what is intended without changing the fact that the portability election once made is irrevocable. The actual statement would likely vary from case to case. The following is an example:

"The portability election made on this return is irrevocable. The DSUEA (or DSUE amount) reflected in Part 6 (page 4) of the Form 706 is subject to possible adjustment based on post-filing facts. Supplemental information will be filed with respect to the estate of the decedent to report additional items that may adjust the amount of the portability election. Thus, the final DSUEA is subject to these post-filing adjustments which would increase the portability amount (i.e., the amount of the deceased spouse's unused exclusion amount) after considering the value of the gross estate, deductions, adjusted taxable gifts as finally determined and adjusted. The executor will file supplemental information once these amounts are determined."

Caution: While the inclusion of a formula of this type is very logical, the current state of the regulations and instructions is silent as to how to treat such post-filing
matters. The IRS is granted an extended audit period under Code §6501 to determine the DSUEA on the decedent's return when used by the surviving spouse. Code §6501 does not expressly grant the taxpayer an extended review of the DSUEA. Would it be logical to do so? Of course it would. Whether decedent's estates will be allowed reciprocity may require regulatory relief or judicial construction.

It would be very helpful if the IRS clarifies how practitioners should address DSUEAs that change with post-filing facts within allowable reporting requirements. Someday, a court will likely determine whether the IRS's right to extended review applies also to taxpayers with any reciprocity when post-filing facts or facts unknown at the time of filing later come to light. Thus, in the absence of better or clearer direction from the IRS, the author recommends that the return preparer indicate the irrevocability of the DSUEA election and the adjustment of the portability amount, but not the existence of the election, relative to unknown facts. This type of adjustment statement is common with QTIP elections, special-use elections, and reverse QTIP elections.

10.3 Limited Tax Court Relief

As matters now stand, the tax court may lack jurisdiction to consider applications for relief in the computation of the portability amount, at least before the surviving spouse makes a gift or dies and seeks to use the DSUEA (of a prior deceased spouse). With limited exception, the tax court needs the IRS to issue a Notice of Deficiency or Notice of Liability before the court can acquire jurisdictions. See Code §§6212, 6213, 6901. One of the exceptions when a Notice of Deficiency is not required pertains to the value of gifts that utilize the basic exclusion amount (gift tax exemption) when no gift tax is payable. No declaratory relief, however, expressly addresses computation of the portability amount or basic exclusion amount when no estate tax is payable. Whether the tax court rules change or not remains to be seen. For the time being, the determination of the portability amount may ultimately have to be addressed when the DSUEA is used by the surviving spouse. The extended limitations period provided for the IRS by statute to review portability amounts enables the IRS to take a prolonged look back.

10.4 Can the Taxpayer Have an Extended Look-Back Right as is Afforded the IRS?

Code §6501(a) limits the IRS from assessing tax after three years from the filing (whether or not such return was filed on or after the date prescribed) of the return and no proceeding in court without assessment for the collection of such tax shall begin after the expiration of such period. Taxpayers seeking a redetermination of a Notice of Deficiency (90-Day Notice) must petition the tax court within said 90-day period (150 days if the taxpayer's address is outside of the United States) or the assessment becomes final. The taxpayer can forego tax court relief and sue for a refund in district court or the court of claims. Claims of refund are generally required, and those claims must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever of such periods expires later, or if no return was filed by the taxpayer, within two years from the time the tax was paid. Code §6511(a).

Currently, the extended audit review period provided to the IRS in Code §2010 to make adjustments to the DSUEA is not reciprocated to the taxpayer. However, there is precedent to allow the taxpayer to adjust for changes even though no tax is payable. For example, adjusted taxable gifts can be reduced in prior years for the calculation of the total adjusted taxable gifts when the return is not final. Thus, in TAM 9718004, the taxpayer could reduce the value of gifts.
made many years earlier (when the IRS could also seek to increase the value of those gifts in the determination of adjusted taxable gifts).

Hopefully, the law will become clear and enable either the taxpayer or the IRS to retroactively look at the relevant facts, including post-filing facts that relate back to legitimate estate tax deductions regardless of which party raises the point.

**Interim Reporting Suggestion:** In the meantime, practitioners should include a statement indicating the potential for additional deductions, particularly when unpaid claims subject to the 2009 Regulations (promissory notes and mortgages are not subject to the limitation of payment first) exist or the amount of the taxable estate is unknown. Supplemental information should be filed with the IRS for adjustment to DSUEA computation. The filing of a protective refund claim in the decedent's estate is less clear, and may not help, since there is no tax payable in that estate. However, by presenting the unknown issues within the statute of limitations, the estate has preserved its position to increase the DSUEA for matters unpaid, including those unpaid within three years of the filing of the decedent's Form 706. The IRS can use collateral or other factors to reduce the DSUEA, although that would be the case anyway. In view of the apparent gap in the statute and regulations on how the decedent's estate should address post-filing adjustments, at this point, the optimum approach appears to be to make the affirmative DSUEA election (assuming that it is desired), state the DSUEA based on current calculations and report its potential for adjustment and why so. Include information sufficient to inform the IRS of the unknown or unresolved items. Rev. Proc. 2011-48 reflects the type of information to include. At the same time, the client should be informed of the current lack of official guidance on how to address these unknown items or amounts. Miscellaneous claims within the allowance of Reg. §20.2053-4(c) should be deducted to the extent possible on Schedule K in order to reduce the scope of these protective refund claims that may be needed. This approach creates fewer unknowns.

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**Appendix 1**

Sample letter regarding portability elections

**DISCLAIMER:** The following contents and form letter should not be construed as, and should not be relied upon for, legal or tax advice in any particular circumstance or fact situation. This letter provides a sample form and is not tailored to particular circumstances of a given client or
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Re: Portability Elections of the Unused Estate Tax Exclusion Amount ("DSUEA") for the Benefit of the Surviving Spouse

Dear Clients:

Recent changes in the federal estate tax law have made the payment of federal estate tax the concern of fewer married couples. At the same time, non-tax issues of importance to you remain the guiding light for the design of your estate plan. Moreover, for surviving spouses and your loved ones, income taxes may have become the tax of greatest concern. This letter overview the importance of updating your estate planning and enabling your executor or trustee on death to take advantage of an important election that can provide valuable, and potentially inexpensive insurance, against estate tax arising when the surviving spouse dies.

For federal estate tax purposes, each individual's estate is entitled to a unified exclusion against estate tax ($5,430,000 for death in 2015), or $10,860,000 for a married couple, if their estate plan or a post-death election enable two exclusion amounts to be used. By the way, the amount of the unified exclusion can be used for gifting to the extent not used in prior years. Under current law, the unified exclusion adjusts for inflation each year during your respective lifetime.

The current federal estate tax rate is 40%. Depending upon your state of residence at the time or your death or the location of your assets at death, the combined federal and state income tax rates that may then apply may be greater or less than the federal estate tax rate. Historically, the federal estate tax was particularly burdensome because the rate was high (55%) and the tax arose on death, not as a result of a gain or other monetizing event. Estate tax is still payable under the law at the same time and terms on which it has always been due. The increase in the unified exclusion and the reduction of the estate tax rate have combined to make estate tax the concern for fewer families, and a lesser cost when it does arise.

Importance of Non-Tax Planning

Whether you wish to leave your share of the estate outright to your spouse or in a trust is primarily a non-tax decision. Outright bequests on death are simple and leave the surviving spouse, or other beneficiary, free to do with the inheritance what he or she pleases to do. If freedom of action is desired, then many estates, may find outright bequests the desired approach. However, if the first spouse to die ("deceased spouse") wants to provide and assure for the ultimate inheritance of the children or other loved ones when the surviving spouse dies, then establishing a trust may be the best approach to achieving that result.
Whether your estate plan is crafted through the use of a Will or living trust, it should reflect what you, individually, want. You can provide generously for your spouse, if you want and still have assurance that your share of the estate will go to your children or loved ones when your spouse dies.

It is common with most any marriage that after the death of the first spouse that other influences may bear upon the surviving spouse to seek to influence a change in the estate plan. Some of these influences exist, such as the desire to provide for the children or grandchildren of the surviving spouse from a prior marriage. Even in a family with no children outside of the marriage, the surviving spouse might remarry or develop relationships that may pursue and encourage changes to the estate plan of the surviving spouse. As the surviving spouse ages, external pressures could undo a lifetime of existing loving relationships.

As I mentioned, a trust for a spouse can be designed with generous benefits for the surviving spouse and still secure ultimate distribution to the loved ones of the deceased spouse. The trust can be directed to receive all net income from the trust. Some trusts are designed to pay the greater of the net income or a fixed percentage of the trust value each year. In addition, the trustee may be authorized to distribute to the surviving spouse principal of the trust for need, such as for health, education, support and maintenance. If desired, the surviving spouse can be given the power to change distribution among the loved ones to the extent allowed by the deceased spouse. Some trusts also allow the surviving spouse to receive, upon demand, up to 5% of the trust each year as a non-cumulative right. If the deceased spouse wants, the surviving spouse can be appointed as the trustee.

The trust does not have to be created with such generous benefits. Distributions can be more restricted, or other beneficiaries can be included as concurrent recipients. Each of you has your own choice to make regarding whether a trust is used for the benefit of the surviving spouse and the features of that trust.

If the surviving spouse receives at least all net income and the trust of the deceased spouse has no other beneficiaries during the lifetime of the surviving spouse, then an election can be made that can be valuable for estate tax planning or income tax planning, or both. That election is called a "QTIP election" (qualified terminal interest property election). For estate of married couples with a value greater than the unified exclusion amount for both of you (let's say $11 million in general terms), the QTIP election enables the estate tax, if any, to be deferred until the death of the surviving spouse. That makes the estate tax the problem of the children or other loved ones, not of the surviving spouse.

For estates with a value below two available unified exclusion amounts (let's say under $11 million), the QTIP election provides a great post-death tool to either reduce income taxes when the surviving spouse dies, provide flexibility in case your total estates might end up with a value greater than two available unified exclusion amounts as of the death of the deceased spouse, or both. The QTIP election need not be made until the estate tax return of the deceased spouse is filed.

Thus, if a trust is desired for the benefit of the surviving spouse after the death of the deceased spouse, using a trust to which a QTIP election can be made may provide great post-death flexibility to address circumstances and valuations not yet known while achieving overall tax savings consistent with your non-tax wishes.
On the other hand, the deceased spouse may prefer outright distribution to the surviving spouse. We recommend that as part of an outright distribution plan that the surviving spouse be given the opportunity to elect, within nine months after the death of the first spouse, whether to accept outright the benefits left or to disclaim the benefits into a trust for the benefit of the surviving spouse. The surviving spouse can still accept the benefits outright. However, allowing a trust to arise only in the event of a disclaimer can provide asset protection, asset management and possible added estate tax savings if the surviving spouse wishes benefits to pass in trust. The surviving spouse would be the sole beneficiary and receive at least all net income, and in addition principal for need along the lines discussed above. There is no reason to not at least include a disclaimer trust in a plan designed for outright distribution to the spouse since the trust only exists if the surviving spouse wants it to arise. There are other details with a disclaimer trust, which we can review if you wish.

At this point, it is important to note that for most estates a trust does not have to be used in order to save estate tax. The decision to use a trust for the benefit of the surviving spouse is primarily a non-tax decision.

The portability election

A key component of the changes in the estate tax law is the creation of the deceased spousal unused exclusion amount (called the "DSUEA"). The new law allows the executor of the estate of the deceased spouse to transfer over to the surviving spouse the DSUEA. In effect, any unused exclusion amount of the deceased spouse is made available through this election for the benefit of the surviving spouse. In order to make the election to transfer the DSUEA to the surviving spouse a timely estate tax return must be filed in the estate of the deceased spouse.

The term "portability election" refers to this election to transfer the DSUEA from the estate of the deceased spouse for the benefit of the surviving spouse. The surviving spouse keeps his or her own basic exclusion amount regardless of whether a portability election is made. Thus, if no portability election is made and the surviving spouse has made no taxable gifts, then he or she will have a $5,430,000 basic exclusion amount. The surviving spouse's basic exclusion amount increases with inflation under current law. Thus, it may be substantially greater by the time the surviving spouse dies.

The portability election increases the available estate tax free amount available to the surviving spouse by the DSUEA. Thus, if the deceased spouse has a DSUEA of $5 million in the above example, the new applicable exclusion amount available to the surviving spouse will be $10,430,000 in the above example. All that is needed to receive the increase for the DSUEA is to make file a timely, complete and properly prepared estate tax return. The IRS has also created rules that can make the filing of an estate tax return simpler for estate that are not required to file an estate tax return under general filing rules. Thus, less burdensome valuation rules can apply when the estate tax return is only being filed to make tax elections (such as a portability election or QTIP election with an estate under the value required to file the estate tax return).

I consider portability elections to be a type of "estate tax insurance" only without annual premiums. If as of the death of the surviving spouse the taxable estate may be greater than one basic exclusion amount, the portability election saves estate tax. A variety factors not currently evident may arise to create estate tax by the time of the death of the surviving spouse. Consider
the following unknown risks of possible eventual estate tax: (i) inheritances left outright or gifted to either of you from other loved ones will grow your estate; (ii) growth and liquidity with investments or real estate (iii) your relative youth and life expectancy for prospects of growth; (iv) changes in the estate tax law that may reduce the exclusion amount available to you; (v) your future savings habits and whether your estate will grow in value from reduced expenses in the future.

Only a one-time outlay is required for your investment with professionals to value assets and prepare the estate tax return. Yet, substantial tax savings may result. Let's use an example. Assume a couple has an estate of $2 million currently and that the estate grows to $5 million by the time of the death of the surviving spouse many years from now. If the current law remains, there would be no estate tax even without a portability election. In that instance, the outlay for the cost to prepare the estate tax return would be for naught. However, if the estate tax exemption declines to $4 million (and the current administration would like a $3.5 million exemption), then $1 million of value would be subject to federal estate tax over a $4 million exemption. That would mean $400,000 of federal estate tax. Had a portability election been made, there would be no estate tax.

Compare this one-time investment to file an estate tax return with a portability election to term life insurance. Term life insurance requires annual premiums. Premium payments either increase with age after a number of years, or possibly each year. A $400,000 term life insurance policy could cost a few hundred dollars, but more likely over $2,000 per year at ages when the insurance would more likely pay off. Over 10 years, the insured could well invest $20,000, $50,000 or $100,000, or more, to fund the term life insurance. Yet, only 1% of term life insurance policies pay off! The reason is that with advanced age the premiums become prohibitively expense.

While not quoting the cost of a particular estate tax return, if the cost of a portability return is $5,000, the investment is a pittance when compared to term life insurance. Yet, the benefit can be substantially greater since the election to transfer DSUEA could save a lot more than even the $400,000 referenced in the above example. Moreover, your investment with the estate tax return would be a fraction of the cost of term insurance. When the time comes, we can estimate for you the investment need to prepare an estate tax return with a portability election.

The portability election is not all-or-nothing. For example if a trust is left for the surviving spouse and no QTIP election is filed, the portability election can still be made. The DSUEA would simply be a lower amount. For example, if your combined estate is $8 million, one-half to each of you, a $4 million trust from the surviving spouse could either have a QTIP election made (in which case the DSUEA would be about $5.4 million potentially on a death in 2015) or if no QTIP election is made the DSUEA would be about $1.4 million ($5.4 million less $4 million).

If your executor (or trustee of your living trust) plans to make a QTIP election, an estate tax return must be filed to make that election. In that setting, the portability election is almost a freebee since the estate tax return is needed anyway.

1. Once portability election is made, it is irrevocable (until the final due date, including extension of time lawfully obtained has expired).
2. It is especially important that you nominate an executor for your estate and
trustee of your living trust who will approach tax elections honestly and for the best interest of
your loved ones. There have been situations in which a fiduciary (particularly a surviving spouse
with loved ones different from those of the deceased spouse) have used tax elections,
particularly QTIP elections, to change the estate tax liability from the estate of the surviving
spouse to the share passing to the issue of the deceased spouse. While this is not a common
occurrence, consider who you want to oversee tax elections, generally, or whether a co-
executor or co-trustee may be appropriate.

3. Paperwork relating to an estate tax return, including the return, work papers,
evidence of title and estate planning documents will need to be retained for an extended period.
This follows because the IRS is given an extended period of time to review estate tax returns for
purposes of determining the DSUEA left to the surviving spouse.

4. A surviving spouse can only use DSUEA left by the last deceased spouse. If the
surviving spouse remarries and a later spouse dies, the unused DSUEA from the earlier
deceased spouse will be lost. However, if the surviving spouse makes lifetime gifts, generally,
before a subsequent spouse dies, the DSUEA is not lost.

We hope this introduction to changes in estate tax law and the important consideration
of the portability election are of benefit to you. We look forward to answering any questions you
have and assisting you with your estate planning.
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