2014

Supercharged Credit Shelter Trusts Versus Portability

Jonathan G. Blattmachr

Mitchell M. Gans
Maurice A. Deane School of Law at Hofstra University

Diana S.C. Zeydel

SUPERCHARGED
CREDIT SHELTER TRUST℠

By Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S.C. Zeydel

"Portability" is a new tax election available to married persons that permits the estate of the first spouse to die to elect that the decedent's unused estate tax exemption (called the deceased spouse's unused exemption amount or "DSUE amount") be transferred or "ported" over to the surviving spouse who may use it to shelter the surviving spouse's own taxable gifts or taxable estate. Whether a couple should rely on portability may be a complex financial matter. This article will compare the results of simply relying on portability with no further planning (the "Pure Portability Plan") to (1) using portability coupled with an immediate gift by the surviving spouse of the DSUE amount to a grantor trust (the "Portability Plan"), (2) creating a traditional "Credit Shelter Trust" at the death of the first spouse to die, (3) using a Supercharged Credit Shelter Trust[sm], and (4) using the spouses' exemptions as early in lifetime as possible.

Jonathan G. Blattmachr is a director of Pioneer Wealth Partners, LLC, in New York, New York, director of estate planning for the Alaska Trust Company, and co-developer of Wealth Transfer Planning, a software system for lawyers. **Mitchell M. Gans** is the Rivkin Radler Distinguished Professor of Law at Hofstra University Law School in Hempstead, New York. **Diana S.C. Zeydel** is a shareholder in Miami, Florida, of the international law firm of Greenberg Traurig, P.A., and national chair of its Trusts and Estates department.

iStockphoto/photo illustration by Andrew O. Alcala

The Pure Portability Plan, in which the entire estate of the spouse dying first passes outright to the survivor is, in general, very simple to draft and administer. For a couple who may need all available assets for consumption, waiting until the second death to use the combined shelters may avoid an allocation to property that declines in value or is consumed. It also permits the couple's appreciated assets potentially to receive a second step-up in basis. The Pure Portability Plan, however, will cause the GST exemption of the first spouse to die to be lost. Therefore, it seems that a couple with sufficient wealth to be concerned about eventual transfers to so-called "skip persons" (grandchildren and more remote descendants) is well advised to engage in some estate planning rather than relying on pure portability.

Using Exemptions During Lifetime: Most Efficient Plan

Using Exclusions and Exemptions Early

It is nearly axiomatic that an exemption or exclusion under the tax law should be used as early as practicable for at least two reasons. First, the exemption or exclusion may be eliminated or reduced in the future. Second, if the property grows in value after it is transferred, the value of the exemption or exclusion in effect also grows. For example, if $5 million of property is transferred 30 years before death, under the protection of the gift tax exemption, and grows at an annual after-tax compounded rate of 6%, about $30 million will be excluded from the donor's gross estate at death by reason of the gift.

The gift and GST exemptions are now also indexed for inflation. Nevertheless, assets may likely appreciate in excess of the inflation adjustments. The inflation adjustment will be only about 1.7% from 2013 to 2014. And early use of the exemptions does not prevent use of the inflation-adjusted amounts at a future time.

Potential Inhibitions on Early Use of Shelters

Individual taxpayers in the United States may now transfer up to $5.34 million under the protection of their lifetime gift and GST exemptions (and, as indicated, that amount is indexed for inflation for future years). Although early use of the available shelters is likely most tax efficient, it may not be practicable for many reasons. Probably the principal one is that the owner wishes to continue to own the wealth and to be able to use or benefit from and to control it. The continued use of property given away during lifetime or the ability to control its benefit after it is given away typically will be ineffective to achieve any wealth transfer tax efficiency because the property may be included in the transferor's gross estate at death as though he or she had not made the transfer. See IRC §§ 2036(a)(2) and 2038. Moreover, the retention of benefits from or the use of the property may permanently subject the property to the claims of the transferor's creditors. See, e.g., Restatement (Third) of Trusts § 60, cmt. f.

Nonreciprocal Trusts for Spouses

Although many will not be willing to give up the benefits and control over property by making lifetime transfers under the protection of the gift tax and GST exemptions, it seems that married persons may use their exemptions by creating nonreciprocal trusts for each other that should make the property

potentially available for their use until they both die and, perhaps, permit retention of some control over the assets in the trusts. Such trusts are not without tax risk. And, at best, nonreciprocal spousal trusts should be regarded by the couple as no more than a rainy day fund. Accordingly, a couple should have income or other assets to secure lifestyle, rather than being dependent on the transferred assets. See generally Jonathan G. Blattmachr & Douglas J. Blattmachr, *Efficient Use of the $5+ Million Gift and GST Tax Exemptions*, Est. Plan. Stud. (Oct. 2012).

Income Tax Basis Matters

There can be some offsetting considerations, however, in using exemptions during lifetime. One is minimizing future capital gains. The income tax basis of property owned at death or otherwise included in the owner's gross estate for federal estate tax purposes (subject to exception) is equal to its estate tax value (usually, fair market value as of the date of death). IRC § 1014(a). Property not included in the gross estate may not have its basis so changed.

But, if the property is transferred during lifetime to a trust that is a grantor trust for income tax purposes for the transferor, the transferor (or the transferor's spouse) may substitute or sell without income tax recognition higher basis assets for the trust's lower basis assets. See Rev. Rul. 85-13, 1985-1 C.B. 182; IRC § 1041.

However compelling the case may be to transfer property under the exemptions before death, most will not do so. And that raises the question of what is the most efficient way to use them at death.

Introduction to Use of Exemptions at Death

A married person may not automatically use the estate tax exemption. Property transferred at death in a form qualifying for the estate tax marital deduction will not be part of his or her taxable estate against which the estate tax exemption would be applied. IRC § 2056. The property so transferred to or for the surviving spouse, however, will be included in the estate of

A married person may not automatically use the estate tax exemption.

the surviving spouse at death except to the extent the property is consumed or transferred before then.

Common Goal for Married Couples with Descendants

In the authors' collective experience, the principal estate planning goal of most individuals in a first marriage (or the first marriage in which there are offspring) is to benefit the surviving spouse. In such a case, if the surviving spouse is likely to need or want the assets for his or her personal use, it might seem that there is simply no way that the spouse dying first could use any exemption. But there are at least two ways.

Use the Exemption with a Credit Shelter Trust

A traditional Credit Shelter Trust equal to the estate tax exemption of the first spouse to die of which the survivor is a beneficiary can be used while still making the entire estate available for the benefit of the surviving spouse and without causing the assets protected by that exemption to be included in the gross estate of the surviving spouse.

For example, the survivor can be given, among other interests, the right to income and the power both during lifetime and at death to appoint any or all of the trust property to anyone (other than himself or herself, his or her creditors or estate, or the creditors of his or her estate) without causing trust property to be included in his or her gross estate at death.

Of course, mandating payments (such as income) to the surviving spouse will reduce what will pass estate-tax-free when the survivor dies. Hence, if an important goal of the couple is to provide for the ultimate beneficiaries of their wealth (for example, their descendants), it usually will be preferable not to mandate payments to the survivor. Indeed, it will be preferable, from that perspective, to invade the corpus of any marital deduction share for the surviving spouse and not have distributions made from the Credit Shelter Trust so more passes free of estate tax when the survivor dies.

Preserving the Exemption with Portability

Since 2011, there is another way a married person can avoid wasting his or her estate tax exemption. That is by having his or her executor file a timely and complete U.S. Estate (and Generation-Skipping Transfer) Tax Return (Form 706), which will automatically cause any unused exemption to be transferred or "ported" over to the surviving spouse, who may use it against taxable gifts he or she may later make or against his or her taxable estate at death. See IRC § 2010.

One of the principal questions explored in this article is whether portability should be used when the estate tax exemption of the spouse dying first could be applied in a different way, such as by creating a traditional Credit Shelter Trust.

What Is Best Depends on Goals and the Situation

What the spouses may view as best depends on their primary estate planning goals and any other significant goals they have as well as myriad other factors, such as the couple's wealth and whether either spouse has a descendant from another union. A simple plan to implement and administer is to use the Pure Portability Plan and have all assets of the spouse dying first transferred outright to the survivor and to port the DSUE amount over to him or her. But such a simple plan suffers from consequences that may not be viewed as beneficial either for the surviving spouse or their ultimate takers.

Loss of Creditor Protection

First, the outright transfer of property

to the survivor means those assets may be subject to the claims of the survivor's creditors, including claims of any subsequent spouse, in the event of divorce and at death. The transfer of the wealth of the spouse dying first to a trust for the survivor can avoid most if not all of those claims.

DSUE Amount Is Frozen in Value

Second, the DSUE amount is frozen in value at the death of the first spouse (unless and until it is used and the assets transferred under its protection grow in value) even though the survivor's own exemption will continue to grow by an inflation factor. IRC § 2010(c)(3)(B). Hence, if the wealth grows to more than the combined DSUE amount and the survivor's own exemption at death, probably more will be subject to estate tax when the survivor dies than if the estate tax exemption of the spouse dying first had been used when he or she died.

Potential Loss of DSUE Amount

Third, if the survivor remarries and survives the new spouse, the survivor will lose the DSUE amount inherited from the first spouse unless used by lifetime gifts before the new spouse dies. A surviving spouse is only entitled to use the DSUE amount of the last spouse who predeceased him or her except to the extent the DSUE amount from the next previous spouse has been used by the survivor by making lifetime taxable gifts. See IRC § 2010(c)(4)(B)(i). The probability is relatively high a new spouse will have no DSUE amount available to port to the surviving spouse because it is used to protect property passing on his or her death to his or her own descendants.

Failure to Use GST Exemption

Fourth, the Pure Portability Plan does not make use of the GST exemption of the first spouse with the result that it will be wasted because it cannot be ported over to the survivor. A QTIP trust could be created for the surviving spouse equal to the amount of the unused GST exemption of the first spouse to die, and the estate of that spouse could make a so-called reverse QTIP election under IRC § 2652(a)(3). But the simplicity of the Pure Portability Plan would be sacrificed.

Even if the spouse dying first uses his or her GST exemption in the Portability Plan by creating a QTIP trust to which his or her estate would allocate GST exemption, the GST exemption so allocated will leak as the income is paid to the surviving spouse, as it must be with such a trust, as discussed in more detail below.

Critical Aspect of Portability Plan: DSUE Amount to Grantor Trust

The fact that the DSUE amount is frozen in size and the fact that a Credit Shelter Trust may grow between the deaths of the two spouses has caused some to suggest that the survivor should immediately use the DSUE amount after the first spouse dies, which we are calling the Portability Plan (as opposed to the Pure Portability Plan, which does not involve such an immediate gift). That approach would increase what the ultimate takers (for example, the descendants) would receive for a number of reasons.

Avoid State Death Tax

For example, unless the survivor's gift under the protection of the DSUE amount is subject to gift tax (as in Connecticut and Minnesota), using the DSUE amount avoids state death tax (for example, in New York or any of the other American jurisdictions that do not also impose a gift tax) on the first death. The DSUE amount in excess of the state estate tax exemption will have been transferred to the surviving spouse and qualify for the state death tax marital deduction or exemption as well as the federal estate tax marital deduction. As explained below, however, a similar, if not an enhanced, result of avoiding state death tax when the first spouse dies can be achieved using Rev. Proc. 2001-38.

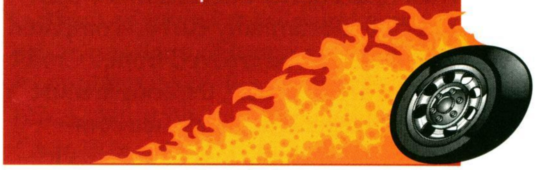
Income-Tax-Free Compounding

Another potential benefit for the ultimate takers of the couple's property (for example, their descendants) of using portability is that the survivor could make a gift to a trust that is a grantor trust for him or her but for the primary or exclusive benefit of the ultimate takers, which would mean the trust would grow free of income tax because the burden of paying the income tax on the income earned by the trust will be imposed on the surviving spouse. Cf. Rev. Rul. 2004-64, 2004-2 C.B. 7. When compared to the estate tax benefits of a Credit Shelter Trust, transferring the DSUE amount to a grantor trust in the Portability Plan likely is superior.

Survivor as Beneficiary of Grantor Trust

It is possible that this gift by the survivor equal to and under the protection of the DSUE amount could be made to a trust of which the survivor is the beneficiary or is one of the beneficiaries. That raises two issues, however, which may foil the attempted use of the DSUE amount. First, under the law of most American jurisdictions, the trust may be subject to the claims of the survivor's creditors. See, e.g., N.Y. Est. Powers & Trusts Law § 7-3.1. If so, that means that the trust would be included in the gross estate of the survivor even if the survivor never benefited from the property. See, e.g., Rev. Rul. 77-378, 1977-2 C.B. 347; *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986). It may be possible to avoid that automatic estate tax inclusion if the trust is created under the law of a jurisdiction that does not allow creditors of the settlor

The fact that the DSUE amount is frozen in size and the fact that a Credit Shelter Trust may grow between the deaths of the two spouses has caused some to suggest that the survivor should immediately use the DSUE amount after the first spouse dies.



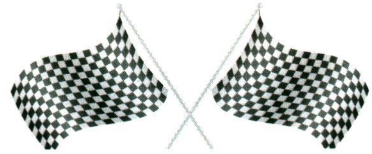
to attach the trust assets. See, e.g., PLR 200944002 (not precedent) and *Estate of German v. United States*, 7 Cl. Ct. 641 (1985). But see *In re Huber*, 493 B.R. 798 (Bankr. W.D. Wash. 2013).

According to the IRS, however, even if the creditor access is sufficiently retarded so as to not cause automatic estate tax inclusion, the trust nonetheless may be included if there is a finding of an understanding between the grantor and the trustee that the trustee would exercise discretion by making distributions to the grantor. That likely means that distributions to the surviving spouse should not be allowed or would have to be irregular and minimized, if the goal is to prevent the trust created with the inherited DSUE from being included in the gross estate of the surviving spouse and to maximize what the ultimate beneficiaries receive. At a minimum, consideration should be given to a mechanism for the surviving spouse to cease being a beneficiary before death.

Contrast to Credit Shelter Trust

On the other hand, as indicated above, if the first spouse to die creates a Credit Shelter Trust at death using his or her estate tax exemption, the surviving spouse may be a complete beneficiary and can be given lifetime and testamentary nongeneral powers of appointment (including, for example, the unilateral power to withdraw property for his or her health, education, maintenance, and support) without concern about estate tax inclusion.

A major difference between such a Credit Shelter Trust and the Portability Plan (that is, portability coupled with an immediate gift by the surviving spouse equal to the DSUE amount to a grantor trust) is that the grantor trust expected to be created under the Portability Plan will grow free of income tax, which may be the most powerful opportunity in wealth transfer tax planning. But, as indicated, either the survivor cannot be a beneficiary of that trust or his or her interests in the trust must be substantially curbed compared to what could be enjoyed from a Credit Shelter Trust. Hence, the couple must weigh the benefits of tax-free compounding with the loss of benefits to



A major difference between such a Credit Shelter Trust and the Portability Plan is that the grantor trust expected to be created under the Portability Plan will grow free of income tax, which may be the most powerful opportunity in wealth transfer tax planning.

the survivor that a Credit Shelter Trust may provide. Fortunately, virtually all of the benefits for the surviving spouse of a Credit Shelter Trust and income-tax-free compounding may be achieved by implementing a Supercharged Credit Shelter Trust[sm], as discussed below. This seems important because it probably is unrealistic to think a surviving spouse would give away to others an amount equal to the DSUE soon after the first spouse dies.

GST Exemption Problem with Portability Plan: Leakage

One of the other problems with the Portability Plan compared even to a traditional Credit Shelter Trust is that the GST exemption of the surviving spouse is not portable and will be lost unless it is used in some way other than allocating it to a Credit Shelter Trust, for there will be no such trust with portability. (Typically, the first spouse's GST exemption is allocated, to the extent thereof, to the Credit Shelter Trust.) It has been suggested that the first spouse's GST exemption be allocated to a QTIP trust that the first spouse to die will create at death for the survivor and for which the estate of the first to die will make the so-called reverse QTIP election under IRC § 2652(a)(3), and his or her unused GST exemption will be allocated to that trust. There are, however, at least two limitations or issues to consider.

First, the QTIP trust will be included in the gross estate of the survivor and, therefore, will be eroded by any estate tax it must pay when the survivor dies and thereby reduce the amount protected by the GST exemption, unless the survivor directs that payment of any estate tax on the QTIP trust be imposed on other assets (if available).

Second, even if other assets are available to pay the estate tax, the GST exemption allocated to the QTIP trust will leak by the income required to be paid to the surviving spouse.

Development of Supercharged Credit Shelter Trust[sm]

A Credit Shelter Trust not only preserves the estate tax exemption of the first spouse to die but also provides an opportunity to leverage the exemption of the first spouse during the remaining lifetime of the surviving spouse. To the extent there is appreciation and accumulated income in the trust, it may pass on the surviving spouse's death free of estate tax (and free of generation-skipping transfer tax through succeeding generations of the ultimate beneficiaries of the couple's property, assuming an allocation of GST exemption to the trust). The amount in the trust passing tax free at the surviving spouse's death would be enhanced, of course, if trust distributions to the surviving spouse were minimized. The amount in the trust would be further enhanced if the Credit Shelter Trust were the surviving spouse's grantor trust, so that the survivor could pay the tax on all the trust's taxable income without adverse transfer tax consequences. The reason for this second enhancement is that the payment by the surviving spouse of the income tax on the trust's income would permit the Credit Shelter Trust to grow income-tax-free. The trust, in other words, would enhance the estate and GST tax benefits of a Credit Shelter Trust by income-tax-free compounding. In other words, it would become supercharged.

The authors developed a structure to make the Credit Shelter Trust a grantor trust for the surviving spouse and thereby supercharge it through what we called the Supercharged Credit Shelter Trust[sm]. See Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter*

Trust℠, Prob. & Prop., July/Aug. 2007, at 52. Although that was developed before portability was even considered (much less enacted), the authors believe it produces a substantially better result for both the ultimate takers of the couple (for example, their descendants) and for the surviving spouse than does the Portability Plan, in most cases.

Structure of a Supercharged Credit Shelter Trust℠

In the Supercharged Credit Shelter Trust℠ plan, at least one spouse, if not each of the spouses, creates a lifetime QTIP trust for the other spouse if the other spouse is a U.S. citizen so that by making the QTIP election under IRC § 2523(f), transfers to the trust will qualify for the gift tax marital deduction. (Under IRC § 2523(i), no lifetime marital deduction is allowed if the beneficiary spouse is not then a U.S. citizen.) If only one lifetime QTIP is created, the spouse who creates the lifetime QTIP would be the spouse anticipated to survive. A lifetime QTIP trust will be a wholly grantor trust for the spouse who created the trust, under at least IRC §§ 676 and 677, if the beneficiary spouse is also at least a discretionary recipient of trust principal. Under IRC § 2044, the lifetime QTIP trust will be included in the gross estate for federal estate tax purposes of the spouse who is the beneficiary of the trust but it will remain a grantor trust for federal income tax purposes for the spouse who created it even though it has been included in the gross estate of the other spouse (as long as the first spouse was not granted or did not exercise a general power of appointment granted to that spouse in the lifetime QTIP trust (which would indeed be rare)). See Treas. Reg. § 1.671-2(e)(5).

Some may question whether it is possible for a QTIP trust to remain a grantor trust following the death of the QTIP beneficiary. Critiques have stemmed from an incorrect reading of the effective date of the operative regulation, as well as the specific exception for general power of appointment trusts, but only if the power is in fact exercised. See T.D. 8831, 1999-2 C.B. 264, and T.D. 8890, 2000-1 C.B. 122.

It may be tempting to conflate the transfer-tax rules with the grantor-trust rules. Perhaps confusing is the use of the words "gratuitous transfer" in the applicable regulation. This might cause one to import the transfer tax meaning of those words into the grantor trust rules, notwithstanding that the regulation expressly denies such a definition of those words.

To understand the import of Treas. Reg. § 1.671-2(e), it is critical to observe the fundamental departure from transfer tax principles. Conflating the transfer-tax rules and the grantor-trust rules is problematic for at least two reasons. First, the regulation does not make the transfer-tax rules a relevant consideration. Indeed, at two different junctures, it disavows these rules. It provides in Treas. Reg. § 1.671-2(e)(2)(i) that the determination whether a gratuitous transfer to the trust has occurred is to be made without regard to the gift tax rules. It goes on to provide that as a general rule a shift does not occur when property is transferred from one trust to another, but a shift does occur in connection with a general power of appointment only if the power is in fact exercised, even though a general power is, of course, treated as taxable under the transfer tax rules without regard to whether it is exercised.

Instead, the regulation indicates that when a trust that makes a transfer to another trust, although that transfer is a gratuitous transfer within the meaning of the regulation, the grantor of the original trust remains the grantor of the new trust, as a general matter. Because the gift tax is imposed on individuals, and not on trusts, it would be impossible for a trust to be viewed as having made a gratuitous transfer within the meaning of the gift tax. In addition, the regulation contemplates that a corporation or a partnership could make a gratuitous transfer to a trust for business purposes, and in that case the corporation or partnership is the grantor of the trust. Such a transfer would not have gift tax implications. In short, the regulation makes clear that the concept of a gratuitous transfer for purposes of the regulation must be determined without regard to transfer-tax principles.

The requirement that to become a taxable grantor of a trust, a voluntary transfer of property is required is further highlighted by Example 9. In Example 9, G creates and funds a trust, T1, for the benefit of B. G retains the power to revest the assets of T1 in G within the meaning of IRC § 676. B is granted a general power of appointment under the trust agreement and exercises that power in favor of a new trust, T2. B becomes the grantor of T2 in the example, even though G most certainly has made a taxable gift as a result of the loss of control over the property. Cf. *Diebold v. Commissioner*, T.C. Memo 2010-238, rev'd on other grounds, 736 F.3d172 (2d Cir. 2013).

Given the definition of "gratuitous transfer" in the regulation, on the termination of an inter vivos QTIP trust, there is a gratuitous transfer of property to the succeeding trusts within the meaning of the regulation. That conclusion is reached without regard to transfer tax principles. The critical question is the identity of the grantor. The foregoing analysis demonstrates that the fact that the beneficiary experiences a transfer tax event is not sufficient to cause the beneficiary to become the grantor of the succeeding trusts for income tax purposes. Indeed, without IRC § 2044, the donee of an inter vivos QTIP trust could not be deemed to make a transfer for transfer tax purposes because the donee does not own the QTIP property. Estate tax inclusion occurs as a result of IRC § 2044, a special provision necessary to include property that would not otherwise be part of the QTIP beneficiary's gross estate, not by reason of an exercise of a general power by the QTIP beneficiary. This same analysis also was applicable to a general power of appointment for estate tax purposes until the law on unexercised general powers of appointment was changed. See *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56 (1942).

Even assuming the Treasury were inclined to amend the regulation yet again in order to adopt a different view, it could not do so. For, under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), and

Mayo Foundation for Medical Education Research v. United States, 131 S. Ct. 704 (2011), it has no authority to draft a regulation that is contrary to the unambiguous terms of the underlying statute. The grantor trust provisions in the Code (other than IRC § 678) make clear that they apply to the person who actually makes a contribution to the trust, not a person who is deemed to have made a transfer under the transfer tax rules. This lack of parallelism between the grantor trust rules and the transfer tax rules is not surprising. After all, it is, as a general matter, well established and is indeed the basis for many commonly used estate-planning tools—the installment sale technique, for example, exploits this lack of parallelism in the sense that the grantor is deemed to own the assets in the trust for income tax purposes but not for estate tax purposes.

Accordingly, by the terms of the lifetime QTIP trust or under the exercise of a special power of appointment by the beneficiary spouse, the lifetime QTIP trust will become a Credit Shelter Trust using the unified credit (estate tax exemption) of the beneficiary spouse in whose gross estate the QTIP trust is included but remains a grantor trust for the donor spouse. (As noted in the original Supercharged article, however, the Supercharged Credit Shelter Trust℠, in order to avoid potential application of IRC § 2041 on the death of the donor spouse, either should be created in a jurisdiction where creditors of a settlor may not attach assets in a lifetime QTIP or a self-settled trust generally and distributions to the survivor should be limited to health, education, maintenance, and support.) Note that it would even be possible for the donor spouse to retain a secondary life estate in the lifetime QTIP trust without causing estate tax inclusion. See Treas. Reg. § 25.2523(f)-1(f), ex. 10.

Simulating a Step-Up in Basis

Because the credit shelter trust formed from the lifetime QTIP trust will remain a grantor trust for federal income tax purposes for the spouse who created it (and who is the beneficiary of the credit shelter trust), it will grow free of income tax without the spouse who created the lifetime QTIP trust being treated as making a gift by paying the income tax on the trust's income. See Rev. Rul. 2004-64, 2004-2 C.B. 7. In addition, even though the Credit Shelter Trust will not be included in the gross estate of the surviving spouse and, therefore, the basis of its assets may not be stepped up under IRC § 1014(a) when he or she dies, he or she may substitute assets with higher bases than those in the trust at any time, even just before death, free of income tax by reason of Rev. Rul. 85-13, 1985-1 C.B. 184. This substitution may simulate the effect of the tax-free step-up in basis at death for assets included in the gross estate and, in fact, at least for purposes of gain, may have bases in excess of their values when the surviving spouse dies. See IRC § 1015. It should be noted that the same capacity to substitute higher basis assets also would be available for a grantor trust created by the surviving spouse using the inherited DSUE amount under the Portability Plan.

The same capacity to substitute higher basis assets also would be available for a grantor trust created by the surviving spouse using the inherited DSUE amount under the Portability Plan.

Other GST Exemption Issues with the Plans

As mentioned above, the GST exemption of the first spouse cannot be ported over to be used by the survivor. The loss of that GST exemption would be inconsistent with the adoption of the Portability Plan, which by premise is used to try to maximize what the ultimate takers of the couple's property will receive.

To attempt to avoid the loss of the use of the GST exemption of the first spouse, it has been suggested that under the Portability Plan the first spouse to create a QTIP trust for the surviving spouse equal to the first spouse's unused GST exemption making a so-called reverse QTIP election made under IRC § 2652(c)(3) so the GST exemption of the first spouse could be allocated to it. There are at least two issues in doing that. First, if such a QTIP trust is created, it is possible that the survivor will not have enough property to use the entire inherited DSUE amount. The reason is that the use of the first spouse's estate tax shelter and GST exemption have become de-coupled, causing the need to place more property in trust to use both shelters on the first death.

Because the first spouse's QTIP trust, which is GST-exempt, will be reduced by the payment of income to the surviving spouse, a part of the leverage that can occur by reason of the GST exemption allocation will be eroded. It seems that the erosion of GST tax benefits may be offset to a degree by the DSUE amount gift trust, which can grow income-tax-free. Thus, it does seem that the Portability Plan would on average be superior to the Credit Shelter Trust from a wealth transfer perspective, although, as previously discussed, the surviving spouse cannot, as a practical matter, have the same array of interests in the DSUE amount trust as with a Credit Shelter Trust.

The bottom line is that it likely would be best if the GST exemption of the spouse dying first could be allocated to a trust that has been supercharged (that is, to a trust that is a grantor trust for the surviving spouse) and does not leak out income. That cannot be done with the Portability Plan unless the surviving spouse allocates the surviving spouse's own GST exemption to the DSUE amount trust. It can be done with a Supercharged Credit Shelter Trust℠ because the spouse dying first and not the surviving spouse will be treated as creating the trust. In fact, the Supercharged Credit Shelter Trust℠ provides the option of using the GST exemption of either spouse.

More on GST Exemptions and the Supercharged Plan

If the spouse who created the lifetime QTIP trust (that will become a Supercharged Credit Shelter Trust℠ for him or her when the first spouse dies) makes the reverse QTIP election under IRC § 2652(c)(3) and allocates his or her GST exemption to that trust when it is created, the GST exemption will increase, if the trust grows in value, during the balance of the spouse's lifetime as well as after the death of the spouse dying first. The amount of GST exemption available to the spouse who created the lifetime QTIP trust will continue to grow by the inflation adjustment provided under IRC §§ 2010(c)(3)(B) and 2631(c).

To the extent, if any, that the value of the lifetime QTIP trust exceeds the remaining unused estate tax exemption of the spouse who was the beneficiary of the lifetime QTIP trust and who dies first, this excess can be transferred to a separate QTIP trust, which also will be GST-exempt if the survivor allocated his or her GST exemption to the lifetime QTIP trust when it was first created.

Furthermore, as noted in the original Supercharged Credit Shelter Trust℠ article, such a plan likely will enhance the amount of property protected from estate and GST tax, sometimes by a significant amount (possibly, a multiple), compared to having a Credit Shelter Trust created when the first spouse dies because both the unified credit and the GST exemption of the first spouse have been supercharged by reason of being in a grantor trust for that spouse (and potentially even more so if the survivor allocated his or her GST exemption to the lifetime QTIP trust when first created).

As indicated, it may or may not be more efficient for the surviving spouse to allocate his or her GST exemption to the lifetime QTIP trust (at the time it is created) rather than having the first spouse to die allocate his or her GST exemption to it when he or she dies. If the surviving spouse has allocated his or her GST exemption at the time the lifetime QTIP is formed, it may grow (and free of income tax) from the time the surviving spouse created the lifetime QTIP trust and when the other spouse dies. There will be leakage from this trust, however, up until the first spouse dies, when the must-pay-the-income QTIP trust may morph into a discretionary Credit Shelter Trust.

The increase in value of the lifetime QTIP trust might exceed the amount of income that must be paid from it to the first spouse to die up until the time the survivor dies. And, if so, it likely will be better if the spouse who created the lifetime QTIP allocates his or her GST exemption to the lifetime QTIP trust rather than have the first spouse allocate his or hers to the Supercharged Credit Shelter Trust℠ (which will be formed from the lifetime QTIP trust) when he or she dies. Whether the couple can count on an increase in the lifetime QTIP trust in excess of the income payable each year to the first spouse to die depends on many factors, including how long it is before the death of the first spouse to die.

It is, perhaps, appropriate to note that the ultimate beneficiaries of the couple's wealth (for example, their descendants) would not have to suffer through leakage of the GST exemption of the spouse dying first in a QTIP trust if that spouse did not create a QTIP trust for the survivor but at death transferred an amount equal to his or her GST exemption to a trust for these ultimate beneficiaries. This would have the effect of accelerating an estate tax that might otherwise be deferred or eliminated, if a Supercharged Credit Shelter Trust℠ for the surviving spouse is created under the lifetime QTIP. Indeed, the ultimate takers almost always will be better off if the spouses do not provide for each other when the first of them dies, assuming a constant transfer tax system. Nonetheless, the authors' premise in comparing the Portability Plan to the Supercharged Credit Shelter Trust℠ plan, a traditional Credit Shelter Trust, and nonreciprocal lifetime trusts is that the spouses want all of their combined wealth available to them or the survivor until they both have died and any comparison of options must be premised on that.

Therefore, it seems that, adhering to that premise as the primary goal, the couple's secondary goal of maximizing what their ultimate takers will receive most likely will be achieved by the lifetime use of their exemptions by transfers to nonreciprocal trusts for each other, which will get their gift/estate and GST exemptions working as early as possible. If they choose not to do that, the Supercharged Credit Shelter Trust℠ plan almost certainly will be preferable to the Portability Plan or a traditional Credit Shelter Trust plan, in most cases.

Supercharged Credit Shelter Trust℠ and State Death Tax

State Death Tax Exemption Dilemma

Many states have an independent state death tax system with a state death tax exemption smaller than that allowed under federal law. If the first spouse uses the full federal exemption by making a gift to a traditional Credit Shelter Trust, for example, state death tax will be due at his or her death because the state death tax exemption is smaller than the federal exemption. Alternatively, if he or she limits the use of the exemption to the state death tax exemption, there would be no state death tax when the first spouse dies but probably more will be included in the gross estate of the surviving spouse because a larger marital deduction was used than would have been used had the entire federal estate tax exemption been transferred to the Credit Shelter Trust.

Portability may provide a solution (except, perhaps, in Connecticut and Minnesota, which have gift taxes). The surviving spouse, however, must be willing to give away during his or her lifetime an amount equal to the inherited DSUE amount. Not only may a surviving spouse be hesitant to do that, but he or she, as explained above, would not be able to enjoy the same level of benefit and control he or she may have with a traditional Credit Shelter Trust.

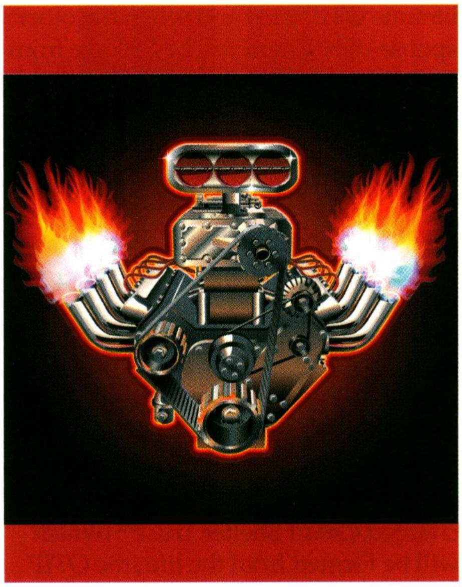
It seems, however, that the state death tax exemption problem can be avoided and, in fact, planning may be enhanced for the family by having the estate of the surviving spouse trigger the application of Rev. Proc. 2001-38, 2001-1 C.B. 1335. In fact, it even seems

to work to avoid gift tax in Connecticut and Minnesota.

Under Rev. Proc. 2001-38, the IRS ruled that the estate of the surviving spouse is permitted to undo or reverse any QTIP election made in the estate of the first spouse to die that was unnecessary to reduce the federal estate tax, which means that to the extent it is undone, the QTIP trust would not be included in the survivor's gross estate under IRC § 2044. Note that, even if the revenue procedure is invoked, it seems that any GST exemption allocated to the QTIP trust would be preserved, although, as discussed in Mitchell M. Gans & Jonathan G. Blattmachr, *Quadpartite Will: Decoupling and the Next Generation of Instruments*, 32 Est. Plan. 3 (Apr. 2005), it seems likely that it would be first allocated to the Credit Shelter Trust, which in this case would be equal to the state estate tax exemption and then to any so-called reverse QTIP trust (at least one of which would be made equal to the excess of the federal GST exemption amount over the value of the Credit Shelter Trust, which will equal the state death tax exemption).

In fact, the estate of the surviving spouse now has a choice: (1) do not invoke Rev. Proc. 2001-38, which will mean that the assets will be included in his or her estate at death but will allow the assets (subject to the usual exceptions, for example, for the right to income in respect of a decedent (IRD)) to receive an automatic change in basis under IRC § 1014; or (2) invoke the revenue procedure so that assets will be excluded from the gross estate of the survivor. Nevertheless, it seems possible that if a QTIP election is made that results in porting of the DSUE amount, the IRS may revise the revenue procedure to disallow its application, considering that the QTIP election was likely necessary to achieve the tax benefit of a DSUE amount. It would seem administratively problematic to administer a retroactive disallowance of portability, particularly if the DSUE amount has been used to make taxable gifts.

An advantage portability might have over relying on Rev. Proc. 2001-38 is that the trust created by the surviving spouse to use the DSUE amount could be a grantor trust for the surviving spouse so that it is supercharged, and it need not leak by distributions of income to the surviving spouse. This apparent advantage of using portability, however, can also be garnered using the revenue procedure and a Supercharged Credit Shelter Trust[sm].



Funding a Credit Shelter Trust with IRD

Avoid Funding a Credit Shelter Trust with IRD

Because the federal estate tax exemption is so large, many individuals will not have sufficient assets to fully fund a Credit Shelter Trust. Even if they have such assets, it seems likely that many of these individuals would have no choice but to fund it with assets that represent the right to IRD described in IRC § 691, such as interests in qualified retirement plans and IRAs. Except for Roth IRAs and other limited exceptions, qualified plans and IRAs will be subject to ordinary income tax when the required distributions are made. In other words, the right to IRD (such as a traditional IRA) has an inherent income tax liability in it, meaning it is a less desirable (valuable) asset with which to fund a Credit Shelter Trust than an asset that has received an automatic change in basis to its fair market value when its owner dies. Hence, it usually is preferable to fund a Credit Shelter Trust with non-IRD assets and, if the decedent was married, to have the plan or IRA pass to his or her surviving spouse. See generally Natalie B. Choate, *Life and Death Planning for Retirement Plans* ch. 3 (7th ed. 2011). But the spouse dying first simply may have insufficient non-IRD assets with which to fund the Credit Shelter Trust.

Portability May Avoid Such Funding

Portability can avoid this problem. The right to the IRD could pass to the surviving spouse, meaning the estate tax exemption of the spouse dying first will not have been used and portability may be invoked. The survivor could immediately or even at death use the DSUE amount to transfer non-IRD assets estate-tax-free using the DSUE amount, which will not have been eroded by income tax as would have occurred had a Credit Shelter Trust been created and funded with the right to IRD. Of course, the survivor may not have non-IRD assets in life or at death with which to transfer under the protection of the DSUE amount.

Summary and Conclusions

Estate tax advisors and their married clients may now face an additional complication in estate planning: to use or not use the first spouse's exemption or rely on portability. Although the Pure Portability Plan is simple to draft and implement, it suffers from many drawbacks including reduced creditor protection, loss of a mechanism to enhance the benefits of the shelter by future appreciation and the risk of loss by remarriage, and loss of the first spouse's GST exemption. Some of these shortfalls can be avoided by adopting a more complicated plan (such as one involving the creation of a reverse QTIP trust) but that is likely no less complicated than a plan that creates a Credit Shelter Trust. Another possibility is to plan on having the survivor transfer to a grantor trust the DSUE amount shortly after the first spouse dies. Greater leverage is achieved with the Supercharged Credit Shelter Trust[sm], which essentially uses the same structure as the Credit Shelter Trust plan but enhances the results by superior GST planning and the potential for tax-free compounding. ■