Professional Advisors Leadership Council

"PERMANENT" ESTATE & GIFT TAX RELIEF IS FINALLY HERE. NOW WHAT??

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"PERMANENT" ESTATE & GIFT TAX RELIEF IS FINALLY HERE. NOW WHAT??

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I. What's "Permanent"? Ain't No Sunset When It's Gone

The enacted law (H.R. 8, Pub. L. 112-240) is called the "American Taxpayer Relief Act ***of 2012***" (not of "early 2013"), even though the Senate voted (89 to 8) to pass the bill at about 1:30 a.m. on January 1, 2013, with the House vote (257 to 167) coming later that day. President Obama signed the Bill on January 3rd while he was in Hawaii, using the "autopen" procedure.

The estate and gift tax changes in ATRA 2012 are found two subsections that fit onto two pages in the 157-page Act.

The Act also renews one income tax break that may be useful in 2013 to *some* estate planning clients who did not previously use this break: Renewal and extension (through December 31, 2013) of the maximum $100,000 exclusion from gross income for a taxpayer who is at least 70½ years of age and who arranges for and makes a ***direct*** distribution from his or her IRA account to a 501(c)(3) charitable organization that is not a donor advised fund or a section 509(a)(3) supporting organization.[1]

(A) *The significance of repeal of the 2010 /2012 sunset under the EGTRRA (2001) and TRUIRJCA (2012) tax relief laws*

The most important change the Act made to the federal transfer tax regime is in section 101(a), which applies to *all* of the tax provisions in the Act, and which repealed the automatic sunset in Title IX (section 901) of EGTRRA 2001, the first Bush tax relief law that was enacted in June 2001.

Originally, EGTRRA section 901 required all of the Bush-era tax relief, including the estate, gift and GST tax relief, to expire automatically as of January 1, 2011. The previous tax relief law, TRUIRJCA 2010 (the Tax Relief, Unemployment Insurance Extension and Job Creation Act, enacted on December 17, 2010) amended EGTRRA 2001 by keeping the general sunset in place but extending the automatic sunset date by two years, to and including December 31, 2012.

Because section 101(a) of the 2012 Act completely repealed the sunset provision in EGTRRA section 901, we now have a stable set of estate, gift and GST tax rules and rates (except for annual inflation adjustments) in 2013 and into the indefinite future. We

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[1] *See* section 208 of the Act, amending Code § 408(d)(8)(F). The Act also allowed qualified individuals who had taken IRA distributions in December 2012 to re-direct that money to a qualifying 501(c)(3) charitable organization in January 2013, in order to claim the exclusion, but the opportunity to do that for 2012 distributions has now expired.

have not had this situation for a long time, because since 1998, either the top marginal estate and gift tax rate or the estate tax applicable exclusion amount or the gift tax applicable exclusion amount (or some combination of two or more of these) has been subject to year-to-year change or the prospect of automatic expiration.

With two exceptions (one rate change and one technical correction explained separately below), ATRA 2012 has simply duplicated the estate, gift and GST tax rules as they existed in 2012 and has made them apply in 2013 and all future years.

Because of the Act's repeal of the automatic sunset, various factions in Congress and in the Executive Branch will not be able to rely on a future sunset as a source of leverage. It will take affirmative legislative action by Congress to *enact* future rate changes or changes in the lifetime applicable exclusion amount or in the lifetime GST exemption.

(B) ***Income Tax Rate Changes Affecting Estates and Trusts Starting in 2013***

The Act also modified the *income tax* rates that apply to estates and trusts for tax years beginning on or after January 1, 2013. The top marginal income tax rate of 39.6 percent has been restored, and for tax years beginning in 2013, that 39.6-percent rate will apply to an estate or trust's taxable income exceeding $11,950.

In addition, and under the Patient Protection and Affordable Care Act of 2010, the "new" Medicare surtax of 3.8 percent under Code section 1411(a)(2) will apply in post-2012 tax years to the *undistributed* passive net investment income of an estate or trust (interest, dividends, capital gains, rents and royalties, etc.) whose adjusted gross income exceeds the lower end of the top bracket ($11,950 for tax years beginning in 2013).[2] Of course, to the extent that passive net investment income of an estate or trust is passed through to the beneficiaries on their K-1s for a tax year beginning after 2012, the *beneficiaries* will be subject to the 3.8-percent tax on that investment income, if their own modified adjusted gross incomes exceed the stated thresholds ($200,000 for single filers, $250,000 for married couples filing jointly).

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[2] The 3.8-percent additional tax will not apply to income from "trade or business" activity in which the fiduciary of the estate or trust or the fiduciary's agents "materially participate" in the activity that generates the investment income, such as rents or capital gains, or dividend distributions from an actively-managed, closely-held corporation. "Material participation is supposed to be determined under the section 469 passive activity rules, but the Treasury Department has never issued proposed regulations to explain how the section 469 rules should be applied to estates and trusts. How the "material participation" requirement will apply to estates and trusts is likely to remain an uncertain and "evolving" area.

(C) *Stable marginal rates and a stable lifetime exclusion amount for 2013 and beyond*

Subsection 101(c) of the Act amended Code section 2001 to add three additional brackets to the "upper end" of the unified estate and gift tax rate table, effective January 1, 2013, so that the top marginal rate (and the flat GST tax rate) is now 40 percent, compared to the top marginal rate of 35 percent that applied to decedents dying and gifts made in 2011 and 2012.

The maximum lifetime exclusion amount (before inflation adjustment) is still $5 million, and as in 2011 and 2012, the full amount of the exclusion can be used either to shelter gifts from the gift tax or to shelter assets passing at death from the estate tax.

In 2011 and 2012, the prospect of automatic sunsetting effective January 1, 2013 (and the unpleasant possibility of a decrease in the lifetime exclusion amount to $1 million and/or an increase in the section 2001 top marginal tax rate to 55 percent) led many estate planners and commentators to worry about ***clawback***: The "punishment" of donors who used the higher lifetime exclusion amount ($3.5 million to $5.12 million in 2009-2012) to make large taxable gifts and who later died in a post-2012 year when the lifetime exclusion amount would be lower.

If "clawback" were to be considered a post-mortem "punishment" of earlier aggressive *inter vivos* gifting, the "punishment" would result from the combined effect of Code subsections 2001(b) and 2001(g). As part of the familiar cumulative estate tax computation, Code § 2001(b)(2) would (and still will) give a decedent credit for the gift tax calculated at year-of-death rates on all post-1976 taxable gifts. If clawback" occurred, it could be regarded as an unexpected increase in the *estate tax* imposed on the assets that the decedent had *left* at death, and not as an *ex post facto* punishment for having made large taxable gifts in earlier years with no out-of-pocket gift tax cost.

Fortunately, because Congress would have to take direct action to decrease the lifetime exclusion amount or to increase the section 2001 marginal tax rate(s) again, the problem of "clawback" has now receded far into the background. In 2011 and 2012, there seemed to be majority support in Congress to address clawback with a technical correction.[3]

(D) *Continued inflation indexing of basic exclusion amount and annual exclusion amount in 2013 and later years*

The inflation-indexed "applicable exclusion amount" (base $5 million) for 2013 was announced by the IRS on January 11, 2013, in Rev. Proc. 2013-15, section 2.13. The

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[3] For example, *see* Sen. Harry Reid's mid-2012 bill, S. 3393, which would have added a new subsection 2001(h) and a new subsection 2502(d), to explicitly deal with a decrease in the applicable exclusion amount by adding adjustments to the estate tax and gift tax computations.

inflation-indexed maximum exclusion amount (and also the inflation-indexed maximum lifetime GST exemption amount) is $5,250,000 in 2013, compared to $5,120,000 in 2012.

The annual per-donee exclusion from taxable gifts under Code section 2503(b) has been increased to $14,000 for 2013 gifts, as a result of an inflation adjustment. And for gifts to donee spouses who are not U. S. citizens, the annual exclusion from 2013 taxable gifts is $143,000. *See* Rev. Proc. 2012-41 (October 26, 2012), section 3.19.

(E) *How likely is it that Congress will tinker directly with marginal rates and the exclusion amount?*

A short, careful answer: No one knows. Whenever *both* a majority in Congress *and* a majority of the voting public come to regard the unsustainable path of some federal spending as a dire, immediate crisis that demands revenue increases in addition to spending cuts, no one could rule out an increase in the section 2001 estate and gift tax rates, or the addition of further rate brackets and higher rates to apply to the lifetime gifts and estates of the super-wealthy (for example, on gross estates exceeding $50 to $100 million).

A more daring (and possibly reckless) answer: Congress is unlikely to pass a decrease in the lifetime exclusion amount, because a decrease in the exclusion amount would displease many potential campaign donors and would have a mostly symbolic effect, without raising substantial additional revenue in an efficient fashion. Keep in mind that the last time that the Congress took affirmative action to *reduce* a federal transfer tax exclusion or exemption was in 1942 or 1943, when the old (pre-1977) estate tax specific exemption was decreased from $50,000 to $30,000.

To this writer's best recollection, the last time that Congress caused or allowed a federal estate or gift tax rate to *increase* was in August 1993, when President Clinton signed OBRA 1993, which restored the top marginal estate tax rate to 55 percent, retroactive to January 1, 1993 (President G. H. W. Bush had pocket-vetoed a late 1992 bill that would have prospectively restored the 55-percent rate), and one result of the retroactive rate increase was a unsuccessful constitutional challenge. ***NationsBank of Texas, N.A. v. United States***, 269 F.3d 1332 (Fed. Cir. 2001).

ATRA 2012's increase in the top marginal estate and gift tax rate to 40 percent could be viewed as an action by Congress to *limit* or *prevent* the rate ***increase*** (to 55 percent) that would have automatically occurred on January 1, 2013 if Congress had not acted to repeal the sunsetting in EGTRRA 2001 and TRUIRJCA 2012.

II. Quick Reminders About the Rates, Rules and Settings for 2013

(A) *A summary of the major rules for 2013 and later years*

The most important transfer tax parameters for 2013 and beyond, compared to the last two years, are summarized in the table on the next page.

For persons dying or for gifts made in . . .	**2011**	**2012**	**2013 and later**
Maximum lifetime exclusion amount (usable on lifetime gifts or at death), inflation-indexed	$ 5,000,000	$ 5,120,000	$ 5,250,000
Top marginal tax rate (estate tax *and* gift tax)	35 percent	35 percent	40 percent
Tax credit equivalent of maximum lifetime exclusion	$ 1,730,800	$ 1,772,800	$ 2,045,800
Lifetime generation-skipping transfer (GST) exemption, inflation-indexed	$ 5,000,000	$ 5,120,000	$ 5,250,000
Flat GST tax rate	35 percent	35 percent	40 percent
Is first-dying spouse's basic unused exclusion amount "portable" to surviving spouse?	YES; election on a timely-filed Form 706	YES; election on a timely-filed Form 706	YES; election on a timely-filed Form 706
Per-donee annual exclusion from taxable gifts under Code § 2503(b), inflation-indexed	$ 13,000	$ 13,000	$ 14,000

(B) ***40 percent top marginal rate means an effective estate and gift tax rate of 40 percent***

Although additional brackets with 37-, 39-, and 40-percent marginal rates apply to gifts made in 2013 and later years and to the estates of decedents dying in 2013 and later years, when the inflation-adjusted maximum lifetime exclusion amount is converted to the "applicable credit amount," the effect of the additional marginal rates is that taxable transfers exceeding the lifetime exclusion amount will generate an estate tax or gift tax (net after the credit) at an effective flat rate of 40 percent.

(C) ***GST tax lifetime exemption at a maximum of $5.25 million, and a flat GST tax rate of 40 percent for transfers in 2013 and later years***

The Act has made no change in the GST tax rules that applied in 2011 and 2012, other than the inflation adjustment to the maximum lifetime GST exemption.

(D) ***Section 2058 deduction for state death taxes remains; the old (pre-2005) credit for state death taxes under Code §2011 is now permanently repealed***

The old federal "credit for state death taxes," under Code section 2011, was phased out under EGTRRA 2001 between 2002 and 2004, and was repealed for 2005 and later years and replaced with an estate tax *deduction* for state death taxes under Code section 2058. Both the repeal of the credit and the addition of the § 2058 deduction were subject to automatic sunsetting, first after December 31, 2010, and then after December 31, 2012. Now that the automatic sunsetting has been repealed by ATRA 2012, the demise of the federal credit for state death taxes is permanent, and so is the § 2058 deduction for state death taxes.

Because Indiana never de-coupled its statutory definition of the § 2011 federal credit from the post-2004 version of Code section 2011 itself, the Indiana estate tax (a "sponge tax" or "pickup tax") is permanently a nullity, unless the Indiana General Assembly amends I.C. 6-4.1-11 to use a pre-2002 definition of the federal credit or to transform the Indiana estate tax into a stand-alone tax (Neither action is likely in the short term).

III. A Short Refresher Course About Portability

(A) ***Portability now available for married decedents dying after 2012***

The Act made only two changes to the portability rules. *First,* the repeal of the TRUIRJCA 2010 sunset means that portability will remain available to the executors and surviving spouses of decedents who die in 2013 and later years. *Second,* the Act made a technical correction to Code § 2010(c)(4) as recommended by the Congress's Joint Committee on Taxation in early 2011, so that the Code is now consistent with the IRS's interpretation of Congressional intent in the temporary Treasury Regulations. The technical correction is explained starting on Page 9 below.

In early guidance in 2011, the IRS referred to the "portable" exclusion amount — which was validly "transferred" to a surviving spouse — as the DSUEA [***D***eceased ***S***pouse ***U***nused ***E***xclusion ***A***mount]. Later, the IRS changed the label to the "DSUE Amount." This writer prefers and continues to use "DSUEA" because that acronym is short and can easily be pronounced as "**d'*SOO*-yah**."

The primary current resources available on portability are as follows:

- New Schedule C to the Form 709 for 2012, and the accompanying instructions (for use by a surviving spouse who has a portable exclusion amount from a deceased spouse and who made taxable gifts in 2012).
- On the Form 706 for 2012 decedents, Line 9b on page 1 and new Sections C and D of Part 6, plus the accompanying instructions.
- Temporary estate tax regulations (Reg. §§ 20.2010-1T through 20.2010-3T), effective June 15, 2012, and published as part of T.D. 9593, 77 Fed. Reg. 36150.

- Temporary gift tax regulations (Reg. §§ 25.2502-1T and 25.2502-2T), also effective June 15, 2012, and published at the same time as the temporary estate tax portability regulations.
- IRS Notices 2011-82 (September 29, 2011) and 2012-21 (February 17, 2012), which anticipated some of the issues covered the temporary regulations, and which have largely been superseded by those regulations.

(B) ***The maximum portable "basic exclusion amount" remains at $5 million***

The maximum amount of a first-to-die spouse's unused lifetime exclusion amount that can be "transferred" to the surviving spouse via a portability election on a timely Form 706 return is $5 million — that is, the basic maximum lifetime exclusion amount under Code section 2010(c), *without* inflation indexing.

The 2012 Act did not change any of the basic rules in Code § 2010(c) regarding the amount of the DSUEA or how and when the portability election should be made. The surviving spouse who "receives" a portable exclusion amount or DSUEA from a predeceased spouse can use that portable exclusion amount to shelter otherwise taxable gifts from the gift tax and to shelter assets passing at death from the estate tax. The Act also did not change these rules.

Finally, as was the case in 2011 and 2012, the portability election and the DSUEA have no applicability whatsoever to the generation-skipping transfer tax.

(C) ***The DSUEA (or "DSUE amount") and the DIPS rule***

It is still the case that a surviving spouse who has received a DSUEA from a predeceased spouse can only use, at any given time, the DSUEA (if any) from his or her immediately preceding deceased spouse. In 2011, this writer began using the acronym **DIPS** (***D***eceased ***I***mmediately ***P***receding ***S***pouse) to describe this concept. In the Temporary Regulations, the IRS uses the phrase "last deceased spouse."

If a surviving spouse ***W*** received a full $5 million DSUEA from Predeceased Spouse No. 1 in 2012, did not use any of that DSUEA with respect to gifts in 2012 or 2013, ***and*** if the surviving spouse ***W*** then marries again, ***AND*** if that new spouse dies first (becoming Predeceased Spouse No. 2), then for purposes of further taxable gift giving or for estate tax purposes after her later death, ***W*** can only use the DSUEA, if any, of Spouse No. 2 (assuming that a valid, second portability election is made after Spouse No. 2's death), because only Spouse No. 2 is the DIPS. *See* Temp. Regs. §§ 20.2010-2T(a) and (b) and 25.2502-2T(a)(1)(i).

On the other hand, if surviving spouse ***W*** made taxable gifts in 2012 or 2013 before Spouse No. 2's death, ***W*** could still use the DSUEA that she "received" from Predeceased Spouse No. 1 for gift tax reporting purposes, because Spouse No. 1 would still be the DIPS. The subsequent death of Spouse No. 2 would mean that the still-unused part of the DSUEA from Spouse No. 1 could no longer be used by ***W*** with respect to *future* gifts or for estate tax purposes after her death. But the intervening death of Spouse No. 2 (who would become the DIPS) would not invalidate W's earlier use of the DSUEA from Spouse 1 for gift tax purposes, at times when Spouse 1 was still the DIPS. *See* Temp. Reg. § 25.2502-2T(c)(1). Here is how the preamble to the Temporary Regulations explains this concept:

> Under the rules in § 25.2505—2T, a surviving spouse may use the DSUE amount of a predeceased spouse as long as, for each transfer, such DSUE amount is from the surviving spouse's last deceased spouse at the time of that transfer. Thus, a spouse who has survived multiple spouses may use each last deceased spouse's DSUE amount before the death of that spouse's next spouse, and thereby may apply the DSUE amount of multiple deceased spouses in succession. However, this does not permit the surviving spouse to use the sum of the DSUE amounts of those deceased spouses at one time, and a surviving spouse may not use the remaining DSUE amount of a prior deceased spouse following the death of a subsequent spouse.

Preamble, Part 5 c, 77 Fed. Reg. at 36154-36155.

When a surviving spouse uses DSUEA amounts from multiple different predeceased spouses at different times, with respect to taxable gifts made by the surviving spouse, Temp. Reg. § 25.2505-2T(c) applies a special rule, which limits the usable applicable exclusion amount of the surviving spouse to the sum of (1) the DSUEA of the last deceased spouse *plus* (2) the part of the DSUEA of each other [previous] deceased spouse to the extent such DSUEA[s] were applied to one or more previous gifts by that surviving spouse. At any given time, this rule does not allow a surviving spouse to use the DSUEA from anyone except the last deceased spouse (DIPS).

If a surviving spouse receives a DSUEA as a result of a valid portability election following the death of a DIPS, the remarriage of the surviving spouse to someone else does not affect the availability of the DSUEA for future use, so long as the new spouse remains alive. Further, if the surviving spouse who receives a DSUEA remarries and then divorces, the still-living ex-spouse is not a DIPS, and the original DSUEA amount from the predeceased spouse remains available for use. *See* Temp. Reg. § 25.2502-2T(a)(3).

Although Code section 2010(c) itself is silent on this issue, Temp. Reg. § 25.2502-2T(b) says that when a surviving spouse has a DSUEA from a predeceased spouse and makes a taxable gift, the DSUEA is treated as being used first, *before* applying the surviving spouse's own applicable lifetime exclusion amount, in calculating the amount of the surviving spouse's *total* exclusion amount (own exclusion plus DSUEA) that is used up in the form of a credit against the gross gift tax on the taxable gift. This rule produces a slight benefit to any surviving spouse who has a DSUEA and who makes taxable gifts, by leaving more of the spouse's own exclusion "untouched" and available to be adjusted upward for inflation in later years.

The DIPS or "last deceased spouse" rules can create some hardship for a surviving spouse or for a surviving spouse's estate, because once a spouse satisfies the criteria to be the DIPS or "last deceased spouse," that spouse's DSUEA is the only DSUEA that could be used for estate tax purposes after the surviving spouse's later death — even if that last predeceased spouse has *NO* DSUEA, and even if a timely portability election is made on a Form 706 for that last predeceased spouse.

(D) *The 2012 Act's technical correction to Code section 2010(c)(4)(B) and what it means in "serial multiple marriage" situations*

When the "portability" concept was added to Code § 2010(c) in December 2010, various Congressional staffers, expert commentators, and Treasury personnel could not agree about whether subsections 2010(c)(2) and 2010(c)(4)(B), as enacted, would allow a surviving spouse to marry multiple spouses, to survive all but one of them, and to pass on to the last surviving spouse an exclusion amount that consisted of not only his or her own DSUEA, but at least a part of the DSUEA of the last deceased spouse.

This issue was presented squarely in "Example 3" in a December 2010 report of the Joint Committee on Taxation. That Example 3 has the same fact pattern as this writer's **Example 3** stated below. The consensus in late 2010 and early 2011 was that the Joint Committee had reached the result that Congress had intended, but that the wording of Code § 2010(c)(4)(B) was inconsistent with Congressional intent.

A technical correction to Code § 2010(c)(4)(B)(ii) — replacing the phrase "basic exclusion amount" with "applicable exclusion amount" was put into several estate tax reform bills that were stalled in the Congress in 2011 and 2012. The IRS's Temporary Regulations interpreted Code § 2010(c)(4)(B) in a manner consistent with the technical correction. Ultimately, the correction was included in ATRA 2012 (*see* Page 35 below).

The result of the technical correction is that if a Surviving Spouse 2 receives a DSUEA from Deceased Spouse 1, and if Surviving Spouse 2 marries Last Spouse 3 and dies before Last Spouse 3, then a timely portability election on a Form 706 for Spouse 2 will allow Last Spouse 3 to receive a DSUEA that includes not only the unused part of Spouse 2's own lifetime exclusion, but also at least part of the DSUEA from first Deceased Spouse 1, who was still the DIPS (last deceased spouse) of Spouse 2 at the time of Spouse 2's death.

As amended by the 2012 Act, subsection (c)(4) of Code § 2010 reads as follows:

> (4) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT. – For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of –
>
> (A) the basic exclusion amount, or

(B) the excess of –

(i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

Although subparagraph (i) allows the DSUEA calculation to include an unused DSUEA from a previous spouse, the "lesser of" structure and subdivision (A) will always limit the total DSUEA amount that can pass by any one deceased spouse to a surviving spouse to $5 million ***at most,*** because the "basic exclusion amount" is $5 million (not indexed for inflation).

(E) ***Some sample scenarios for calculating the DSUEA and the applicable exclusion amount of the surviving spouse at the "second death"***

The reader can verify the DSUEA computations in the following examples by using the gift tax or estate tax worksheets (as the case may be) in Sections C or D of Form 706 or in Schedule C of Form 709.

Example 1. Ginger died in February 2011 with a $3 million gross estate, all of which passed under her Will outright to her daughter Frieda. Her husband Fred was independently wealthy and did not elect to take against Ginger's Will. Ginger and Fred made no taxable gifts during their lifetimes, and so Ginger had a full $5 million lifetime exclusion available at her death in 2011. Ginger's taxable estate and transfer tax base was $3 million. Ginger therefore left $2 million of her $5 million exclusion unused and "on the table." Ginger's "deceased spouse unused exclusion amount" or DSUEA was $2 million.

Fred, as executor of the estate of his deceased spouse Ginger, filed a timely Form 706 for Ginger, which constituted a timely election under Code §2010(c)(5) to add Ginger's unused exclusion or DSUEA of $2 million to Fred's own $5 million lifetime exclusion amount. Fred then became able to use the combined exclusion amount of $7 million to shelter lifetime gifts from the gift tax. Fred's combined exclusion amount increased to $7,120,000 in 2012 because of the 2012 inflation adjustment to Fred's own $5 million exclusion. Fred made no taxable gifts in 2011 or 2012.

Fred died in December 2012 without having remarried. Because Fred used none of the $7.12 million combined exclusion to shelter 2011 or 2012 gifts from the gift tax, Fred's executor can use a total lifetime applicable exclusion of $7.12 million to reduce the estate tax on Fred's Form 706. The $7.12 million comprises Fred's own basic exclusion amount of $5,120,000 plus the $2 million DSUEA "transferred" from Ginger.

Example 2. Assume the same facts as in the previous example, except that late in 2011, surviving spouse Fred married Wilma. Wilma was an heiress who had children and grandchildren from her previous marriage and who made extensive lifetime taxable gifts. Wilma died early in 2012. Wilma's projected federal estate tax computation showed that none of her lifetime applicable exclusion amount (maximum $5.12 million) would go unused, so Wilma's DSUEA is zero. When Fred died later in December 2012, the portability election made by the executor for Fred's first spouse Ginger is no longer beneficial to Fred, because Ginger is not the "last such deceased spouse" of Fred (Wilma is the last deceased spouse). Fred will have only his own lifetime exclusion amount ($5,120,000) usable on Fred's Form 706.

Example 3. Heathcliff made $3 million in taxable gifts during his lifetime and died in 2011 with no taxable estate and an unused lifetime exclusion of $2 million. Heathcliff's estate made a timely portability election to permit his surviving spouse, Catherine, to use Heathcliff's unused exclusion.

Catherine had not made any taxable gifts during her lifetime, and so immediately after Heathcliff's death in 2011, Catherine had a total available lifetime exclusion of $7 million, comprising her own $5 million "basic exclusion amount" plus the $2 million DSUEA that was "transferred" from Heathcliff.

Late in 2011, Catherine remarried, to Edgar, and Catherine died in 2012, leaving Edgar as her surviving spouse. Catherine made no lifetime taxable gifts in 2011 or 2012 and had a taxable estate of $3.12 million. Catherine's estate made a timely portability election to permit Edgar to receive and use Catherine's unused exclusion amount.

Catherine's DSUEA is computed as follows under Code § 2010(c)(4), reflecting the technical correction, which was made retroactive in ATRA 2012:

DSUEA from Heathcliff in 2011	$ 2,000,000
plus Catherine's own lifetime exclusion amount at the time of her death in 2012	+ 5,120,000
Catherine's "applicable exclusion amount" at her death as defined in Code § 2010(c)(2)	$ 7,120,000
minus Catherine's transfer tax base under § 2001	– 3,120,000
Catherine's tentative DSUEA transferable to surviving spouse Edgar if a timely election is made	$ 4,000,000
Catherine's actual DSUEA transferable to Edgar (lesser of $5 million or $4 million)	$ 4,000,000

On the next page, **Example 4** illustrates the rule that if a deceased spouse made taxable gifts earlier in his lifetime, paid a net gift tax on some of those gifts, and later died, leaving a surviving spouse, then for the purpose of computing that deceased spouse's DSUEA, the amount of his lifetime taxable gifts (which ordinarily would be included in his transfer tax base under Code § 2001 and used in the DSUEA calculation under Code § 2010(c)(4)(B)), will be *reduced* by the amount of the gifts on which gift tax was paid for the year(s) in which those taxable gifts were made. *See* Temp. Reg. § 20.2010-2T(c)(2). This rule is intuitively "fair," because if the deceased spouse paid gift tax from his own funds on a lifetime taxable gift, that part of the gift should not be subtracted in determining his tentative DSUEA amount after his later death.

Example 4. Vic made his first lifetime taxable gift in 2002, in the amount of $2 million. Vic's gift tax lifetime exclusion amount was $1 million in 2002, so $1 million of the $2 million gift was taxable, and Vic used his own funds to pay the gift tax on the $1 million taxable portion. Vic made no other taxable gifts after the 2002 gift.

In 2004, Vic married Sadie. Vic died in 2011 with a federal taxable estate of $1 million, and Sadie survived him. If a Form 706 were required to be filed for Vic, the estate tax computation would look like this:

Vic's federal taxable estate	$ 1,000,000
plus Vic's lifetime taxable gifts	+ 2,000,000
Vic's transfer tax base on Form 706 (Line 5)	$3,000,000
Tentative tax on Line 5 amount	$ 890,800
minus Line 7 gift tax on lifetime taxable gifts, computed at 2011 rates (35% flat)	– 350,000
Gross estate tax before credit (Line 8)	$ 540,800
minus full applicable credit amount	– 1,730,800
Net federal estate tax due	0

Because $1 million of Vic's 2002 taxable gift (the part of the gift on which Vic paid gift tax) must be excluded from the DSUEA calculation, Vic's DSUEA is calculated as follows:

Vic's applicable exclusion amount in year of death (2011)	$ 5,000,000
minus Vic's taxable estate	– 1,000,000
minus Vic's lifetime taxable gifts on which Vic did *NOT* pay gift tax ($2 million minus $1 million)	– 1,000,000
Vic's tentative DSUEA under Code § 2010(c)(4)(B)	$ 3,000,000
Vic's actual DSUEA transferable to Sadie with a timely election on Form 706 (lesser of $3 million or $5 million basic exclusion)	$ 3,000,000

The last **Example 5**, on the next page, illustrates the use of the DSUEAs from more than one spouse where a surviving spouse remarries twice and uses the DSUEA from the first predeceased spouse to make *inter vivos* taxable gifts, plus the DSUEA from the second and last predeceased spouse to reduce the federal estate tax.

Example 5 is adapted from the Example in Temp. Reg. § 25.2505-2T(c)(2).

Example 5. Mike (Husband 1) dies on January 15, 2011, and is survived by Wife Liz. Neither Mike nor Liz had made any taxable gifts during Mike's lifetime. Liz, as Mike's executor, makes a timely portability election on Mike's Form 706. Mike's Will left all assets outright to Liz, and so Mike's taxable estate and transfer tax base are zero. Therefore, Mike's DSUEA is $5,000,000.

On December 24, 2011, Liz makes completed taxable gifts to her children in the total amount (minus annual exclusions) of $2,000,000. Liz filed a timely Form 709 for those 2011 gifts. Liz is treated as using up $2 million of Mike's DSUEA first, so Liz owes no net gift tax for 2011. At the end of 2011, Liz has a remaining applicable exclusion amount of $8 million (the remaining $3 million of Mike's DSUEA, plus Liz's own "untouched" $5 million exclusion amount).

In January 2012, Liz marries Eddie (Husband 2). Before Liz could make any further taxable gifts, Eddie dies in an accident on June 30, 2012. Eddie's DSUEA amount is $2 million, and Liz, as Eddie's executor, makes a timely portability election on Eddie's Form 706.

In the second half of 2012, after Eddie's death, Liz makes another taxable gift of $4 million to her children. For 2012 gift tax reporting purposes, the DSUEA that Liz can use with respect to her 2012 gift is $4 million, consisting of the $2 million DSUEA from Eddie (Husband 2) plus the $2 million of Mike's DSUEA that was applied to Liz's 2011 taxable gifts. Therefore, by the end of 2012, Liz has her own $5.12 million lifetime exclusion amount left, but she has no DSUEA left from Mike (Husband 1), because he ceased to be Liz's last deceased spouse or DIPS. And Liz has no DSUEA left from Eddie, because his entire $2 million DSUEA was used up.

Therefore, if Liz dies in 2013 without remarrying again and without making any further taxable gifts, her applicable exclusion amount at the time of her death, and usable on her federal estate tax return will be $5,250,000, consisting of her own exclusion amount, adjusted for inflation.

(F) ***Making a timely, valid portability election***

The only way to make a timely portability election is to file a timely Form 706 return for the deceased spouse, even if the size of the deceased spouse's gross estate or transfer tax base would not otherwise require a Form 706 to be filed. For this purpose, "timely filing" means filing Form 706 by the regular 9-month deadline, or timely filing Form 4768 to obtain an automatic 6-month filing extension, and then filing the Form 706 itself on or before the extended filing deadline.

Consistent with Treasury's previously-published guidance in 2011 and 2012, the Form 706 for 2012 decedents is structured so that a portability election is *automatically* made when Form 706 is timely filed. If, for some reason, the executor ***does not want*** to make a portability election, the executor should check a box in Section A of Part 6 and skip Sections B and C.

The IRS apparently has no plans to develop a "short-form" 706-EZ for decedents' estates that will not owe any net federal estate tax and that are filing Form 706 *solely* to make the portability election. Notice 2011-82 stated that for the purpose of making a valid portability election, the Form 706 that is filed must be a "complete and properly prepared return." However, the Temporary Regulations and the Form 706 Instructions allow the executor to omit the actual date-of-death market values of all assets for which a 100-percent marital deduction or charitable deduction is available. For each such asset, the executor must come up with a good-faith estimate of the value, look up that value in a range-of-values table (Page 16 of the Instructions), and then use the "plugged" value that the table supplies for that range. *See also* Temp. Reg. § 20.2010-2T(a)(7)(ii) and 2012 Form 706, Recapitulation Lines 10 and 23.

As of mid-November 2012, the official "party line" of the IRS's Cincinnati / Covington, KY center was that the IRS would eventually issue a federal estate tax closing letter for every Form 706 that is filed, even if the Form 706 was filed for a "no-tax-due" estate, solely for the purpose of making the portability election.

IV. Basic Estate & Gift Tax Planning Techniques to Consider or Use in and After 2013

(A) *The best news of all: A return to practical, non-tax-driven planning*

From 2002 through 2012, the U. S. gift and estate tax system was stuck in a pattern where either the top marginal estate and gift tax rate *or* the estate tax lifetime exclusion amount *or* both changed not less frequently than every two years. And in every year from 2009 through 2012, high-net-worth individuals faced the prospect of a sunsetting or significant change in estate or gift tax rules within a time frame as short as one year.

Even in 2012, when portability, a 35-percent top rate, and a "unified" $5 million lifetime exclusion were in effect, few knowledgeable people were willing to bet real money on the extension of these rules for more than a year or two. And so, for the last few months of 2012, high-net-worth estate planning clients seemed to fall roughly into four categories:

- Clients who made their large lifetime gifts in 2011, in order to quickly take advantage of the increase in the lifetime applicable exclusion amount and the lifetime GST exemption to $5 million apiece;
- Clients who scrambled to make their large lifetime gifts in late 2012, before the possible (probable? imminent?) decrease of the lifetime exclusion amount to $1 million on January 1, 2013, if EGTRRA and TRUIRJCA sunset occurred;

- Clients who had valid, rational motives to make large lifetime gifts in 2011 or 2012 but who were reluctant to "pull the trigger" and chose to wait until 2013 (or later), after Congress acted; and
- Clients who were willing to seize on any excuse to continue to procrastinate (Generalized "economic uncertainty" and Congressional dithering, dissembling, and delay are always sufficient reasons to put off planning decisions).

The procrastinating high-net-worth clients in the last group had a lot of company — clients with modest net worth and with little or no real exposure to federal gift and estate taxes, who also used "uncertainty" as an excuse to delay *basic* estate planning.

For most estate planning professionals (except the most fortunate or the most enterprising ones), most estate planning clients no longer have good reasons to worry about federal gift, estate, and GST taxes. And most of these clients have no good reasons to worry that federal transfer tax rules will become more onerous or confiscatory at any time in the foreseeable future. Therefore, 2013 marks the beginning of an era when most of our clients can focus their attention on what should have been the focus all along: The practical, non-tax-driven aspects of estate planning (who gets what, for what reasons, when, and with what restrictions or conditions), consistent with the real-world values, needs, and concerns of values the clients and their loved ones.

(B) ***For high-net-worth clients with surplus assets, continued use of lifetime taxable gifts (directly or in trust) to use lifetime exclusion amount***

Because the maximum lifetime exclusion amount will remain at $5.25 million (plus any future inflation adjustments) until Congress affirmatively acts to reduce the exclusion, and because the top marginal estate and gift tax rate is unlikely to be any lower than the current 40 percent, 2013 and later years continue to be a very good time for high-net-worth individuals to make large taxable gifts of surplus assets that they won't need for their own future financial security.

Any taxable gift that would not qualify for the marital or charitable deductions, and which therefore would generate a gift tax, is a potential way to use a high-net-worth client's lifetime exclusion amount. A lump-sum gift forgiveness of a significant pre-existing loan made to children or other family members could be an appropriate way to use a part of a $5.25 million lifetime exclusion amount.

In the current low-interest-rate environment (the section 7520 rate is 1.20 percent for February 2013 transfers), CLATs remain quite attractive, because the discounted present value of the lead annuity interest (and therefore the gift tax charitable deduction) will be larger when the section 7520 rate is lower).

Until Congress enacts further restrictions (*see* below), donors can continue to make gifts to GRATs and (if no other potentially appreciating assets are available for gifting) to QPRTs. Even if a GRAT or a series of "laddered" or "staggered" GRATs is not designed to have remainder interest(s) close to zero, and even though a QPRT will always have a remainder interest greater than zero, the $5.25 million lifetime exclusion amount makes it relatively easy to fund such GRATs and QPRTs without paying any net gift tax.

If there is a significant chance that a client could die within a short time after making a taxable gift of an asset with a low cost basis relative to market value, and if the *donees* have adjusted gross incomes large enough to cause them to be subject to the top 20 percent capital gains tax rate *AND* the 3.8-percent Medicare surtax, then the client should weigh the estate and gift tax advantages of a gift against the capital gains tax that the donee(s) would owe upon reselling the gifted asset, because of the loss of a basis step-up to fair market value if the client had not made the gift and had held the asset until death.

Three ideas that became popular in 2012, or at least received considerable discussion, are (1) the QTIP-eligible inter vivos trust with a delayed decision about whether to make the QTIP election, (2) the lifetime credit trust for the benefit of the donor's spouse (the SLAT, discussed separately below starting on Page 22), and (3) the retained income gift trust or RIGT. The QTIP-eligible inter vivos trust is not new and is self-explanatory, but the RIGT deserves a little discussion.

The essential idea behind the RIGT, which dates back to the mid-1990s, is that the donor makes a gift (ideally, a gift of an asset that will appreciate in value) to an irrevocable trust that contains an unusual and intentional defect: The donor retains the right to receive at least some of the income from the trust (but no principal distributions) for the donor's lifetime. An independent trustee has the discretion to distribute principal from time to time to the other beneficiaries. In practice, the trustee may exercise this discretion by making principal distributions in amounts that are at least equal to the appreciation in the trust assets from time to time. When the donor dies later, his retention of the life income interest will cause all of the trust assets to be included in his gross estate for estate tax purposes, and those assets will receive a stepped-up basis. The original gift to the trust will not count as a lifetime taxable gift, so the donor's lifetime exclusion amount will not be reduced. And the post-gift appreciation of the trust assets will have escaped estate tax to the extent that the appreciation was paid out in the form of principal distributions. If the donor paid a net gift tax at the time the trust was funded (because the original gift exceeded his or her lifetime exclusion amount) and if the donor lived at least three years, the gift tax paid would also be excluded from the donor's gross estate.

Whether gifts to RIGTs will still "work" may depend in part on whether the IRS would claim that the appreciation in the assets, which would not be left in the trust after the donor's death, should be excluded from the donor's adjusted (lifetime) taxable gifts as part of the estate tax computation under Code § 2001(b).

(C) ***Continued use of generation-skipping transfer tax lifetime exemption for gifts to skip persons or to GST trusts***

Because the maximum lifetime GST exemption will remain at $5.25 million (subject to future inflation adjustment) for the foreseeable future, 2013 is a very good time to fund generation-skipping trusts with lump-sum gifts, and to allocate GST exemption to those trusts to keep their inclusion ratios at zero.

Of course, whenever a donor makes a taxable lump-sum gift directly to skip persons or to a GST trust (unless the trust is a Health and Education Exclusion Trust [HEET]), that gift will also use up a dollar-for-dollar part of the donor's regular lifetime exclusion amount.

In this writer's opinion, as time passes, it will become more likely, not less likely, that Congress might enact some often-proposed restrictions on the ability of generation-skipping dynasty trusts to permanently avoid GST tax in every generation of skip person beneficiaries (*see* the separate discussion on Pages 28 and 29 below). The longer that a client waits to fund a GST-exempt dynasty trust, the greater the risk that Congress would enact restrictions before the trust could be funded.

(D) ***Use of lifetime exclusion to shelter gifts of paid-up life insurance policies from the gift tax***

For clients who are insurable, who want to use their lifetime exclusion amounts, and who are having a hard time identifying lifetime gift strategies that they like, a one-time lump-sum cash gift to an ILIT could be appropriate. The lump sum could be used to fund a single premium payment, and the ILIT would not need to include Crummey withdrawal powers or to receive further annual cash gifts to keep the life insurance in force. For a client who is no longer insurable at reasonable cost, even a one-time gift of a paid-up life insurance policy to an ILIT (including a policy purchased by the insured from an existing "old" ILIT) could be appropriate, so long as the client was willing to run or to manage the risk of dying within 3 years after making the gift of the policy.

(E) ***For married couples that have potential estate tax exposure after the "second death," use of traditional marital deduction formula clauses for A & B trusts (now less need, if any, to cap or adjust the credit shelter amount)***

During the 2002-2012 period, and because of the increase in the maximum estate tax lifetime exclusion amount every 1 to 2 years, the one-size-fits-all use of marital deduction formula clauses and A-B trust structures could lead to impractical results or even hardship for married couples who were merely "well off." If the total value of a couple's collective gross estates fell below the total of two lifetime exclusion amounts, a pecuniary credit shelter formula clause without a "cap" on the credit trust's size could end up forcing most or all of the couple's significant assets (other than joint tenancy property) into a credit trust *that was not actually needed in order to minimize or zero-out the federal estate tax, but which would nevertheless limit the surviving spouse's access to those trust assets.*

Now that we know that each spouse's maximum lifetime exclusion amount is going to remain at $5.25 million (plus future inflation adjustments) until Congress affirmatively changes it, it is easier for married couples to choose and use a specific dollar "cap" their documents, to put a limit on the amount of asset value that will be allocated and distributed to the credit trust. The cap need not be frequently updated.

In this writer's opinion, if the combined potential gross estates of a married couple is currently somewhat less than $10.5 million ($5.25 million times two), *AND* if the couple has not made any lifetime taxable gifts and has no plans to do such gifting, *AND* if there is some chance that their combined net worth could exceed $10.5 million by the time that either of them dies, then the use of a formula clause to fund a credit trust is appropriate, but it is not the only appropriate way to make maximum use of each spouse's lifetime exclusion amount. The couple and their lawyers should focus on the purely practical (non-tax) aspects of the design of the marital share (or marital trust) and credit trust. If the chosen structure will give the surviving spouse a significantly lesser interest in the credit trust (*e.g.*, no life income interest) compared to the marital share or marital trust, there may still be good practical reasons to put a dollar cap on the maximum amount of asset value that can be allocated to the credit trust via the formula clause.

A single QTIP trust structure (with a partial QTIP election) and a Clayton QTIP trust structure remain viable options for married couples in 2013 and later years.

(F) ***For married couples, formula clauses that fund the marital trust or marital share first with a "scaled back" pecuniary amount***

For those estate planning professionals who favor the use of formula clauses even for "merely well-off" married couples, so that the allocation and distribution of some asset value to a credit trust is *assured* to the extent necessary to cause zero estate tax to be owed by either spouse's estate, consider using ***an old technique*** — a formula clause that directs the personal representative or successor trustee to determine the amount of the marital share (or the amount passing to a section 2056(b)(5) trust where the spouse has a testamentary or lifetime general power of appointment) in *two steps*:

- For the first step, the Will or trust instrument directs the fiduciary to establish a tentative funding amount for the marital share or marital trust, equal to the entire residuary estate or trust residue.
- For the second step, the Will or trust instrument directs the fiduciary to decrease or scale back the bequest or distribution to the marital share or marital trust by the maximum amount that will increase the deceased spouse's taxable estate to the amount that can pass free of federal estate tax after applying the deceased spouse's unused lifetime exclusion amount, etc.

If the couple has a stable marriage, is "merely well-off," and does not face a huge risk of a large estate tax bill after the "second death," a formula clause that could allocate the entire residue to the marital share would produce less hardship and more flexibility for the surviving spouse than a pecuniary credit shelter formula clause that funds the credit trust *first* and leaves the remaining residue (which may be zero) to the marital share.

(G) ***Disclaimer-funded credit trusts still work***

This writer's long-standing prejudice is that a formula clause (either pecuniary credit shelter or pecuniary marital) is not *the best way*, or the only way, to minimize or zero out the federal estate tax after each death when the married clients fit the following profile:

- Stable relationship, no foreseeable likelihood of divorce
- A total net worth (both spouses' potential gross estates) that is less than or does not significantly exceed the total of their current unused lifetime exclusion amounts
- No "baggage" from previous relationships (such as 2 sets of children or other descendants from previous marriages whose interests must be protected after the "second death")
- Equal ability of each spouse to responsibly manage all the assets after either one of them dies

For such couples, this writer began using a "disclaimer-funded credit trust" (or "elective credit trust") structure early in the last decade, when either the top marginal estate tax rate or the maximum exclusion amount or both were changing nearly every year. With this structure, each spouse's Will or revocable trust leaves the entire residue outright to the surviving spouse. But if the surviving spouse decides that he or she doesn't need outright ownership of all of those assets, and would be financially secure with just a lifetime income stream in some of the assets, the surviving spouse can make a valid disclaimer of some chosen group or portion of the residuary assets. The disclaimer causes the disclaimed assets to flow into a credit trust that typically is (but need not be) a QTIP-eligible trust. Obviously, the remainder interests in the credit trust should be hard-wired in advance, with no ability by the surviving spouse to change where the remaining trust assets go after his or her later death.

With appropriate safeguards, the surviving spouse can serve as the trustee of the credit trust, and can have a five-and-five annual withdrawal power over trust principal in addition to a life income interest. An independent trustee could be given the discretion to invade principal for the spouse's benefit under a HEMS or similar standard.

After the "first death," if the surviving spouse does not disclaim the optimal amount to fund the credit trust and to use up all of the deceased spouse's unused lifetime exclusion, a portability election can be made to transfer the DSUEA to the surviving spouse.

The main disadvantage of the disclaimer-funded credit trust structure is that there is no assurance that the surviving spouse will feel sufficiently confident and secure, after the first death, to disclaim *any* assets, or the optimum amount, to fund the credit trust.

Now that we "know," with fairly high confidence, that the maximum lifetime exclusion amount is going to remain at $5 million per person plus inflation-indexing, there is less need to use the disclaimer-funded credit trust structure in order to keep a married couple's estate plan flexible and "Congress-proof." But for the purpose of maximizing the surviving spouse's flexibility while making it possible to fund a credit trust with the optimum amount to minimize or zero out the estate tax after each death, this structure will work as well in 2013 and later years as it did over the past dozen years.

(H) *Reminders about the advantages of "traditional" credit shelter trust planning over reliance on the portability election*

The availability of a portability election after the death of the "first-to-die" spouse has given married couples the chance to avoid wasting the deceased spouse's unused lifetime exclusion amount even though the deceased spouse's Will or trust documents reflect poor, outdated, or non-existent death tax planning. This displeases a few estate planning professionals, who apparently would prefer that such inattentive couples be punished, or at least denied a reward, for failing to do basic or updated planning to minimize death taxes.

The main advantages of portability elections are undeniable. A timely-made portability election will avoid the wasting of the deceased spouse's unused lifetime exclusion —

- No matter how the couple's estate planning documents are structured,
- No matter which spouse dies first, and
- No matter how the couple's assets are titled or how their beneficiary designations are worded.

In addition, to the extent that the estate plan puts more assets and more asset value into the potential gross estate of the surviving spouse, those assets will receive a second step-up (or step-down) to fair market value at the surviving spouse's later death.

Beyond the above advantages, however, standard or traditional death tax planning using credit trusts have several advantages, compared to reliance on the portability election alone:

1. The portability election alone does not remove asset value from the potential gross estate of the surviving spouse, and also does not protect future appreciation in assets' value from estate tax at the time of the surviving spouse's later death.

2. The portability election achieves only one goal (allowing the surviving spouse to receive the deceased spouse's unused exclusion amount or DSUEA) and does nothing to prevent the surviving spouse from mismanaging or making unwise dispositions of assets that he or she inherits outright. In contrast, a credit trust's assets can be professionally (or at least independently) managed for the benefit of the surviving spouse and eventually for the benefit of the remainder beneficiaries.

3. The DSUEA is not indexed for inflation, and if (for example) a deceased spouse's entire $5 million residuary estate passes to an outright marital share or to a section 2056(b)(5) marital trust, the growth in value of the marital share or marital trust will not be protected by the DSUEA at the time of the surviving spouse's later death unless her total estate is less than her total applicable exclusion amount (including the remaining DSUEA, if any).

4. The DSUEA amount could be wasted or disappear altogether if the surviving spouse does not make lifetime taxable gifts or if he or she *remarries and survives the death of* someone with a *lower* (or non-existent) potential DSUEA.

5. A portability election does not allow the first-to-die spouse's unused lifetime GST exemption to be "transferred" to the surviving spouse.

6. For as long as the Indiana inheritance tax continues to exist (under current law, until January 1, 2022), a portability election, by itself, will do nothing to save or reduce the inheritance tax that could be due on assets that pass outright to the surviving spouse and that are still owned by that spouse at the time of his or her later death. In contrast, it is quite easy to save substantial inheritance tax by funding a QTIP-eligible credit trust after the "first death," with children, grandchildren, and sons- and daughters-in-law as the remainder beneficiaries.

7. Credit shelter planning for a deceased spouse with gross estate smaller than $5.25 million will "work" even though no Form 706 is required or filed. In contrast, for that same deceased spouse, a portability election can be made *only* by filing a timely Form 706, with the corresponding preparation time and cost.

8. If the "executor" of the first-to-die spouse's estate — the person who has the authority to make the portability election —harbors some resentment, spitefulness, or ill will toward the surviving spouse, the executor may refuse to file a Form 706 (will not make the portability election), even though making the election would do no harm to the executor or to other surviving family members.

9. If a deceased spouse's estate plan relied on credit shelter planning and if no portability election is made, the statute of limitations for IRS examination of the Form 706 return and for assessment of federal estate tax runs 3 years after the later of the filing date or the filing deadline (Code §§ 6501(a), 6501(b)(1), and 6501(c)(4)). But if a portability election is made, the IRS's authority to examine

the deceased spouse's gift tax returns and estate tax return continues on an open-ended basis — and potentially until after the surviving spouse's later death — for the limited purpose of determining the correct amount of the deceased spouse's DSUEA. Code § 2010(c)(5)(B).

10. If a portability election is made, the surviving spouse will be entitled to receive disclosure of information from the IRS about the deceased spouse's estate tax return, and this entitlement to disclosure will continue for as long as the IRS is able to revisit the issue of the correct value of the DSUEA. *See* Temp. Reg. § 20.2010-3T(d).

(I) ***Some basic suggestions for structuring Spousal Limited Access Trusts (SLATs) with greater or lesser risk to married grantors***

"Spousal Access Trust" (SAT) or "Spousal Limited Access Trust" (SLAT) are two labels for a type of irrevocable trust that was used with increased frequency in 2011 and 2012, as a vehicle to receive a large *inter vivos* taxable gift, in order to use up some substantial part of a married donor's lifetime exclusion amount before (it was feared) the exclusion would decrease to as little as $1 million in January 2013.

The SLAT addresses an obvious need: Many married, wealthy individuals would *like* to make large taxable gifts, but they would prefer to continue to have some access to the gifted assets themselves, or to some of the income from those assets, if a way can be devised to keep the transferred assets out of their estates.

The SLAT is essentially an *inter vivos* credit trust with the donor's (grantor's) spouse as one of the beneficiaries, but structured so that the trust will not automatically qualify for the gift tax marital deduction, and so that the remaining SLAT assets will not be included in the gross estate of the grantor or the grantor's spouse upon their deaths, no matter which one of them dies first.

Although the grantor who creates and funds a SLAT will never be a direct beneficiary of the SLAT, the idea is that the grantor will nevertheless derive some financial security from the SLAT, because the grantor's spouse will be eligible to receive distributions and can spend those distributions for the benefit of both spouse and grantor.

In this writer's opinion, it is impossible to structure a SLAT to completely eliminate the risk that a later divorce will make the SLAT impractical or irrelevant as a source of financial support to the grantor or to the spouse. Further, even if the trust instrument defines the spouse's interest in the SLAT as purely discretionary, as the mere *eligibility* to receive distributions in amounts and at times decided by an independent trustee, if the *actual* distributions from the SLAT to the spouse become too regular and too predictable, that may arouse IRS attention, and lead to inquiries about how much of these regular distributions are ending up in the hands or the accounts of the grantor.

Here are the typical features of a SLAT's structure:

- The Trust (SLAT) should be funded only with assets that have been owned solely by the grantor for a significant period of time. Assets that currently are (or recently were) owned by the grantor and the grantor's spouse as tenants in common or as husband and wife are not suitable as gifts to a SLAT, because the IRS might be inclined to treat at least part of such assets as being transferred *by the spouse* to a trust in which the spouse is also a beneficiary, with the risk of inclusion in the spouse's gross estate under Code § 2036(a).
- The grantor cannot serve as the trustee of the Trust. (The grantor might retain the power to appoint, remove and replace an independent investment manager, but if the grantor himself or herself had the direct authority to manage the Trust's investments, that could give the IRS an argument for inclusion of the Trust assets in the grantor's estate under Code section 2038(a).)
- The trustee has the discretion (but never the obligation) to make distributions to or for the benefit of the grantor's spouse and one or more other current beneficiaries, such as the grantor's children or other descendants and/or (optionally) charities.
- After the death of the grantor's spouse, the administration of the Trust may continue for the benefit of the other beneficiaries (or for an enlarged or different class of beneficiaries), or the Trust may terminate, but in any event, the identities and interests of the ultimate beneficiaries are usually hard-wired (*But see* the next bullet point below).
- The Trust *may* (but need not) give the grantor's spouse a limited power of appointment, exercisable during lifetime or at death or both, to direct distributions to existing beneficiaries or to other persons (but not to the spouse, the spouse's estate, the spouse's creditors, etc.).
- If the Trust gives the spouse a limited power of appointment exercisable during lifetime, the *grantor* of the Trust may (but need not be) one of the permissible appointees (*See* the separate discussion of the section 2036 exposure below).

The following are generally regarded as favorable or low-risk features to include or advice to give regarding the design and funding of a SLAT:

(a) Despite the obvious temptations and advantages of making the largest possible gift (in 2012, up to $5.25 million) to a SLAT with no out-of-pocket gift tax cost, the grantor should be discouraged from giving away assets that he or she will need for the grantor's current and future financial security and comfort. The grantor should not assume that distributions from the Trust will flow freely to the grantor's spouse and then on to the grantor in whatever amounts are needed, whenever they are needed.

(b) If the grantor (settlor) wants the SLAT to be a grantor trust for income tax purposes and if the chosen method is to include a section 675(4) substitution power, structure the substitution power so that it is consistent with the safe harbor described in Rev. Rul. 2008-22.

(c) Do not allow the grantor's spouse to serve as the trustee of the Trust. The grantor's spouse can be given the power to replace the current trustee with a new trustee who qualifies as "independent" under Code section 672 and the corresponding regulations.

(d) The grantor's spouse (or any other beneficiary) can be given an annual, non-cumulative (lapsing) five-and-five withdrawal power with respect to the Trust's principal.

(e) Appoint one or more "independent" persons as the trustee(s) of the Trust. A bank or trust company or a trustworthy relative or friend (non-beneficiary) could be named as the co-trustee with exclusive authority over discretionary distributions, and a different co-trustee (also independent) could have authority over management of the Trust assets.

(f) Include a specific decanting power in the trust instrument, which would authorize decanting distributions to a new, second trust that may have fewer beneficiaries and give a stronger or weaker interest to the grantor's spouse or to any other beneficiary, but where the second trust *cannot* add new beneficiaries and *cannot* have the grantor as a beneficiary or as a trustee.

(g) Prohibit the trustee(s) from exercising discretion in any way that would discharge or satisfy the legal obligation of the grantor to support the spouse or an unemancipated child beneficiary (To prevent the trustee from being treated as having a general power of appointment under Reg. § 20.2041-1(c)(1)).

Other choices in "designing" a SLAT will increase the risk that after the death or the grantor or the spouse or both, the IRS will claim that all of the remaining assets in the SLAT are included in the decedent's (grantor's or spouse's) gross estate under Code sections 2036 or 2038. Here are some details about a few of those riskier design choices or features.

(h) *Having **both** the grantor and the grantor's spouse fund SLATs.* The principal risk from having both the grantor and the spouse create and fund SLATs in the same year is that if the two trusts are sufficiently similar in structure, the IRS may invoke the "reciprocal trust" doctrine[4] under which the two trusts would be "uncrossed," causing the grantor and the spouse to each be treated as

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[4] *See* ***Lehman v. Commissioner***, 109 F.2d 99 (2d Cir. 1940); ***United States v. Grace's Estate***, 395 U.S. 316, 89 S.Ct. 1730 (1969); ***Estate of Bischoff v. Commissioner***, 69 T.C. 32 (1977).

having made a section 2036(a) transfer to a trust under which he or she has retained an economic interest for life. If the IRS argument succeeds, then the assets of each trust are included in the gross estate of the person who created it.

(i) *Ways of limiting the risk from the "reciprocal trust" doctrine.* This risk can be eliminated if only one member of the couple creates and funds a SLAT. Expert commentators have identified other, less-effective ways to ***reduce*** the risk, including (1) structuring each trust so that the spouse of the grantor (Wife under Husband's trust, and Husband under wife's trust) has a significantly different economic interest in the SLAT under which he or she is a beneficiary, such as by giving the spouse a five-and-five power under only one of the SLATs (*see* PLR 200426008); (2) giving a broad limited power of appointment to the grantor's spouse under only one of the two SLATs (*see* ***Estate of Levy v. Commissioner***, T.C. Memo 1983-453); (3) creating and funding the two SLATs at different times, at least three months apart; or (4) structuring one of the SLATs so that the spouse of that SLAT's grantor is not a current beneficiary at all under that trust (*see* PLR 9643013).

(j) *Giving the spouse beneficiary under a SLAT a limited power of appointment that can be exercised to appoint Trust assets back to the grantor*. In this writer's opinion, this is extremely risky. If the grantor is the permissible appointee, and especially if the spouse actually exercises the power and appoints assets out of the Trust and to the grantor, the IRS will have an easier time arguing that in substance, the grantor has created a trust and has retained either a direct economic interest for himself or a *general* power of appointment. If the two members of a married couple insist on making the grantor a permissible appointee under the spouse's limited power of appointment, give written advice to both of them, discouraging the spouse from actually *exercising* the appointment power in favor of the grantor.

V. What Congress Might Do to Spoil or Complicate the Current "Regime"

(A) *A reminder about current fiscal pressures and constraints*

The August 2011 budget deal (The Budget Control Act of 2011, Pub. L. 112-25[5]) increased the federal debt ceiling, created the Joint Select Committee on Deficit Reduction (the "Super Committee") to agree upon a package of spending cuts, and required automatic across-the-board cuts in defense spending and in domestic spending other than Social Security and Medicare in the event that the Super Committee failed to report proposed spending reductions by November 23, 2011 (It

[5] The 2011 Budget Control Act amended the Balanced Budget and Emergency Deficit Control Act of 1985.

failed). In the short term (the first half of 2013), there are three main sources of budgetary pressure on Congress and the administration.

First, the automatic spending cuts, known as "sequestration," were supposed to occur starting on January 2, 2013, amounting to roughly $54.5 billion in defense spending reductions per year from 2013 through 2022 and an equal $54.5 billion reduction in non-protected domestic spending per year over the same 10-year period. However, section 901 of ATRA 2012 extended the date for the start of sequestration by two months, from January 2 to March 1, 2013. Further, because sequestration in 2013 will occur entirely in the last 7 months of the current federal fiscal year, the required spending cuts for fiscal year 2013 have been reduced to about $43 billion each from the "defense" side and the "domestic" side. It would be legal for federal agencies to push most of the actual spending cuts into the last 2 or 3 months of the fiscal year (July-September 2013).

Second, the current Continuing Appropriations Resolution ("continuing resolution" or "C R"), which was signed into law last September, expires on March 27, 2013. The House Appropriations Committee was reportedly working on a new C R during the week of February 18-22, but unless a new C R is passed by both Houses and signed on or before March 27th, the federal government's spending authority will be suspended after the 27th.

Third, an increase in the federal debt ceiling will be necessary by May 19, 2013, when the current agreed-upon suspension of the debt ceiling will expire. The debt ceiling itself is not a limitation on federal expending: it is a limitation on the ability of the Treasury Department to issue new federal government debt instruments and to make payments on existing federal debt. However, within the fantasyland inside the Washington Beltway, there is a powerful psychological linkage between the debt ceiling and Congressional aspirations to push for cuts in current and future federal spending.

As of mid-February 2013, Republicans in both the House and the Senate have voiced firm resistance to any further explicit tax increases in 2013. A number of GOP legislators have also opposed the deliberate use of comprehensive tax reform (*e.g.*, broadening the federal tax base by repealing deductions, credits and other loopholes, while decreasing at least some tax rates) to produce *increases* in federal tax revenue. These legislators prefer to keep such tax reform "revenue neutral" or "revenue-negative" overall.

In the current political climate, it seems unlikely to this writer that any proposals to increase estate, gift or GST tax revenue can pass in the 113th Congress. However, over a longer time span of more than two years, there is a greater potential for "unfavorable" changes to the federal transfer tax regime, because of the possibility for a change in party control of the House of Representatives in 2014 and changes in broad public opinion about the urgency of controlling the growth of federal spending. It is easy to imagine the addition of various kinds of specific tweaks and "corrections to the federal estate, gift and GST tax law, as bargaining chips and as part of a bigger package.

(B) *Possible future addition of more estate / gift tax brackets above 40 percent for the super-wealthy*

The economic burden or "footprint" of the federal estate tax and gift tax falls on a tiny fraction of U. S. households — a smaller number of households than was the case just 4 or 5 years ago, as a result of the increase in the lifetime exclusion amount from $2 million in 2008 to $5.25 million today.[6] The Joint Committee on Taxation projected that for filing year 2013 (and assuming that most taxable estates would be reporting and paying estate tax at the 35-percent top marginal rate), the total federal estate tax collected would be $11.375 billion. That is not a huge sum compared to the federal government's other tax collections or to the overall federal budget. And the cost of administering the federal estate tax (including audit costs) is relatively high.

This writer believes that a paradox could come into play as a result of fiscal or budgetary pressures. On the one hand, the federal estate tax raises a relatively small amount of revenue, and increasing estate tax revenues by adding additional, higher rate brackets or by closing "loopholes" would not be any rational policymaker's first choice of tools. On the other hand, the continued existence of the estate tax has some symbolic egalitarian value as a tool to decrease inequality of wealth and income, and the estate tax currently falls on so few families that it might be easy for elected officials to ignore or downplay the complaints from "a few rich people" if estate tax rates were increased or if loopholes were closed.

Therefore, and especially if the public and members of Congress come to see the federal government's long-term fiscal policies and total federal debt as a crisis requiring serious, immediate action, this writer would not be surprised if the addition of some higher marginal estate tax rates, or loophole closers, or both, were proposed and passed as a part of a larger package of reforms. Higher estate tax rate brackets for estates above $10 million and $50 million were already proposed in at least one Senate bill in 2010.

(C) *Broadening the estate/gift tax base (some dusty revenue-raising proposals from prior years)*

For several consecutive fiscal years, the Obama administration included a series of estate and gift tax reform ideas in its "Green Book" budget proposals. Although some of these ideas were translated into legislative language and included in bills introduced by

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[6] The IRS "statistics of income" data sets do not yet include official estate tax data for filing years after 2008. But in a November 2012 report, the Joint Committee on Taxation estimated that an extension of the TRUIRJCA rules ($5 million lifetime exclusion amount and a 35% top rate) would result in about 9,200 to 11,000 Form 706 returns filed in each of the years 2013 through 2017, with only 3,600 to 4,200 of each year's returns showing a net federal estate tax due. "Modeling the Federal Revenue Effects of Changes in Estate and Gift Taxation," JCX-76-12, November 9, 2012), p. 42, Table A-3. Pdf copy available at https://www.jct.gov/publications.html?func=download&id=4492&chk=4492&no_html=1

Democratic lawmakers, generally these ideas have gone nowhere. It is not clear how easy it would be for any of these proposals to receive consensus support from a bipartisan group in either chamber of the Congress. Perhaps the Administration continues to trot out these ideas in order to keep them in circulation.

Each of the following proposals appeared in last year's Green Book ("General Explanation of the Administration's Fiscal Year 2013 Revenue Proposals"), as released by the Treasury Department in February 2012[7].

1. *Modify rules on valuation discounts for gifts and at-death transfers* (Projected revenue increase for 2013-2022: $18.079 billion). This proposal would create a new, broad category of "disregarded restrictions" that would have to be ignored when determining the gift-tax or estate-tax value of an interest in a family-controlled business entity, where the interest is transferred to a member of the family. An alternate version of this idea would prohibit the claiming of any valuation discount for lack of marketability if the family business entity held passive investment assets and was not engaged in the operation of an active business. Regulations would create and allow some safe harbors, regarding either (a) the percentage size of discounts that could be claimed or (b) the restrictions on further transfer or liquidation rights that would *not* be disregarded.

2. *Require a 10-year minimum term for GRATs* (Projected revenue increase for 2013-2022: $3.334 billion). This proposal would apply to GRATs created after the date of enactment and would require every such GRAT to have a minimum term of 10 years. Further, the annuity payments could not be structured to decrease year to year during the term, and the remainder interest in the GRAT would have to have a calculated value (under Code § 7520) greater than zero (although a remainder interest of $0.25 or $0.59 would apparently be OK). The purpose of such a change would be to dissuade older taxpayers from creating and using zeroed-out GRATs, because they would have to take into account the risk that they would die before the end of the 10-year term, thereby destroying any estate tax savings.

3. *Limit the duration of the practical exemption from the GST tax for dynasty trusts* (Projected revenue effect: "negligible"). This proposal targets the use of perpetual dynasty trusts established in states that have either repealed their Rule(s) Against Perpetuities or allow trusts to opt out of the RAP. If a properly-structured dynasty trust is funded with one or more one-time, lump-sum transfers of amounts that do not exceed the aggregate lifetime GST exemptions of the transferors, the dynasty trust will have a permanent inclusion ratio of zero, and therefore an effective GST tax rate of zero, no matter how large the trust

[7] http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf

principal may grow in value. The proposal would provide that on the 90th anniversary of the creation of the trust, the inclusion ratio of the trust (and of all separate share trusts) would "flip" from zero to one (1), subject to exceptions for each trusts split off for a skip-person beneficiary, where the remaining assets would be included in that beneficiary's gross estate upon his or her death. This proposal would apply to GST trusts created after the date of enactment.

4. *Require the assets of many grantor trusts to be included in the grantor's gross estate for estate tax purposes* (Projected revenue increase for 2013-2022: $910 million). This proposal targets the use of intentionally "defective" grantor trusts for the purpose of removing and keeping asset value out of the gross estate of the grantor. This is the vaguest and most problematic of the Administration's proposals, because its potential scope is not clear. Effective for trusts that are created after the date of enactment and for the portion of any existing trust that is funded with a "contribution" made after enactment, the proposal would require that if a trust is a grantor trust for income tax purposes:

- The assets of the trust would be included in the grantor's gross estate for estate tax purposes;
- Any distribution made from the trust to one or more beneficiaries during the grantor's lifetime would be treated and taxable as a gift by the grantor; and
- If the grantor ceased to be treated as the trust's owner for income tax purposes during the grantor's lifetime, the remaining assets in the trust would be subject to gift tax.

The Administration's 2013 Green Book says that the proposal would not apply to GRITs, GRATs, PRTs, and QPRTs, because there are existing rules for estate inclusion that apply to such trusts. However, there is no exclusion in the proposal for ILITs that happen to be grantor trusts for income tax purposes. The proposal also seems not to recognize the fact that many types of irrevocable trusts may be grantor trusts in one year and non-grantor trusts in other years.

5. *Require consistency of basis reporting (for income tax purposes) by transferees who receive assets by gift or inheritance* (Projected revenue increase for 2013-2022: $2.014 billion). Effective for gifts and at-death transfers made after enactment, this proposal would require the recipients of a gratuitously-transferred asset to use, for income tax reporting purposes (gain or loss upon sale), that asset's basis as reported for gift tax purposes (substituted or carryover basis under Code § 1015) or for estate tax purposes (date-of-death fair market value under Code § 1014), subject to modification if the asset was received in 2010 from a decedent for which a modified carryover basis election was made on Form 8939). Versions of this proposal appeared in at least one House bill in 2011 and in two stalled bills in 2012.

Code section 6034A already requires beneficiaries of estates and trusts to take positions in their income tax reporting that are consistent with information reported by those estates and trusts for estate tax purposes. However, except for assets transferred at death in 2010 and for which a modified carryover basis election was made on a Form 8939, the current Code and Regulations do not clearly require an estate or a donor to *report* the stepped-up or carryover basis of a transferred asset *to the recipient*. Draft legislation based on the proposal would add a subsection or two to Code section 6035, requiring fiduciaries and donors to provide basis information to the donees or beneficiaries.

This writer doesn't know whether this proposal is a solution in search of a problem: How often does the recipient of a gifted or inherited asset report a basis on Form 1040, Schedule D that is *higher* than the date-of-death fair market value reported on Form 706 (for an inherited asset) or *higher* than the donor's basis (for an asset received by gift)? Perhaps the Treasury Department doesn't know, either. The text of this proposal does not draw a distinction between the date-of-death fair market value or the donor's basis in an asset, as reported on a Form 706 or Form 709 return, and the date-of-death fair market value or the donor's basis *as finally determined* for estate or gift tax purposes, after an audit or litigation. The proposal also does not mention the required addition to the donor's basis under Code § 1015(d) in the amount of the gift tax paid on the gifted asset.

The above five items are excellent examples of the kinds of ideas —some clever, some innocuous, some mediocre, some rotten — that can acquire staying power among federal tax policymakers. It's worth noting that the *combined* projected 10-year revenue increase from all five proposals is a tiny fraction of the projected 10-year cost (in foregone tax revenue) from ATRA 2012 as a whole: $3.635 trillion, according to the Congressional Budget Office.[8]

In this writer's opinion, the proposals on valuation discounts and short-term GRATs, in particular, are fairly likely to receive some serious consideration in Congress in the next several years, as lawmakers scramble to identify sources of revenue that can be marketed to their colleagues and to voters as "technical corrections" and "loophole closers."

Clients who are thinking of using valuation discounts in family gift planning, or of creating short-term GRATs, would be well-advised to put those plans in place sooner rather than later, before Congress changes the rules.

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[8] *See* http://www.cbo.gov/sites/default/files/cbofiles/attachments/American%20Taxpayer%20Relief%20Act.pdf

Appendix

Code Sections 2001, 2010, 2502, and 2505 as amended by ATRA 2012

Sec. 2001. Imposition and rate of tax

(a) IMPOSITION. A tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

(b) COMPUTATION OF TAX. The tax imposed by this section shall be the amount equal to the excess (if any) of –

(1) a tentative tax computed under subsection (c) on the sum of –

(A) the amount of the taxable estate, and

(B) the amount of the adjusted taxable gifts, over

(2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the modifications described in subsection (g) had been applicable at the time of such gifts.

For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

(c) RATE SCHEDULE.

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200 plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Over \$100,000 but not over \$150,000	\$23,800, plus 30 percent of the excess of such amount over \$100,000.
Over \$150,000 but not over \$250,000	\$38,800, plus 32 percent of the excess of such amount over \$150,000.
Over \$250,000 but not over \$500,000	\$70,800, plus 34 percent of the excess of such amount over \$250,000.
Over \$500,000 but not over \$750,000	\$155,800, plus ~~35~~37 percent of the excess of such amount over \$~~500,000.~~500,000
Over \$750,000 but not over \$1,000,000	\$248,300 plus 39 percent of the excess of such amount over \$750,000
Over \$1,000,000	\$345,800, plus 40 percent of the excess of such amount over \$1,000,000.

(d) ADJUSTMENT FOR GIFT TAX PAID BY SPOUSE. For purposes of subsection (b)(2), if –

(1) the decedent was the donor of any gift one-half of which was considered under section 2513 as made by the decedent's spouse, and

(2) the amount of such gift is includible in the gross estate of the decedent, any tax payable by the spouse under chapter 12 on such gift (as determined under section 2012(d)) shall be treated as a tax payable with respect to a gift made by the decedent.

(e) COORDINATION OF SECTIONS 2513 AND 2035. If –

(1) the decedent's spouse was the donor of any gift one-half of which was considered under section 2513 as made by the decedent, and

(2) the amount of such gift is includible in the gross estate of the decedent's spouse by reason of section 2035,

such gift shall not be included in the adjusted taxable gifts of the decedent for purposes of subsection (b)(1)(B), and the aggregate amount determined under subsection (b)(2) shall be reduced by the amount (if any) determined under subsection (d)which was treated as a tax payable by the decedent's spouse with respect to such gift.

(f) VALUATION OF GIFTS.

(1) IN GENERAL. If the time has expired under section 6501 within which a tax may be assessed under chapter 12 (or under corresponding provisions of prior laws) on –

(A) the transfer of property by gift made during a preceding calendar period (as defined in section 2502(b)); or

(B) an increase in taxable gifts required under section 2701(d),the value thereof shall, for purposes of computing the tax under this chapter, be the value as finally determined for purposes of chapter 12.

(2) FINAL DETERMINATION. For purposes of paragraph (1), a value shall be treated as finally determined for purposes of chapter 12 if –

(A) the value is shown on a return under such chapter and such value is not contested by the Secretary before the expiration of the time referred to in paragraph (1) with respect to such return;

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the taxpayer; or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

For purposes of subparagraph (A), the value of an item shall be treated as shown on a return if the item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.

(g) MODIFICATIONS TO GIFT TAX PAYABLE TO REFLECT DIFFERENT TAX RATES. – For purposes of applying subsection (b)(2) with respect to 1 or more gifts, the rates of tax under subsection (c) in effect at the decedent's death shall, in lieu of the rates of tax in effect at the time of such gifts, be used both to compute —

(1) the tax imposed by chapter 12 with respect to such gifts, and

(2) the credit allowed against such tax under section 2505, including in computing —

(A) the applicable credit amount under section 2505(a)(1), and

(B) the sum of the amounts allowed as a credit for all preceding periods under section 2505(a)(2).

-SOURCE-

(Aug. 16, 1954, ch. 736, 68A Stat. 373; Pub. L. 94-455, title XX, Sec. 2001(a)(1), Oct. 4, 1976, 90 Stat. 1846; Pub. L. 95-600, title VII, Sec. 702(h)(1), Nov. 6, 1978, 92 Stat. 2930; Pub. L. 97-34, title IV, Sec. 402(a)-(c), Aug. 13, 1981, 95 Stat. 300; Pub. L. 98-369, div. A, title I, Sec. 21(a), July 18, 1984, 98 Stat. 506; Pub. L. 100-203, title X, Sec. 10401(a)-(b)(2)(A), Dec. 22, 1987, 101 Stat. 1330-430, 1330-431; Pub. L. 103-66, title XIII, Sec.

13208(a)-(b)(2), Aug. 10, 1993, 107 Stat. 469; Pub. L. 105-34, title V, Secs. 501(a)(1)(D), 506(a), Aug. 5, 1997, 111 Stat. 845, 855; Pub. L. 105-206, title VI, Sec. 6007(e)(2)(B), July 22, 1998, 112 Stat. 810; Pub. L. 105-277, div. J, title IV, Sec. 4003(c), Oct. 21, 1998, 112 Stat. 2681-909; Pub. L. 107-16, title V, Sec. 511(a)-(c), June 7, 2001, 115 Stat. 70; Secs. 302(a)(2) and 302(d), Pub. L. 111-~~312.~~312; Sec. 101(c)(1), Pub. L. 112-240.)

Sec. 2010. Unified credit against estate tax

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

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

(c) APPLICABLE CREDIT AMOUNT. –

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

(2) APPLICABLE EXCLUSION AMOUNT. – For purposes of this subsection, the applicable exclusion amount is the sum of —

(A) the basic exclusion amount, and

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

(3) BASIC EXCLUSION AMOUNT. –

(A) *In General.* – For purposes of this subsection, the applicable exclusion amount is $5,000,000.

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

(i) such dollar amount, multiplied by

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

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

(4) DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT. – For purposes of this subsection, with respect to a surviving spouse of a deceased spouse dying after December 31, 2010, the term "deceased spousal unused exclusion amount" means the lesser of –

(A) the basic exclusion amount, or

(B) the excess of –

(i) the ~~basic~~applicable exclusion amount of the last such deceased spouse of such surviving spouse, over

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.

(5) SPECIAL RULES. –

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

(B) EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT. – Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

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

(d) LIMITATION BASED ON AMOUNT OF TAX. The amount of the credit allowed by subsection (a) shall not exceed the amount of the tax imposed by section 2001.

-SOURCE-

(Added Pub. L. 94-455, title XX, Sec. 2001(a)(2), Oct. 4, 1976, 90 Stat. 1848; amended Pub. L. 97-34, title IV, Sec. 401(a)(1), (2)(A), Aug. 13, 1981, 95 Stat. 299; Pub. L. 101-508, title XI, Sec. 11801(a)(39), (c)(19)(A), Nov. 5, 1990, 104 Stat. 1388-521, 1388-528; Pub. L. 105-34, title V, Sec. 501(a)(1)(A), (B), Aug. 5, 1997, 111 Stat. 845; Pub. L. 107-16, title V, Sec. 521(a), June 7, 2001, 115 Stat. 71.; Secs. 302(a)(1) and 303(a), Pub. L. 111-~~312.~~312; Sec. 101(c)(2), Pub. L. 112-240.)

Sec. 2502. Rate of tax

(a) COMPUTATION OF TAX. – The tax imposed by section 2501 for each calendar year shall be an amount equal to the excess of –

(1) a tentative tax, computed under section 2001(c), on the aggregate sum of the taxable gifts for such calendar year and for each of the preceding calendar periods, over

(2) a tentative tax, computed under such section, on the aggregate sum of the taxable gifts for each of the preceding calendar periods.

(b) PRECEDING CALENDAR PERIOD. Whenever used in this title in connection with the gift tax imposed by this chapter, the term "preceding calendar period" means –

(1) calendar years 1932 and 1970 and all calendar years intervening between calendar year 1932 and calendar year 1970,

(2) the first calendar quarter of calendar year 1971 and all calendar quarters intervening between such calendar quarter and the first calendar quarter of calendar year 1982, and

(3) all calendar years after 1981 and before the calendar year for which the tax is being computed.

For purposes of paragraph (1), the term "calendar year 1932" includes only that portion of such year after June 6, 1932.

(c) TAX TO BE PAID BY DONOR. The tax imposed by section 2501 shall be paid by the donor.

-SOURCE-

(Aug. 16, 1954, ch. 736, 68A Stat. 403; Pub. L. 91-614, title I, Sec. 102(a)(2), Dec. 31, 1970, 84 Stat. 1839; Pub. L. 94-455, title XX, Sec. 2001(b)(1), Oct. 4, 1976, 90 Stat. 1849; Pub. L. 97-34, title IV, Sec. 442(a)(2), Aug. 13, 1981, 95 Stat. 320; Pub. L. 100-203, title X, Sec. 10401(b)(2)(B), Dec. 22, 1987, 101 Stat. 1330-431; Pub. L. 107-16, title V, Sec. 511(d), June 7, 2001, 115 Stat. 70; Sec. 302(b)(2), Pub. L. 111-312.)

Sec. 2505. Unified credit against gift tax

(a) GENERAL RULE. In the case of a citizen or resident of the United States, there shall be allowed as a credit against the tax imposed by section 2501 for each calendar year an amount equal to –

(1) the applicable credit amount in effect under section 2010(c) which would apply if the donor died as of the end of the calendar year, reduced by

(2) the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods.

For purposes of applying paragraph (2) for any calendar year, the rates of tax in effect under section 2502(a)(2) for such calendar year shall, in lieu of the rates of tax in effect for preceding calendar periods, be used in determining the amounts allowable as a credit under this section for all preceding calendar periods.

(b) ADJUSTMENT TO CREDIT FOR CERTAIN GIFTS MADE BEFORE 1977. The amount allowable under subsection (a) shall be reduced by an amount equal to 20 percent of the aggregate amount allowed as a specific exemption under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) with respect to gifts made by the individual after September 8, 1976.

(c) LIMITATION BASED ON AMOUNT OF TAX. The amount of the credit allowed under subsection (a) for any calendar year shall not exceed the amount of the tax imposed by section 2501 for such calendar year.

-SOURCE-

(Added Pub. L. 94-455, title XX, Sec. 2001(b)(2), Oct. 4, 1976, 90 Stat. 1849; amended Pub. L. 97-34, title IV, Secs. 401(b), 442(a)(5), Aug. 13, 1981, 95 Stat. 299, 321; Pub. L. 101-508, title XI, Sec. 11801(a)(40), (c)(19)(B), Nov. 5, 1990, 104 Stat. 1388-521, 1388-528; Pub. L. 105-34, title V, Sec. 501(a)(2), Aug. 5, 1997, 111 Stat. 845; Pub. L. 107-16, title V, Sec. 521(b), June 7, 2001, 115 Stat. 71; Secs. 301(b) and 303(b)(1), Pub. L. 111-312.)