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Estate Tax Exemption Portability: What Should The IRS Do? And What Should Planners Do In The Interim?

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ESTATE TAX EXEMPTION PORTABILITY: WHAT SHOULD THE IRS DO? AND WHAT SHOULD PLANNERS DO IN THE INTERIM?

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Editors' Synopsis: This Article addresses the problem of the lack of portability of the estate tax exemption: if one spouse dies without using the exemption, it is lost, and the surviving spouse cannot retain it for later use. The authors trace the Internal Revenue Service's response to this problem through four private letter rulings and conclude that the analysis used in the rulings is problematic because it could undermine enforcement of the Internal Revenue Code in other contexts. Instead, the authors propose a new approach to resolving the portability problem and recommend that it be implemented administratively so that tax payers may employ it safely.

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I. INTRODUCTION

The estate tax exemption is not portable. As a result, if one spouse dies without having used the exemption, it disappears, and the surviving spouse cannot use the deceased spouse's exemption. While portability legislation has been proposed, Congress has failed to act thus far. Without portability legislation, estate planning has been difficult for a significant number of married couples who have what some may describe as intermediate-level wealth.

In a series of four private letter rulings,[1] the Internal Revenue Service (Service) has responded sympathetically, creating in effect an administrative solution to the portability problem.[2] The difficulty, however, is that taxpayers are unable to rely on such rulings. In the absence of published guidance, the Service may decide to change its position and then apply a new standard to taxpayers who have utilized the previously approved drafting blueprint without having secured their own ruling.[3] This

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[1] *See* Priv. Ltr. Rul. 200604028 (Sept. 30, 2005); Priv. Ltr. Rul. 200403094 (Sept. 24, 2003); Priv. Ltr. Rul. 200210051 (Dec. 10, 2001); Priv. Ltr. Rul. 200101021 (Oct. 2, 2000).

[2] For a discussion of the portability problem and the strategy approved in the rulings, see John F. Bergner, *Waste Not Want Not—Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41 U. MIAMI INST. ON EST. PLAN. P 1400 (2007); Len Cason, *IRS Ruling Approves 'Poorer Spouse Funding Technique,'* 31 EST. PLAN. 234 (2004); Len Cason, *Maximizing Funding of Credit Shelter Trust with Non-IRA Assets*, 29 EST. PLAN. 282 (2002); Reed W. Easton, *How to Fully Fund a Credit-Shelter Trust Without Transferring Assets or Using Retirement Plans*, 105 J. TAX. 349 (2006); Mitchell M. Gans & Jonathan G. Blattmachr, *Making Spousal Estate Tax Exemptions Transferable*, 19 PROB. & PROP., Nov.–Dec. 2005, at 10; John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 REAL PROP. PROB. & TR. J. 275 (2004); Michael D. Mulligan, *Is It Safe to Use a Power of Appointment in Predeceasing Spouse to Avoid Wasting Applicable Exclusion Amount?*, 32 TAX MGMT. EST., GIFTS & TR. J. 191 (2007).

[3] *See* Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005); Cook v. Comm'r, 115 T.C. 15 (2000), *aff'd*, 269 F.3d 854 (7th Cir. 2001). In these cases, the Service disavowed the taxpayer-friendly positions it had taken in private letter rulings and did not provide grandfather protection for these taxpayers who may have modeled their planning on the basis of the analysis contained in the rulings.

uncertainty is particularly problematic because, as will be explained, the Service's analysis in these rulings may be incorrect.[4] Indeed, incorporating the analysis in published guidance could undermine the Service's enforcement of the Code in unrelated contexts.

In this Article, we suggest a new approach. Under this approach, taxpayers would be able to navigate the portability problem, and the Service would not weaken unrelated Code provisions. In Parts II and III, we explain the portability problem and the Service's solution to it. In Part IV, we explore the Service's private letter rulings and critique the Service's analysis. In Part V, we present an alternative solution for the portability problem. We suggest that the Service implement our proposed solution administratively and allow taxpayers to employ it safely in the

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Under section 6110(k)(3) of the Internal Revenue Code (Code), a private letter ruling may not be cited or used as precedent. *See* I.R.C. § 6110(k)(3). On the other hand, if the Service issues published guidance, it may not change its position retroactively. *See generally* JONATHAN G. BLATTMACHR, MITCHELL M. GANS & DAMIEN RÍOS, THE CIRCULAR 230 DESKBOOK ch. 1 (PLI 2006). Unless the Code is unambiguously contrary to the ruling, the modern trend is to hold the Service bound by a taxpayer-friendly position taken in a ruling as long as the ruling has not been revoked at the time of the Service's challenge (even where the Service has revoked the ruling before asserting its new position in court but after the taxpayer has consummated the transaction, the trend is to hold the Service bound by its rulings). *See* Estate of McLendon v. Comm'r, 135 F.3d 1017 (5th Cir. 1998). But dicta in a Claims Court decision suggests that the Service may disavow retroactively taxpayer-friendly revenue rulings. *See* Mulligan, *supra* note 2, at 201 (citing Vons Cos. Inc. v. United States, 51 Fed. Cl. 1, 6 (2001)).

In *Vons*, the Claims Court suggests that the court in *McLendon* failed to apply the Supreme Court's decision in *Dixon v. United States*. *See Vons*, 51 Fed. Cl. at 7 n.4 (citing Dixon v. United States, 381 U.S. 68 (1965)). The Claims Court, however, fails to recognize four significant points: First, while the Supreme Court did permit the Service to disavow a taxpayer-friendly ruling in *Dixon*, the Service had revoked the ruling 10 years before it took a contrary position in the Supreme Court. *See Dixon*, 381 U.S. at 71 n.2. In contrast, in *McLendon*, the Service had not revoked the ruling at the time of the litigation. *See McLendon*, 135 F.3d at 1022. *See also* Rauenhorst v. Comm'r, 119 T.C. 157 (2002) (holding the Service bound by a revenue ruling that it had not revoked). Second, the Court in *Dixon* left open the possibility that a taxpayer could establish that retroactive revocation of a ruling is an abuse of discretion. Third, the Service, as *McLendon* suggests, now invites greater reliance on its rulings than it did at the time *Dixon* was decided. Finally, a distinction must be made—which the *Vons* court fails to make—between rulings that seek to resolve ambiguity in the Code and rulings that take a position contrary to an unambiguous Code provision. The Service may not undermine an unambiguous Code provision with rulings. *See* Comm'r v. Schleier, 515 U.S. 323, 336 n.8 (1995). Yet, nothing precludes the Service from definitively resolving the meaning of an ambiguous provision in favor of taxpayers.

[4] The American College of Trust and Estate Counsel has requested the Service to issue a published ruling, but the Service has not responded.

interim. Finally, we present our concluding comments.

II. THE PORTABILITY PROBLEM

Each taxpayer enjoys a "unified credit" against the estate tax.[5] The credit operates, in effect, as an exemption. If one taxpayer does not use the credit, it cannot be transferred to another taxpayer. Thus, if a husband has no assets and predeceases his wife, his unified credit is wasted in the sense that his wife cannot later apply any of his unused credit (exemption) against estate taxes due at her death.[6]

This waste of the credit may occur not only where, as suggested, a spouse dies without assets but also where a spouse bequeaths more than the optimal amount to the surviving spouse, overutilizing the marital deduction. For example, if a husband dies and bequeaths his entire estate to his wife outright, his exemption is wasted.[7] At the wife's subsequent death, her estate, which includes the assets received from her husband's estate, is fully taxable to the extent it exceeds her own exemption. Had the husband instead left his exemption amount in a credit shelter trust[8] for the benefit of his wife, his exemption would have been preserved; no tax would have been incurred at his death, and the assets in the trust would not be subject to tax at her later death.[9]

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[5] *See* I.R.C. § 2010.

[6] Note, however, that if the husband had made taxable gifts during his lifetime after 1976, they would constitute adjusted taxable gifts. *See* I.R.C. § 2001(b). As such, the gifts would in effect absorb at least part of the exemption and thereby prevent the exemption from being entirely wasted.

[7] Overutilization of the marital deduction can also occur even where the bequest for the benefit of the surviving spouse is not on an outright basis. For example, if the husband placed all of his assets in a trust with an income interest and a general power of appointment to his wife, the entire amount bequeathed in trust qualifies for the marital deduction. *See* I.R.C. § 2056(b)(5). At the wife's later death, her gross estate includes the entire corpus. *See* I.R.C. § 2041. Thus, although the bequest is not on an outright basis, the same potential for waste of the husband's exemption can occur.

[8] A "credit shelter trust" is a trust drafted to avoid inclusion in the surviving spouse's gross estate. The terms of the trust are designed to prevent Code sections 2033 or 2041 from applying in the surviving spouse's estate. When a spouse dies and bequeaths his or her exemption amount—the amount of assets that can pass free of estate tax by reason of the unified credit authorized in section 2010—to such a trust, the exemption is not wasted in the sense that the assets are not subject to estate tax in either spouse's estate. Although not necessary in order to protect the exemption, the trust is usually drafted to permit the surviving spouse access to the trust's assets so that he or she has an opportunity to continue enjoying them. As indicated, however, the access must be limited in order to prevent the application of Code sections 2033 or 2041 at the surviving spouse's death.

[9] Where a pension is involved, a spouse may choose to overutilize the marital

The Code's failure to make the exemption "portable," resulting in the wife's inability to use her husband's unused exemption in this example, cannot be justified as a matter of tax policy. To illustrate, assume that the husband of one couple has no assets and his wife has $8 million in assets, while the husband and wife of a second couple have $4 million in assets each. If both husbands die in 2007 survived by their wives, only the husband of the second couple will be able to use his exemption by placing assets in a credit shelter trust; the other husband's exemption would be wasted because he has no assets to place in such a trust. Thus, even though the two couples are situated identically in terms of aggregate wealth, one couple will be taxed more heavily than the other simply because of the way in which their assets are titled. The Code, in other words, inappropriately penalizes taxpayers who title their assets in a "suboptimal" way.

With proper planning, in many cases, taxpayers can avoid wasting the exemption. For example, the wealthier spouse can always make a gift to the poorer spouse of an amount of assets sufficient to use the poorer spouse's exemption. Ordinarily, such a gift, if made outright, will qualify for the gift tax marital deduction under section 2523 of the Code.[10] As a practical matter, however, the wealthier spouse may be uncomfortable parting with control of the assets. While this concern can be somewhat ameliorated through the use of a lifetime qualified terminable interest property (QTIP) trust[11] rather than an outright gift, many taxpayers may still find the loss of control (as well as the loss of income) that a QTIP trust entails objectionable. In all likelihood, however, concerns such as loss of control will not deter wealthier taxpayers from creating a QTIP or even from making an outright gift of an amount sufficient to avoid wasting the exemption. Concretely, if one spouse has $50 million and the other spouse has no assets, the wealthier spouse may not experience much

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deduction in order to save income tax; if the pension passes to the surviving spouse, rather than to a credit shelter trust, the income tax imposed on the pension may be deferred for a longer period of time. *See* Natalie Choate, *Funding a Credit Shelter Trust with Retirement Benefits*, TR. & EST., Nov. 2001, at 16.

[10] *See* I.R.C. § 2523(i). Section 2523 does not allow a gift tax marital deduction for a transfer made during lifetime to the transferor's spouse where the donee is not a U.S. citizen. *See id.* Also, in the case of a gift not made on an outright basis, no marital deduction applies if the interest given is a nondeductible terminable interest. *See id.* § 2523(b).

[11] See section 2523(f) of the Code for a description of a QTIP trust, which is a trust that may qualify for the gift tax marital deduction by election. See also section 2056(b)(7) for a description of such a trust for estate tax purposes.

discomfort in placing $2 million in a lifetime QTIP trust to make sure that the other spouse's exemption is not wasted.[12] Thus, in failing to provide portability,[13] the Code discriminates not only against couples who title their assets suboptimally but also in favor of wealthier taxpayers.[14]

III. THE SERVICE'S PORTABILITY SOLUTION

Mindful of these inequities, Congress has considered legislation that would make the exemption portable, allowing the surviving spouse to utilize the predeceased spouse's unused exemption.[15] But Congress has failed to act. As the amount of the exemption has increased (and continues to increase), the cost to taxpayers of wasting the exemption has increased concomitantly.[16] In the face of Congress's silence, the Service has attempted to provide its own solution in a series of recent private letter rulings.[17] In these rulings, the Service has adopted a taxpayer-friendly stance with regard to a strategy designed to prevent the poorer spouse from dying without having used his or her exemption.[18]

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[12] Indeed, because the spouse who creates a QTIP trust can, at the time of the trust's creation, select the beneficiary who takes the remainder interest at the donee spouse's death, a wealthy spouse may find such a trust to be a very attractive opportunity. The trust allows the donor spouse, in effect, to pass wealth to his or her chosen beneficiaries free of estate tax by utilizing the donee spouse's exemption. The trust can also reduce estate tax to the extent that the donee spouse's marginal estate tax bracket is less than that of the donor spouse.

[13] *See generally* Gans & Blattmachr, *supra* note 2 (discussing issues resulting from lack of portability and complications from attempting to balance spousal assets to reduce estate taxes).

[14] A spouse who is not concerned about the surrender of control can also utilize the other spouse's exemption by making an inter vivos gift to a third party and by having the non-transferor spouse consent to split the gift. *See* I.R.C. § 2513 (permitting the application of the donor and non-donor spouse's exemption against the gift).

[15] *See* Permanent Estate Tax Relief Act of 2006, H.R. 5638, 109th Cong. § 3 (2006).

[16] *See* I.R.C. § 2010; Gans & Blattmachr, *supra* note 2, at 11.

[17] *See supra* note 1.

[18] The Service, after discussing the portability issue, also addresses the basis question of whether section 1014(e) of the Code applies to deny a basis adjustment on the death of the donee spouse. *See* Priv. Ltr. Rul. 200210051 (Dec. 10, 2001); Priv. Ltr. Rul. 200101021 (Oct. 2, 2000). Although section 1014 is beyond the scope of this Article, the provision applies to deny a basis adjustment where the property passes back to the donor. While property did pass back to the donor (either outright or via a general power marital trust) in these two rulings, the question remains whether the same result would be appropriate where property passes into a discretionary credit shelter trust for the benefit of the donor (or perhaps even a QTIP trust or credit shelter trust mandating income distributions to the donor). *See* Priv. Ltr. Rul. 9321050 (Feb. 25, 1993) (denying a basis adjustment only with respect to the mandatory income interest in the trust for the benefit

A. The Basic GPOA Strategy

Under the General Power of Appointment (GPOA) strategy, the donor spouse creates a revocable trust that confers upon the donee spouse a general testamentary power of appointment. Because the trust is revocable, the donor does not have to surrender control of assets in order to implement the GPOA strategy. The trust provides that, at the death of the donee spouse, the donor's revocation power is extinguished. Thus, if the donor does not revoke the trust before the donee's death, the assets subject to the power pass at the donee's death into a trust for the benefit of the donor spouse. The recipient trust is designed so that the donor is a beneficiary of the trust without causing the trust assets to be included in the donor's gross estate. The trust can be funded either through the lapse of the donee's general power of appointment or through the donee's exercise of the power of appointment (in favor of such a trust created

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of the spouse). *Cf.* Tech. Adv. Mem. 9308002 (Nov. 16, 1992) (applying Code section 1014(e) where the property passed outright back to the donor spouse). As suggested in the technical advice memorandum (TAM), the Service presumably will argue that, section 1014(e) aside, no basis adjustment should occur when the GPOA strategy applies, even though property passes back to the donor via a discretionary trust, on the rationale that the property is not acquired from the decedent within the meaning of section 1014(b)(9). In other words, as the TAM appears to suggest, property passes into the trust at the donee's death by reason of the donor's decision not to revoke—not by reason of the donee's decision to exercise the power or to allow it to lapse.

If, however, a revocable QTIP strategy is used instead (for a discussion of this strategy, see *infra* Part V.A.), the basis adjustment would occur by reason of section 1014(b)(10), and the Service's section 1014(b)(9) argument would appear to become irrelevant. Nevertheless, the Service conceivably might argue that the property in the QTIP trust should be treated for income tax purposes as if entirely owned at all times by the donor spouse on account of its grantor-trust status. If the beneficiary/spouse is eligible to receive principal distributions as well as the trust's income, the donor spouse should be treated as the owner under section 677. *See* Rev. Rul. 85-13, 1985-1 C.B. 184. *See also* Jonathan G. Blattmachr, Mitchell N. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (2002) (suggesting that Code section 1014 apply on the assumption that the grantor of a wholly owned grantor trust had owned the trust's assets). However, such an argument would appear to be inconsistent with the clear and specific language in section 1014(b)(10) to the effect that basis is to be adjusted at the death of the spouse/beneficiary in the case of all QTIP trusts. For a further discussion of the basis issue, see Bergner, *supra* note 2; Charles Davenport, *Tax Basis Revocable Trusts: Many Questions, Few Answers*, 77 TAX NOTES 1175 (Dec. 8, 1997) (Letter to the Editor); Paul M. Fletcher, *Tax Basis Revocable Trusts*, 63 TAX NOTES 1183 (May 30, 1994); Malcolm A. Moore, *Estate Planning for the Surviving Spouse*, ESTATE PLANNING IN DEPTH, SK093 ALI-ABA 1073 (2005); Mulligan, *supra* note 2. *See also* Gans & Blattmachr, *supra* note 2.

under the donee's will).

To illustrate the usefulness of the GPOA strategy, consider two cases. In the first case, one spouse is much wealthier than the other but is unwilling to relinquish control of his or her assets. For example, assume the wife has $8 million in assets and the husband has no assets. In order to retain control over her assets while preventing her husband from wasting his exemption should he predecease her, the wife implements the GPOA strategy by placing $2 million in a revocable trust under which the husband has a testamentary general power. If the husband dies during 2007, the $2 million in the trust is included in his gross estate but generates no estate tax because of his exemption.[19] At the wife's later death, her gross estate does not include the assets subject to the husband's power because the assets remain in trust. Thus, his exemption, which would have been wasted otherwise, is preserved.

In the second case, the wife is not concerned about retaining control over her assets. Instead, the couple's difficulty stems from the character of their assets. For example, assume the wife has $4 million in an Individual Retirement Account (IRA)[20] and the husband has conventional—non-IRA and non-pension—assets having an equal value. To reach an optimal income tax result, the wife should name her husband as the outright beneficiary of her IRA.[21] But if, having done so, she predeceases her husband, her exemption would be wasted. To prevent this, the husband could use the GPOA strategy, giving the wife a general power under his revocable trust. The IRA money would then pass to the husband at her death, qualifying for the marital deduction, and the assets in his revocable trust that are subject to her power would be used to absorb her exemption and fund a credit shelter trust for his benefit after her death. In sum, the strategy can be very helpful in solving the portability problem if recognized as valid by the Service.

B. The Service's Analysis of the GPOA Strategy

According to the Service, the GPOA strategy produces the following consequences: First, because of the donor's revocation power, the donor does not make a completed taxable gift when the trust is created. Second,

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[19] *See* I.R.C. § 2010 (permitting an exemption of $2 million for a decedent dying in 2007).

[20] *See* I.R.C. § 408 (defining an IRA and providing special income tax benefits applicable to an IRA).

[21] *See, e.g.*, Natalie B. Choate, *When a "Trust for the Spouse" Is Treated the Same as "the Spouse,"* TR. & EST., Sept. 2001, at 36.

when the donee spouse dies, because the donor's revocation power is extinguished, the gift—the grant of the general power of appointment—becomes complete. Third, the gift is not taxable because it qualifies for the lifetime marital deduction.[22] Fourth, because the donor spouse is deemed to make the gift to the donee spouse, the donor is not treated as making a taxable gift at the death of the donee to the beneficiaries under the trust—the trust receiving assets on account of lapse or exercise of the donee's power. Instead, the donee is viewed as making the transfer to these beneficiaries. Fifth, because the donee has a general power of appointment, his or her gross estate includes the assets subject to the power.[23] Finally, at the donor's later death, the donor's gross estate does not include the assets in the trust even though the donor was the sole source of the trust's assets and even though the donor was a trust beneficiary. Indeed, the Service has even concluded that inclusion is not required where the donor spouse has a special power of appointment over the trust's assets.[24] Thus, after the donee spouse's death, the trust functions as a credit shelter trust, preventing the waste of the donee spouse's exemption. If the Service's analysis is correct, the donor spouse is able to retain control over, as well as a beneficial interest in, his or her assets without wasting the donee spouse's exemption.

The Service's analysis is predicated on the taxpayer-friendly resolution of two critical issues: First, that the gift made by the donor at the death of the donee is made to the donee, not his or her estate and not to the beneficiaries of the credit shelter trust, and that by reason of the lifetime marital deduction, no taxable gift occurs;[25] and, second, that after the death of the donee the trust will function as a credit shelter trust so that its assets will not be included in the donor's gross estate under section 2036 or 2038 (or otherwise) at the donor spouse's later death. Were the Service to reach a different conclusion on either of these two issues, the GPOA strategy would be ineffective. Indeed, taxpayers who employ the GPOA strategy without obtaining a private letter ruling run the risk that the Service will change its position on either one of these issues.[26]

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22 As suggested, no marital deduction would be available if the donee spouse were not a U.S. citizen. *See* I.R.C. § 2523(i).

23 *See* I.R.C. § 2041(a).

24 *See* Priv. Ltr. Rul. 200101021 (Oct. 2, 2000).

25 *See* I.R.C. § 2523.

26 *See* I.R.C. § 6110(k)(3) (stating that the Service is not bound by its reasoning in a private letter ruling).

IV. AN EXAMINATION AND CRITIQUE OF THE SERVICE'S RULINGS

While the Service's attempt to fashion an administrative solution to the portability problem is commendable, it would be unfortunate if the Service inadvertently undermined settled principles that have application beyond the portability strategy. Perhaps this concern accounts for the Service's reluctance thus far to address the strategy in published guidance such as a revenue ruling or regulation.[27] On the one hand, the Service's marital deduction analysis in the private letter rulings is not problematic. The analysis does not, in other words, pose a threat to settled principles. On the other hand, the Service's conclusion that the trust corpus is not taxable on the donor spouse's later death does indeed pose such a threat.

A. Qualification for the Gift Tax Marital Deduction

As suggested, a critical issue in the GPOA strategy relates to the marital deduction: whether the donor's gift, which occurs when the donor's revocation power is extinguished at the donee's death,[28] qualifies for the deduction. The Code provides that in order to qualify the gift must be made "to a donee who at the time of the gift is the donor's spouse."[29] Thus, the availability of the deduction turns on whether the donor and donee are married at the time the gift becomes complete. If the gift becomes complete the moment before death, the marital deduction is unquestionably available. If, on the other hand, the gift becomes complete the moment after the donee's death, the deduction clearly should not be permitted because the donor and the donee are no longer married at that point. But what if the gift is viewed as becoming complete at the very moment of death rather than the moment before or after death? Taking this view, one could allow the gift to qualify for the marital deduction without adversely affecting settled principles. Indeed, two lines of authority under existing law in analogous contexts treat the transfer as occurring for transfer tax purposes at the moment before death—even though the recipient's right does not fully mature until the moment of death.

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[27] Unlike a private letter ruling, a revenue ruling is generally reliable guidance to taxpayers and binds the Service. *See supra* note 3 and accompanying text.

[28] *See* Treas. Reg. § 25.2511-2(c).

[29] I.R.C. § 2523(a).

B. Common Disaster Line of Authority

First, the estate tax marital deduction regulations provide that if spouses die in a common disaster and no evidence exists as to the order of their deaths, a bequest made by one spouse to the other will qualify for the deduction if state law or the will presumes that the legatee spouse has survived.[30] The regulations further provide, however, that the deduction is only available to the extent that the Code requires that the bequeathed amount be included in the legatee spouse's estate.[31] Thus, if both spouses die at the same moment and the bequest is therefore made at the moment of death—not the moment before or the moment after death—the deduction is not denied on the ground that the marriage had already ended.[32]

In *Estate of Bagley v. United States*,[33] no evidence as to the order of the death of the spouses existed. The husband's will created a trust for the benefit of the wife, giving her a general testamentary power of appointment over the trust. The will also adopted the presumption that, in the case of a common disaster, the wife would be deemed to survive. The husband's estate took the marital deduction, and the Service allowed it.[34] The wife's estate argued that the property subject to the power should not be included in her gross estate. The court rejected this argument. Concluding that the power was conferred on the wife at the moment of the husband's death—which, given the lack of evidence as to the order of deaths, plausibly could have been at the moment of the wife's death—the court's holding required the wife's estate to include the property subject to the power under section 2041.[35] Although the Service did not challenge the deduction in the husband's estate, and the court therefore did not address it, clearly the court and the Service were in tacit agreement that the taxpayer took the deduction correctly.

Thus, the common disaster regulations, along with the court's decision in *Bagley*, suggest that a bequest (or gift) deemed to occur at the moment of the recipient spouse's death is made while the spouses are still

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30 *See* Treas. Reg. § 20.2056(c)-2(e).

31 *See id.*

32 *See* Estate of Gordon v. Comm'r, 70 T.C. 404 (1978) (applying the simultaneous death regulation and permitting the marital deduction).

33 443 F.2d 1266 (5th Cir. 1971).

34 *See id.* at 1267.

35 *See id.* at 1269–70. The husband's estate claimed the marital deduction on the ground that the trust qualified for the estate tax marital deduction under Code section 2056(b)(5). *See id.* at 1267.

married. While the common disaster regulation applies, by its terms, only to cases where both spouses die at approximately the same time and with no evidence as to the order of death, no policy justification exists for refusing to extend this rationale to the GPOA strategy. Indeed, as suggested, the Service appropriately is seeking to find an administrative solution to the portability problem. Extending the common disaster rationale in the fashion suggested in order to accomplish this objective would pose no threat beyond the strategy.

C. *Johnstone* Line of Authority

The second line of analogous authority under existing law that supports the moment-before-death theory stems from the Ninth Circuit's decision in *Johnstone v. Commissioner*.[36] In *Johnstone*, the donor created an inter vivos trust for the benefit of her son, granting him a general testamentary power of appointment. During her life, she had the right to alter or amend, but not revoke, the trust.[37] At the moment of the son's death, the donor's ability to modify or eliminate the son's power was extinguished.[38] After alluding to the notion that a person holding a power does not have a general power of appointment because of an outstanding contingency that is not resolved during his or her lifetime,[39] the court held that the son had a general power of appointment and that the property subject to the power was therefore included in his gross estate.[40] The holding in *Johnstone*, which the Service embraces,[41] thus suggests that, where the donor's ability to eliminate the donee's power is extinguished at the moment of the donee's death, the donor's power creates a

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36 76 F.2d 55 (9th Cir. 1935).

37 *See id.* at 56.

38 *See id.* at 58.

39 *See* Treas. Reg. § 20.2041-3.

40 *See Johnstone*, 76 F.2d at 59. Under the law in effect at the time of the *Johnstone* decision, the gross estate would include property subject to a general power only if the person holding the power had exercised it. In *Johnstone*, the court concluded that the decedent had in fact exercised the power. *See id.*

41 *Johnstone* remains good law. In *Estate of Margrave v. Commissioner*, 71 T.C. 13 (1978), *aff'd* 618 F.2d 34 (8th Cir. 1980), *acq.* Rev. Rul. 81-166, 1981-1 C.B. 477, the majority and some of the dissenting judges did disagree on the import of *Johnstone*. Not one of the judges, however, questioned the continued viability of *Johnstone*. Furthermore, in Revenue Ruling 81-166, 1981-1 C.B. 477, the Service implicitly endorsed the continuing viability of *Johnstone* by holding that *Margrave* represents a narrow life-insurance-related exception to the rule that property subject to a general power of appointment is includible in a decedent's gross estate, even if the property interest is subject to a power of revocation up to the moment of death.

contingency[42] that is deemed to be resolved during the donee's lifetime[43]—before the moment of death.[44] In short, *Johnstone*

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[42] It must be conceded that *Johnstone* could be read differently. Under section 2041(b)(1)(C)(i) of the Code, a person holds a non-general power if it can only be exercised with the consent of the person creating the power (in the case of a pre-1942 power, as in Johnstone, the power is a non-general power if its exercise requires the consent of any person). Thus, *Johnstone* could be read as holding that, at the moment of death, the decedent had a general power because, at that point, the need for the donor's consent had been extinguished. As between these two readings, it would seem that *Johnstone* is better understood as based on the contingent aspect of the power. To illustrate, assume that A is given a general power and that the instrument further provides that B, a trust protector who has no beneficial interest, can eliminate A's power by amending the instrument. Given B's ability to eliminate the power, it should not be viewed as a general power as long as B has the power to amend. This is not because B's consent, or cooperation, is required in order for A to exercise it. For, under section 2041(b)(1)(C)(ii), the requirement that the power holder secure the consent of a person without any interest in the trust does not render it a non-general power. Rather, it is because the power is subject to a contingency: that B not amend the trust to eliminate the power. *See* United States v. Merchants Nat'l Bank of Mobile, 261 F.2d 570 (5th Cir. 1958) (indicating that a third party's right to eliminate a power renders it a non-general power on the rationale that, as a result of the third party's right, it is not exercisable by the person holding the power). Note, parenthetically, the rather subtle difference between this analysis of a power subject to an amendment power and a case where the power holder can only exercise it with the consent of a third party having no beneficial interest. In the latter case, the requirement for third-party consent does not render it a non-general power. *See id.* And one cannot take the position that it is a non-general power on the ground that it is subject to the contingency of securing the third party's consent without rendering this clear Code provision meaningless. But whether one reads *Johnstone* as a consent case or as a contingency case, the result is the same: the decedent held a general power of appointment because, during his lifetime, the contingency/consent issue had been resolved. There is one other alternative reading of *Johnstone* to consider. Under this reading, even if the donor's modification power had remained intact after the decedent's death, inclusion still would have been required.

However, no authority would support the application of section 2041 of the Code in this context. Indeed, in *United States v. Turner*, 287 F.2d 821, 827 (8th Cir. 1961), the government's argument was based on the premise that section 2041 cannot apply where the donor retains a revocation power, and the court agreed with this premise. *See also Merchants Nat'l Bank of Mobile*, 261 F.2d at 573–74 (indicating that any outstanding contingency, like a revocation power, precludes inclusion in the power holder's estate unless the contingency is resolved at the moment of the power holder's death or earlier). *But see infra* note 45 (discussing Revenue Ruling 67-370, 1967-2 C.B. 324, which addresses an analogous issue in the section 2033 context).

[43] *Johnstone* has been distinguished from later authorities that refuse to apply section 2041 (as well as section 2033) where the claim or right had not accrued until the moment after death and was therefore a mere expectancy. *See* Rev. Rul. 75-126, 1975-1 C.B. 296 (embracing Connecticut Bank and Trust Company v. United States, 465 F.2d 760 (2d Cir. 1972), and therefore concluding that wrongful death proceeds should not be included in

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the decedent's gross estate because the claim does not exist until after the decedent has died); Rev. Rul. 75-127, 1975-1 C.B. 297 (same); *Margrave*, 618 F.2d at 38–39 (refusing to apply section 2041 where life insurance on the decedent's life was owned by a third party and was payable to the decedent's revocable trust on the ground that the decedent's general power was "merely a power over an expectancy"). *See also* Estate of Barr v. Comm'r, 40 T.C. 227 (1963) (holding that a pension benefit was not includible in the employee's estate because payment was within the discretion of the employer, and it was therefore a mere expectancy); *but see* Treas. Reg. § 20.2039-1(b), ex. 4 (indicating that a retirement payment made to the decedent's spouse is included under section 2039 even though the employer had no legal obligation to make payment provided that the employer had a policy of making payment in such circumstances). The distinction, according to the Tax Court majority in *Margrave*, is that, in *Johnstone*, assets, not a mere expectancy, were in the trust subject to the decedent's power at the time of death; in contrast, in the later authorities, there was nothing more than an expectancy that did not ripen into an asset or claim until after death. *See Margrave*, 71 T.C. at 19. *See also Conn. Bank & Tr.*, 465 F.2d at 763.

This distinction, however, is somewhat troubling. For while *Johnstone* did not involve an expectancy in a technical property-law sense, it could easily be viewed as such in terms of its substance given the fact that the decedent's power could have been extinguished until the moment of death. *See Margrave*, 618 F.2d at 38–39 (indicating, without discussing *Johnstone*, that, if the donor retains the right to revoke the power, there is only an expectancy subject to the power, and section 2041 therefore cannot apply). *But see* United States v. Merchants Nat'l Bank of Mobile, 270 F.2d at 573–74 (embracing *Johnstone* on the ground that a general power is taxable even though subject to a contingency as long as it is resolved at or before the power holder's death); Tech. Adv. Mem. 7744010 (July 29, 1977) (suggesting that the donor's right to revoke a power of appointment does not defeat the application of section 2041). Indeed, if *Johnstone* is correct, it creates the problematic potential for double taxation: the grantor of a trust similar to the one in *Johnstone* would be treated as having made a taxable gift at the moment of the power holder's death. *See* Treas. Reg. § 25.2511-2(f) (resulting in the simultaneous imposition of the gift tax on the grantor and estate tax in the power holder's estate). While this was not the result in *Johnstone* because the gift tax had not yet been enacted—indeed, had the court ruled differently, the assets in the trust would have passed in accordance with the decedent's direction without being subject to any transfer tax—the court's holding does create the potential for this outcome.

Were the Service to disavow *Johnstone* on the ground that the decedent's power related to what was in substance a mere expectancy, the potential for double taxation would be eliminated. *See* Mitchell M. Gans & Jay A. Soled, *A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference*, 7 FLA. TAX REV. 569 (2006) (discussing the government's ability to overrule adverse court decisions by regulation); BLATTMACHR, GANS & RIOS, *supra* note 3, ch. 1. The grantor would be treated as making a taxable gift at the time of the power holder's death and the trust's assets would not be included in the power holder's gross estate. This would appear to be the correct outcome given the reality, as suggested, that the power holder's interest in the trust is no more substantive, at the time of death, than the decedent's right to receive the wrongful death proceeds in the cited revenue rulings or the decedent's right to control the life insurance proceeds in *Margrave*. Were the Service to take this approach, it could supports the Service's implicit conclusion in the private letter rulings that the donor spouse's revocation power is deemed to be extinguished the moment before the donee spouse's death—while they are still married.[45]

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nonetheless confirm the availability of the marital deduction in the context of the GPOA strategy. After all, it would be consistent with the policies underlying the marital deduction to do so, as the common-disaster authorities reflect.

[44] A distinction appears between *Johnstone* and the GPOA strategy approved in the private letter rulings. While in *Johnstone* the donor could have eliminated the son's power of appointment, she could not revoke the trust. In contrast, in the private letter rulings the donor spouse had the right to revoke the trust in its entirety. The difference is not a significant one. Indeed, if the Service or the courts were to deem the difference significant, the GPOA strategy could be salvaged nonetheless by making the donor's retained power parallel to the donor's power in *Johnstone*. Like a revocation power, the power to modify would render the donor spouse's gift incomplete until the donee spouse dies. *See* Treas. Reg. § 25.2511-2(c).

[45] *But cf.* Rev Rul. 73-207, 1973-1 C.B. 409 (indicating that, for gift tax purposes, a gift that occurs at the moment of the husband's death cannot be split with the wife because they are no longer married at that moment).

Had the donor's modification power in *Johnstone* remained intact after the son's death, the property subject to the power presumably would not have been included in the son's gross estate. For, as suggested, a power subject to a contingency that remains unresolved at the time of the power holder's death should not be subject to section 2041 (or the predecessor provision at issue in *Johnstone*). *See Margrave*, 618 F.2d at 38–39; *Turner*, 287 F.2d at 827; *Merchants Nat'l Bank of Mobile*, 261 F.2d at 573. Indeed, as the Eighth Circuit in *Margrave* suggests, even if the donor's right to revoke the power is extinguished at the moment of death, the power should not trigger section 2041 on the rationale that the power relates to a mere expectancy. Thus, where a donor confers a power of appointment on a donee, inclusion in the donee's estate under section 2041 should only occur if donor's gift becomes complete prior to the moment of the donee's death (and, perhaps, as the Eighth Circuit in *Margrave* suggests, inclusion may not be appropriate even where the donor's revocation power is extinguished at the moment of the donee's death).

This is to be contrasted with the treatment of a contingent interest under section 2033. In Revenue Ruling 67-370, 1967-2 C.B. 324, the donor created a revocable trust. The remainderman under the trust died while the donor was still alive. Even though the donor's revocation power remained intact after the remainderman's death, the Service concluded that the remainderman's interest was taxable under section 2033—with the Service acknowledging that the contingency would bear on the valuation analysis. Thus, unlike section 2041, section 2033 does not contain a contingency exception and apparently, therefore, contemplates the possibility that the donee could be required to include the interest in his or her gross estate even though the donor's gift is not yet complete at the time of the donee's death (for example, because the donor's revocation power remains intact, the gift is incomplete under Treasury Regulation § 25.2511-2(b)).

Parenthetically, Revenue Ruling 67-370, reaches a troubling conclusion: whereas a beneficiary under a will who predeceases the testator has at the time of death a mere expectancy and is therefore not required to include it in the gross estate, as discussed above, the ruling concludes that a beneficiary in a similar position under a revocable trust

D. Terminable Interest Rule Issue

Even assuming the gift to the donee spouse is deemed to occur the moment before death, the marital deduction still may be denied if the gift is found to constitute a nondeductible terminable interest.[46] In approving the GPOA strategy in the private letter rulings and concluding that the marital deduction is available, the Service does not address this issue, thus

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is subject to a contrary rule. There is no policy rationale for this distinction. In substance, because it can be revoked at any time, the interest under a revocable trust is just as much an expectancy as the interest under the will of a living testator and should be treated as such. For a parallel argument suggesting that *Johnstone* should be overruled, see *supra* note 43. Indeed, as suggested in the note discussing *Johnstone*, imposing the estate tax on such an expectancy creates the problematic potential for double taxation occurring simultaneously: the grantor of the trust is subject to gift tax, and the decedent is subject to estate tax. Moreover, as a practical matter, including such a remainder interest in the beneficiary's estate is of little consequence in that, despite the contrary contention in the ruling, the grantor's continuing revocation power gives it a nominal, if not zero, value: as a matter of traditional valuation, see Treasury Regulation § 20.2031.-1(b), a hypothetical purchaser of an such an interest would take into account the existence of the revocation power under state law and would therefore be unwilling to pay more than a nominal sum as a purchase price. *See* Adams v. United States, 218 F.3d 383 (5th Cir. 2000) (taking into account uncertainty under state law in applying the hypothetical-purchaser rule). *See also* Rev. Rul. 75-71, 1975-1 C.B. 309 (acknowledging the difficulty of valuing the right to receive a bequest under the will of a living testator). In short, given this practical consequence and the potential for double taxation, it makes little sense to treat what is in substance an expectancy as if it were something more substantive. (Should the Service consider revoking the ruling, it might also reconsider Revenue Ruling 75-71, where it imposed gift tax on the assignment of an expectancy by determining that the gift was not complete until the expectancy had ripened into a claim capable of valuation. The ruling not only creates an unjustified distinction between the estate tax and gift tax treatment of the transfer of an expectancy, but also relies on the now-discredited theory that a gift remains incomplete where value cannot be readily determined. *See* Estate of DiMarco v. Comm'r, 87 T.C. 653, n.8 (1986). For a discussion of this theory, see Mitchell M. Gans, *Gift Tax: Valuation Difficulties and Gift Completion*, 58 NOTRE DAME L. REV. 493 (1983).)

Finally, Revenue Ruling 67-370 is perhaps an anachronism, issued at a time when the distinction between a revocable trust and a will was more substantial. In more recent years, this distinction has been disappearing because of efforts, at both the federal and state level, to treat these two forms of transfer in the same fashion based on the recognition that in substance they are equivalents. *See* Alan Newman, *The Intention of the Settlor Under the Uniform Trust Code: Whose Property Is It, Anyway?* 38 AKRON L. REV. 649 (2005) (discussing section 603 of the Uniform Trust Code, under which the trustee owes no duties to the beneficiary of a revocable trust during the settlor's life—thus mirroring the rule that, in the case of a will, the beneficiary has no claim for actions taken during the testator's life). *See also* I.R.C. § 645.

[46] *See* I.R.C. § 2523(b).

implying that the gift to the donee spouse is not a nondeductible terminable interest. The risk remains, however, that the Service might reexamine the position it takes in the rulings and reach a different conclusion on this issue.[47]

In the rulings, the donee spouse is given a stand-alone or "naked" testamentary general power of appointment—stand-alone in the sense the donee gets the power without an income interest. Unlike a general power that is exercisable during the life of the donee, such a testamentary stand-alone power does not satisfy the general power exception. to the terminable interest rule.[48] Thus, in order to qualify for the marital deduction, the gift must satisfy the contours of a case law exception.[49] Under this exception, if the donee spouse is given an election to either accept or reject a gift within a reasonable period of time and in fact accepts it, the deduction is available.[50] But if, as in some of the rulings, the donee allows the power to lapse,[51] this cannot be viewed as an acceptance of the gift, and the case law exception to the terminable interest rule would appear unavailable. Even if, as in the remaining rulings,[52] the donee exercises the power in favor of his or her estate, the question remains whether the exception applies; for the exception has only been applied thus far in cases where the donee personally accepts the gift. In sum, although the Service takes a taxpayer-friendly approach on the terminable interest question in the rulings in its attempt to find a solution to the portability problem, questions will remain about this issue until the Service issues published guidance.[53]

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[47] For a further discussion of the terminable interest problem, see Gans & Blattmachr, *supra* note 2.

[48] *See* Treas. Reg. § 25.2523(e)-1(f)(6) (indicating that giving the donee an income interest is not necessary if the donee has a general power exercisable during life).

[49] *See* Rev. Rul. 82-184, 1982-2 C.B. 215 (embracing the cases that create the exception).

[50] *See id.*

[51] *See* Priv. Ltr. Rul. 200210051 (Dec. 10, 2001); Priv. Ltr. Rul. 200101021 (Oct. 2, 2000).

[52] *See* Priv. Ltr. Rul. 200604028 (Sept. 30, 2005); Priv. Ltr. Rul. 200403094 (Sept. 24, 2003).

[53] In the meantime, practitioners may consider making the donee spouse's estate the default taker under the power of appointment. Under this approach, the terminable interest rule should not apply on the ground that, upon the lapse of the power, the interest does not pass to a third party but instead passes to the donee spouse's estate. *See* Treas. Reg. § 25.2523(b)-1(B)(1)(i).

E. The GPOA Strategy and the Step Transaction Doctrine

In order for the GPOA strategy to be effective, the assets in the trust must not be included in the donor spouse's gross estate at his or her later death. If the gross estate includes the trust assets, the donee spouse's exemption is in effect wasted, and the strategy fails. In the private letter rulings approving the strategy, the Service concludes without substantive analysis that the surviving spouse's gross estate does not include the trust's assets under section 2036 or 2038 on the theory that the donee, rather than the donor, had transferred them to the trust. This aspect of the rulings is the weakest link in the Service's conclusions with respect to the strategy.[54] While the Service understandably seeks to adopt a reading of the Code to assist taxpayers encountering portability difficulties, it should not gratuitously adopt a position that other taxpayers can use to create unintended consequences.[55] Incorporating the conclusions reached in the rulings in published guidance might weaken sections 2036 and 2038 significantly as applied in other contexts. After explaining how such guidance could undermine these sections, we discuss an alternative solution for dealing with portability—a solution that planners may currently use without downside risk and that the Service can authorize administratively without concern about a negative impact in other contexts.

The weakness in the rulings is their failure to consider the step transaction doctrine.[56] In concluding that the donor (surviving) spouse's estate does not include the assets in the trust under section 2036 or 2038, the private letter rulings ignore the doctrine. Under the doctrine, the donor spouse easily would be viewed as the transferor of the property held in the trust. After all, the donor spouse transfers the assets to the trust and can revoke the trust at any time until the moment of the donee spouse's death. When the donee spouse exercises the power or instead allows it to lapse at

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[54] *But see* Mulligan, *supra* note 2, at 195–97 (suggesting that the weakest aspect of the rulings is the conclusion that the donor's gift to the donee at the time of the donee's death qualifies for the lifetime marital deduction).

[55] If the Service adopts a taxpayer-friendly principle in a revenue ruling, taxpayers may be able to utilize that principle in other contexts. *See* Dover Corp. & Subsidiaries v. Comm'r, 122 T.C. 324 (2004) (holding the Service bound by a taxpayer-friendly principle even though the Service had announced the principle in a different context).

[56] *See generally* Jay A. Soled , *Use of Judicial Doctrines in Resolving Transfer Tax Controversies*, 42 B.C. L. REV. 587 (2001) (describing courts' application of the step transaction doctrine to resolve controversies involving transfer taxes).

the time of death, the assets remain in trust only because the donor spouse chooses not to exercise the revocation power.

Consider this similar arrangement: A donor spouse gives property to the donee spouse on the understanding that the donee will convey the property to a trust for the benefit of the donor. If the donee, in accordance with the understanding, immediately conveys the property to the trust, the donor would almost certainly be treated as the grantor of this trust under the step transaction doctrine.[57] And if the donor had an income interest under the trust, the donor's estate unquestionably would include the trust assets under section 2036(a)(1).[58]

Likewise, in the case of the GPOA strategy, the donor spouse should be treated as the transferor of the trust property. The donor spouse decides not to revoke the trust only if he or she is satisfied with the terms of the donee's instrument exercising the power or the donee's spouse's decision to allow the power to lapse. Put differently, because of the donor's revocation power, the donee cannot, as a practical matter, make a disposition of the trust's assets that is objectionable to the donor.[59] Indeed, absent the Service's concern about portability, the Service might not have decided so facilely that the donor spouse should not be viewed as the transferor.[60] In short, if the step transaction doctrine is not ignored and if the donor is, say, the income beneficiary of the trust—or has some other interest or power with respect to the trust that falls within the scope of section 2036 or 2038—the donor spouse's estate should include the trust's assets.[61]

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[57] *See* Estate of Skifter v. Comm'r, 56 T.C. 1190, 1200 n.5 (1972), *aff'd*, 468 F.2d 699 (2d Cir. 1972); Estate of Sinclaire v. Comm'r, 13 T.C. 742 (1949) (applying the step transaction doctrine in these circumstances and thereby invoking section 2036 of the Code). *See also* Treas. Reg. § 20.2036-1(a) ("An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred.").

[58] *See Sinclaire*, 13 T.C. at 746.

[59] *Cf.* Tech. Adv. Mem. 9308002 (Feb. 26, 1993) (indicating that property was not acquired from the decedent for purposes of section 1014 where the donor spouse could have revoked the trust until the death of the donee spouse). *But cf.* Priv. Ltr. Rul. 9321050 (Feb. 25, 1993) (determining that, where the donor spouse did not retain a revocation power, section 2036 was inapplicable in the donor spouse's estate at her later death even though the donee spouse had allowed the power to lapse, and as a result, the donor spouse was entitled to the trust's income during her life).

[60] *See* Mulligan, *supra* note 2, at 195–96 (suggesting that the Service could invoke the step transaction doctrine in the context of the GPOA strategy).

[61] Sections 2036 and 2038 of the Code are applicable only if, in addition to making a transfer, the decedent held certain rights or powers with respect to the trust. *See*

Thus, incorporating the Service's conclusions in the rulings in published guidance would weaken sections 2036 and 2038 unintentionally to the extent that the guidance could be read as disavowing the applicability of the step transaction doctrine in this context. Perhaps, however, the guidance might seek to make this distinction between the hypothesized arrangement and the GPOA strategy: in the former case, the donee makes an inter vivos transfer to the trust, whereas in the latter case the transfer to the trust occurs by reason of the donee's death. The guidance, in other words, could concede that the doctrine does not apply where the donee's transfer occurs at the donee's death on the ground that death is such a unique event that it should not be integrated with the donor's transfer. At the same time, the guidance could maintain that the doctrine would continue to apply where the donee's transfer to the trust has no relation to the donee's death.

However drafted—whether disavowing the doctrine entirely or only where the donee's transfer was death-related—the guidance would represent a break with current law and thereby would weaken sections 2036 and 2038 in contexts unrelated to the portability problem. Until now, the step transaction doctrine has been assumed to apply where the donor's transfer and the donee's transfer were part of a prearranged plan, even if the donee's transfer occurred at the time of death.

In *Estate of Skifter v. Commissioner*,[62] the Tax Court refused to invoke the doctrine where the decedent had made a transfer of ownership of a life insurance policy on his life to his wife and she then bequeathed it back to him in trust, naming him as trustee.[63] In rejecting the Service's section 2042 argument that the decedent-insured held an "incident of ownership," the court reasoned that inclusion would not have been appropriate under section 2036 or 2038 if a non-insurance asset were instead held in the trust. Seeking to maintain the parallel approach for insurance and non-insurance assets that Congress apparently intended, the court held that the proceeds were not includible under section 2042.[64] The court, however, strongly suggested that, if the facts showed that the transfer to the donee and the donee's bequest had been part of a prearranged plan, inclusion of the proceeds in the donor's gross estate

I.R.C. §§ 2036, 2038.

[62] 56 T.C. 1190 (1972), *aff'd* 468 F.2d 699 (2d Cir. 1972).

[63] *See id.* at 1200 n.5.

[64] *See id.* at 1198–99.

would have been appropriate.[65] In Revenue Ruling 84-179, the Service similarly suggests that on facts similar to *Skifter*, it would apply the doctrine if the donor's transfer and the donee's bequest had been prearranged.[66] Thus, any published guidance addressing portability that disclaimed the applicability of the step transaction doctrine merely because the donee's transfer occurred at the time of death would appear to narrow the scope of sections 2036 and 2038 in non-portability contexts as well.[67]

This is not to suggest, however, that the Service necessarily should have applied section 2036 or 2038 in the surviving spouse's estate in the GPOA rulings. Rather, had it properly applied the step transaction doctrine and found that the surviving spouse had made a transfer, the Service would have had to make an additional determination: whether the surviving spouse had an interest or right with respect to the trust sufficient to invoke one of these sections.[68] If, for example, the surviving spouse had the right to receive the income from the trust during life, section 2036(a)(1) would bring the trust's assets into the surviving spouse's gross estate. Similarly, if the terms of the trust gave the surviving spouse a special (non-general) power of appointment—an approach that, as a practical matter, a prudent practitioner might well recommend when

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[65] *See id.* at 1200 n.5. The Second Circuit, in affirming the Tax Court decision, emphasized the fact that the bequest back to the decedent was made "long after he had divested himself of all interest in the policies." Estate of Skifter v. Comm'r, 468 F.2d 699, 703 (2d Cir. 1972). Also, the Tax Court intimated that inclusion would have been appropriate had the two transfers been part of a prearranged plan. *See Skifter*, 56 T.C. at 1200 n.5.

[66] *See* Rev. Rul. 84-179, 1984-2 C.B. 195 (emphasizing that the decedent's transfer to the donee and the bequest back to the decedent in trust were unrelated and not part of a prearranged plan).

[67] In explaining its position in Revenue Ruling 84-179, the Service makes clear that it would invoke the step transaction doctrine if the decedent's transfer and the donee's bequest for the benefit of the decedent were part of a prearranged plan. *See* Gen. Couns. Mem. 38,751 (June 12, 1981). Indeed, the memorandum explicitly indicates that cases where the donee's transfer occurs shortly after the decedent's transfer would invoke the doctrine. *See id.*

[68] Sections 2036 and 2038 require not only that the decedent make a transfer but also that the decedent retain (in the case of section 2036) or have at the time of death (in the case of section 2038) continuing control or access with regard to the trust. The nature of the control or access that triggers inclusion is different depending on which of the two sections is at issue. *See generally* CHARLES L.B. LOWNDES, ROBERT KRAMER & JOHN H. MCCORD, FEDERAL ESTATE AND GIFT TAXES chs. 8 & 9 (3d ed. 1974).

utilizing the GPOA strategy[69]—section 2038 would require inclusion at the surviving spouse's death.[70]

F. Implied Understanding and Creditors' Rights

What if the surviving spouse had neither an income interest nor a power of appointment but were merely a discretionary beneficiary of the trust? Would section 2036 apply in these circumstances? The Service would be able to invoke the section on one of two grounds: (1) if the donor spouse had an implied understanding that he or she would receive distributions from the trust;[71] or (2) if the donor spouse's creditors had the ability, under state law, to reach the trust's assets.

1. Implied Understanding

In terms of an implied understanding, although the lower court decisions may be in some tension with the Supreme Court's decision in *United States v. Byrum*,[72] courts uniformly apply the section where such an implied understanding about trust distributions exists.[73] Similarly, in

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[69] Cautious practitioners who rely on the private letter rulings may be concerned about the possibility that the Service might decide to change its position and argue that the donor spouse makes a taxable gift at the death of the donee to the beneficiaries of the trust. Even if the donor is a beneficiary of the trust, under this theory, the entire amount conveyed to the trust could be taxable under section 2702. *See* Treas. Reg. § 25.2702-1(c)(1) (indicating that, unless the gift is wholly incomplete, section 2702 applies, making the entire amount contributed to the trust a taxable gift unless the donor retains a "qualified interest"). To prevent against the risk of being taxable, cautious practitioners will give the donor spouse a special power of appointment. *See* Treas. Reg. § 25.2511-2(c) (rendering the gift wholly incomplete and thereby defeating the application of section 2702 where the donor retains a power of appointment). For a discussion of the use of such a power in order to eliminate this risk, see Gans & Blattmachr, *supra* note 2. But, as suggested in the text, this precaution could cause the strategy to fail should the Service reach the correct conclusion about the step transaction doctrine and thereby invoke section 2038. Nonetheless, given the downside risk of a taxable gift at the death of the donee spouse, the suggested precaution is worth adopting even if it may result in the failure to achieve the upside goal of preserving the donee spouse's exemption.

[70] Unlike section 2036 of the Code, section 2038 does not have a retention element. *See, e.g.*, Rev. Rul. 70-348, 1970-2 C.B. 193. Thus, section 2038 can apply even if the decedent did not retain the power at the time of transfer but acquired it before death. Nonetheless, this principle is not without limitation: the section does not apply if the decedent acquires the power in a transfer that is not related to the decedent's initial transfer. *See* Rev. Rul. 84-179, 1984-2 C.B. 195 (embracing this aspect of *Skifter*).

[71] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7 (illustrating this principle).

[72] 408 U.S. 125 (1972).

[73] *See, e.g*, Estate of Paxton v. Comm'r, 86 T.C. 785 (1986). In *Byrum*, the Supreme Court held that the decedent could not retain possession or enjoyment (within the meaning

terms of a creditors' rights theory, little question remains about the appropriateness of invoking section 2036 on this ground.[74]

2. *Creditors' Rights*

Thus, even without an implied understanding about distributions, the section nonetheless applies if under state law the donor spouse's creditors could reach the trust's assets. In most states,[75] where the grantor of a trust is a permissible beneficiary, his or her creditors can reach the grantor's assets to the extent that the trustee could, under a maximum exercise of discretion, make distributions to the grantor.[76] Assuming that state law views the donor spouse as the grantor of the trust—which should be the case whenever the GPOA strategy applies given the fact that the donor spouse funds the revocable trust that converts into the credit shelter trust for the benefit of the donor spouse after the donee spouse's death—the

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of section 2036) where the cooperation of a third party is necessary and the third party owes a fiduciary duty to someone else. *See Byrum*, 408 U.S. at 143. In *Paxton*, in contrast, without acknowledging this aspect of *Byrum*, the court concluded that the decedent had retained possession or enjoyment even though the trustee owed a fiduciary duty to beneficiaries other than the decedent. *See Paxton*, 86 T.C. at 806, 808. Like the court in *Paxton*, the Service in Revenue Ruling 2004-64 also failed to consider the trustee's fiduciary duty to others. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7. On the other hand, in *Bongard*, the court intimates that a fiduciary duty owed to someone other than the decedent might preclude a finding of retained possession or enjoyment, but ultimately ruled against the estate on the ground that the general partner's fiduciary duty should be disregarded because the partnership did not carry on an active business. *See* Estate of Bongard v. Comm'r, 124 T.C. 95, 154, 163 (2005).

74 Under the creditors' rights theory, the grantor's gross estate includes the trust under section 2036(a)(1) if the creditors of the grantor may attach the assets in the trust. *See, e.g.*, Herzog v. Comm'r, 116 F.2d 591 (2d Cir. 1941); *Paxton*, 86 T.C. at 785; Estate of German v. United States, 7 Ct. Cl. 641 (1985); Outwin v. Comm'r, 76 T.C. 153 (1969); Rev. Rul. 2004-64, 2004-2 C.B. 7; Rev. Rul. 77-378, 1977-2 C.B. 347.

75 *See, e.g.*, IND. CODE ANN. § 32-2-1-18 (LexisNexis 2002); KAN. STAT. ANN. § 33-101 (2000); N.Y. EST. POWERS & TRUSTS LAW § 7-3.1 (McKinney 2002); OHIO REV. CODE ANN. § 1335.01(A) (LexisNexis 2006).

76 *See* RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f. *But see In re* Schultz, 324 B.R. 712, 720 (Bankr. E.D. Ark. 2005) (indicating that, given the authorities that are contrary to the *Restatement's* approach, the court was not required to consider the standard contained in the instrument in determining the amount creditors could reach); Robert T. Danforth, *Rethinking the Law of Creditors' Rights in Trusts*, 53 HASTINGS L.J. 287, 294 (2002) (suggesting that, in the case of a trust providing for the support of the settlor, courts might permit creditors to reach the trust's assets even if they did not provide the settlor with support-related items, but criticizing the self-settled trust doctrine in general on the ground that creditors should not be able to defeat the rights of other beneficiaries).

donor's creditors should be able to reach his or her assets.[77] Simply put, if creditors have this right under state law, the donor spouse's gross estate should include the trust's assets. Importantly, however, this would be the case only if the step transaction doctrine applies. Otherwise, section 2036 should not apply. The ability of the donor spouse's creditors to reach the trust's assets does not, in and of itself, make the section applicable. Section 2036 can only apply where, in addition, the donor spouse is viewed as having made a transfer to the trust.[78] As suggested, absent the step transaction doctrine, the donor spouse is not so viewed.

3. *Creditors' Rights and Section 2041*

To be sure, inclusion in the donor spouse's estate could nonetheless occur under section 2041 based on a creditor theory without regard to the transfer issue. In other words, if as a matter of state law the donor spouse is treated as having funded the trust and her creditors could therefore reach the trust's assets, the spouse's estate would include the assets under section 2041[79] even though she is not deemed the transferor for tax purposes.[80] But this is a difficulty that can probably be avoided in most states through proper drafting. As long as the trust instrument provides that distributions to the donor spouse are subject to an ascertainable

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[77] However, a state court might be receptive to the argument that the donee spouse's general power of appointment sufficiently breaks the chain so that the donee spouse should be viewed more properly as the person funding the trust. Such reasoning would be parallel to the Service's decision not to apply the step transaction doctrine in the private letter rulings; choosing to respect the form of the transaction, the state courts, like the Service, might view the donee spouse as making the transfer and funding the trust when the taxpayer exercises the general power of appointment or allows it to lapse.

[78] *See* Rev. Rul. 77-378, 1977-2 C.B. 347; Rev. Rul. 76-103, 1976-1 C.B. 293. Nor would section 2033 apply. For where the decedent's right to access assets lapses at death, the section does not apply. *See* Helvering v. Safe Deposit & Tr. Co. of Baltimore, 316 U.S. 56 (1942) (refusing to apply the predecessor of section 2033 in these circumstances).

[79] *See* Treas. Reg. § 20.2041-1(c) (indicating that if one can exercise a power to discharge a legal obligation of the power holder, the power is a general power of appointment within the scope of section 2041).

[80] *See* Treas. Reg. § 20.2041-1(b)(2) (providing that section 2041 will not apply if the power is "within the concept of sections 2036 through 2038"). But if, as is assumed in the text, the donor spouse is not viewed as the transferor for estate tax purposes, the power could not fall within the scope of sections 2036 or 2038 and could, therefore, constitute a general power falling within the scope of section 2041. *See* Priv. Ltr. Rul. 8916032 (Apr. 21, 1989).

standard relating to health, education, maintenance, or support, section 2041 should not be applicable.[81]

Thus, while as a practical matter section 2041 should not be an impediment to the GPOA strategy, if the Service successfully invoked the step transaction doctrine, section 2036 would remain a threat on either of two theories: the donor spouse had an implied understanding concerning distributions, or the donor spouse's creditors had the right to reach trust assets under state law.

V. AN ALTERNATIVE TO THE GPOA STRATEGY

A. The Lifetime QTIP Trust

In terms of planning, the question becomes how to negate the section 2036, and possibly the section 2038, risk. If the donor spouse elected to create a QTIP trust, neither section 2036 nor section 2038 could be invoked at the death of the donor spouse[82] because the donee spouse is treated as the transferor for estate and gift tax purposes.[83] As a result, sections 2036 and 2038—both of which can only apply if the decedent had made a transfer—become unavailable to the Service in the donor

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[81] Where such a standard limits a power, section 2041 does not apply. *See* I.R.C. § 2041(b)(1)(A). Thus, if, as a matter of state law, creditors cannot reach more than the trustee could distribute under a maximum exercise of discretion under the standard contained in the instrument, see *supra* note 76, and if the instrument contains such an ascertainable standard, creditor access would thereby be limited and inclusion in the donor spouse's estate under section 2041 would be precluded. *Cf.* Tech. Adv. Mem. 199917001 (Jan. 15, 1999) (acknowledging that such a standard could limit creditor access under state law and would therefore limit the Service's ability to include the trust in the grantor's estate under section 2036 of the Code). Before using this drafting approach, however, a person should confirm that the state law in question follows the *Restatement* or that it generally does not permit the settlor's creditors to reach trust assets. For as indicated in note 76 *supra*, some courts appear to allow creditors access without regard to the standard contained in the instrument. *See, e.g.*, State v. Coyle, 575 N.Y.S.2d 975 (App. Div. 1991) (permitting the state, a medical provider, full access even though the instrument permitted an invasion only for "luxuries[ ] not provided by public welfare funds or medical insurance"). Nonetheless, a distribution power subject to a standard relating to health, education, maintenance, or support should not trigger section 2041, unless as a matter of state law the existence of the standard is deemed entirely irrelevant in determining the creditor-access issue. *See, e.g.*, Rev. Rul. 82–63, 1982-1 C.B. 135 (indicating that whether a standard is ascertainable is a matter of state law).

[82] The donee spouse's gross estate would include the trust assets. *See* I.R.C. § 2044. The inclusion is a desirable outcome because it prevents the donee spouse's exemption from being wasted.

[83] *See* Treas. Reg. § 25.2523(f)-1(f), ex. 11.

spouse's estate.[84] Thus, if the donor spouse makes the election, these sections, as well as the step transaction doctrine, become irrelevant. Also, as suggested, section 2041 should not apply as long as distributions are subject to an appropriate ascertainable standard.[85]

Thus, if the donor spouse creates a QTIP trust shortly before the death of the donee spouse, the donee spouse's exemption is not wasted, and the trust functions as a credit shelter trust after the donee spouse's death. The donor spouse's estate will not include the trust's assets if distributions are subject to an appropriate, ascertainable standard.[86] But if the donor spouse is unwilling to do this because of possible loss of control, could she accomplish her objectives by borrowing a page from the GPOA strategy? In other words, could the donor spouse create the QTIP trust while maintaining control by retaining, as in the GPOA strategy, the right to revoke the trust until the death of the donee spouse? This raises the question whether the donor spouse could make a QTIP election on a gift tax return filed after the death of the donee spouse where the donee's income interest was subject to the donor's revocation power until the moment of the donee's death. The Service, in a private letter ruling, has addressed this question and concluded that the election could be made in these circumstances.[87]

The QTIP strategy is attractive paradoxically from both the taxpayer's and the Service's perspective. In terms of taxpayers, if properly drafted, the QTIP strategy has no downside risk. As long as the donor spouse retains a special power of appointment once the donee spouse has died,[88] the donor cannot be treated as having made a taxable gift on the death of the donee spouse. In other words, even assuming the Service were to

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[84] *See id.*

[85] *See supra* note 79 and accompanying text.

[86] As indicated, the lifetime QTIP trust could be made irrevocable when the first spouse dies, just as the general power of appointment discussed in the private letter rulings also becomes irrevocable at that time. As discussed in the text, there seem to be grounds for the conclusion that the Service should allow the marital deduction even though irrevocability occurs at that time. Nevertheless, to eliminate any risk on this issue, it seems appropriate for the spouse who will be creating the lifetime QTIP trust to make it irrevocable at least a short time before his or her spouse dies.

[87] *See* Priv. Ltr. Rul. 200413011 (Dec. 3, 2003).

[88] For a discussion of the donor's ability to retain such a power in the case of a QTIP trust, see J. Blattmachr, M. Gans & D. Zeydel, *The World's Greatest Gift Tax Mystery, Solved*, 115 TAX NOTES 243 (2007). *See also* Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trust*, 21 PROB. & PROP., July/Aug. 2007, at 52.

change its view and conclude that the QTIP election is inapplicable because the gift of the income interest to the donee did not occur until after the donee's death, the donor spouse should not be treated as having made a taxable gift to the trust's remainder beneficiaries.[89] While the same power-of-appointment approach could be utilized in conjunction with the GPOA strategy to avoid this downside risk,[90] the QTIP strategy offers a powerful upside advantage: if the Service recognizes the QTIP election as valid, it cannot later invoke section 2036 or 2038 in the donor spouse's estate.[91] In contrast, a taxpayer who utilizes the GPOA strategy without securing a private letter ruling must run the risk that, at the donor spouse's death, the Service will argue that under the step transaction doctrine one of these sections applies.[92] Finally, unlike the GPOA strategy, the QTIP strategy does not create any terminable interest risk.[93] Nonetheless, until the Service or Congress acts, taxpayers who want to make certain that a waste of the exemption does not occur should make sure that the donor spouse's revocation power is extinguished *before* the donee spouse's death.

From the Service's perspective, the QTIP strategy is also attractive. While enabling taxpayers to avoid the portability problem, the QTIP

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89 *See* Treas. Reg. § 25.2511-2(c).

90 *See* Gans & Blattmachr, *supra* note 2, at 10. However, it has been suggested that the donor's special power of appointment might not be effective in rendering any possible gift incomplete on the donee's death. *See* Mulligan, *supra* note 2, at 191. This suggestion does not seem plausible. If the Service were to maintain that the donor makes a taxable gift at the time of the donee's death, it would do so on the ground that the donee had already died at the time of the gift (for example, a terminable interest argument could not be made in the QTIP context); otherwise, the gift would qualify for the marital deduction. If the view is that the donee died at the time of the gift, the donor spouse would necessarily be viewed as the one making the transfer to the trust—with the donor's special power rendering any such gift incomplete. *See* Treas. Reg. § 25.2511-2(c).

91 *See supra* text accompanying notes 77–79.

92 If the QTIP strategy applies, an additional strategy exists: after the donee spouse's death, the trust will be treated as the donor spouse's grantor trust. For a discussion of this drafting approach and the advantages it offers, see *supra*, note 88. Note, however, in the case of the GPOA strategy, as long as the donee spouse allows the general power to lapse, the trust will be treated as the donor spouse's grantor trust. *See* Treas. Reg. § 1.671-2.

93 If the Service accepts the QTIP election, the QTIP exception to the terminable interest rule will preclude the Service from invoking the rule. *See* I.R.C. § 2523(f)(1)(B). Thus, should the Service agree that the gift occurs the moment before the donee spouse's death, it must permit the marital deduction. In the case of the GPOA strategy, in contrast, even assuming the Service agrees with the taxpayer as to the timing of the gift, it may nevertheless argue that the deduction is unavailable on the basis of the terminable interest rule. *See supra*.

strategy does not create the unintended consequences inherent in the GPOA strategy: it does not undermine the step transaction doctrine and therefore does not weaken section 2036 or 2038. Thus, if the Service wants to find an administrative solution to the portability problem, it should adopt a revenue ruling that embraces the QTIP strategy. The ruling should make clear that the taxpayer can make the QTIP election after the death of the donee spouse and that, as a result, neither section 2036 nor section 2038 can apply at the donor spouse's later death.[94]

B. An Alternative to the Lifetime QTIP Trust

Another strategy without downside risk that planners may consider involves structuring the documents to permit a possible disclaimer by the donee spouse's executor. Under this strategy, the donee spouse receives a general testamentary power under the donor spouse's revocable trust. In the donee's estate planning documents, the power is not exercised.[95] As a result of the donee's death, the property subject to the power passes by operation of the lapse of the donee's power to a trust designed to function as a credit shelter trust for the benefit of the donor spouse. The donor spouse's revocable trust provides that if the donee or the donee's executor disclaims the power, the property in the trust reverts to the donor.

After the donee's death, the donee's executor either disclaims, which would cause the property to return to the donor, or instead allows the property to lapse into the credit shelter trust. Before making this decision—before deciding whether to implement the strategy or instead terminate it by disclaimer—the executor could seek a private letter ruling. If the Service were to rule favorably, the strategy would be implemented. However, if the Service refused to rule or could not rule within the nine month disclaimer period,[96] the executor's disclaimer could terminate the

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94 As an alternative, the Service could adopt a regulation that mirrors the QTIP regulation in the context of a general-power-of-appointment trust. *See* Treas. Reg. § 25.2523(f)-1(f). Such a regulation would provide that once the donee's spouse's estate includes the corpus of a lifetime marital trust under section 2041, neither section 2036 nor 2038 could apply at the donor spouse's later death. Such a regulation would enable the Service to embrace fully the GPOA strategy without the concern of inadvertently weakening these sections. However, whereas the QTIP regulation has authority in the Code (section 2044(c)), a general-power-of-appointment trust does not.

95 The donee exercising the power might mean an acceptance that would preclude the donee's executor from disclaiming after the donee's death. *See* Tech. Adv. Mem. 8142008 (Dec. 31, 1980).

96 *See* I.R.C. § 2518.

strategy.[97] Most importantly, if the executor terminates the strategy by disclaimer, the property would pass back to the donor spouse without any gift tax being imposed on the donor and without any other adverse tax consequence other than the failure to achieve the upside objective of preserving the donee's exemption. In short, like the QTIP strategy, this strategy offers upside potential for resolving a couple's portability problem without creating any downside risk.

VI. CONCLUSION

Effective use of the unified credit (the estate tax exemption) for the first spouse of a married couple to die is an important feature in good estate tax planning. Such use generally occurs by having the spouse create a credit shelter trust from which the surviving spouse will benefit without causing the trust's assets to be included in the gross estate of the surviving spouse. For several reasons, the exemption may be wasted. For example, one spouse dies without sufficient assets to use the full exemption. Another cause of the wasting of the exemption may be that the character of the assets held by the first spouse to die are not as efficient as other assets in funding the exemption. Although Congress has considered allowing the surviving spouse to use any unused exemption, no such legislation has been enacted. The Service, however, in a series of private letter rulings, has approved a strategy that, if valid, would permit couples to avoid the portability problem. Under the strategy, the donor spouse creates a revocable trust, giving the donee spouse a testamentary general power of appointment over the trust's assets.

Among other conclusions, these rulings state that the donor spouse's gift to the donee spouse occurs while they are still married and that the gift therefore qualifies for the gift tax marital deduction. The Service also concludes that the donee spouse's estate includes the assets subject to the power and the assets are therefore available for use against his or her exemption. Most importantly, the Service concludes that the donor spouse's gross estate does not include the trust created with the general-power-of-appointment property, even if the donor has the right to the income from the trust, holds a special power of appointment over the trust, or both.

Although commendable, the reasoning of the private letter rulings appears to be fundamentally flawed. The rulings do not take into account

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97 *See* Rolin v. Comm'r, 588 F.2d 368 (2d Cir. 1978) (permitting a disclaimer in similar circumstances).

the step transaction doctrine, under which the donor spouse almost certainly should be viewed as the transferor of the property in the trust, subjecting the property to inclusion in the donor spouse's gross estate at his or her later death and thereby causing the strategy to fail.

Given this flaw, the use of a lifetime QTIP trust in the donor spouse's revocable trust is an attractive alternative. Because the Service can approve this strategy without causing adverse consequences in unrelated contexts, it should do so to provide taxpayers with a portability solution. In the meantime, in order to minimize risk of failure, planners should consider using the QTIP strategy instead of the general power strategy approved in the rulings.