Portability Temporary and Proposed Regulations (Issued June 15, 2012)

Temporary and Proposed Regulations Clarify (Very Liberally in Favor of Taxpayers) Many Uncertainties Regarding Determination of and Use of the Unused Exclusion Amounts of Deceased Spouses by Surviving Spouses

June 2012
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

Contents

Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Overview

Temporary and proposed regulations were issued on June 15, 2012. There are a few new general regulations for §§2010 and 2505 (interestingly, regulations were never previously issued for those statutes), but the newly issued regulations primarily provide guidance regarding the portability provisions included under §303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Act"). The portability provisions generally allow a surviving spouse to use any unused exclusion from his or her deceased spouse. The regulations provide guidance on a variety of issues including election requirements, details regarding computing the unused exclusion amount, and the surviving spouse's use of the unused exclusion amount (either by gifts or for estate tax purposes following the surviving spouse's death).

The regulations generally provide very taxpayer-friendly positions (surprisingly friendly as to several issues) regarding a variety of issues. The regulations adopt reasonable positions, avoiding what would seem to be nonsensical results that might occur with respect to various issues under a literal reading of the statutory provisions of §2010(c)(4) and §2505 (the sections describing the unified credit against estate tax and gift tax, respectively). Perhaps the specific authorization in §2010(c)(6) for the Secretary of the Treasury to prescribe regulations necessary or appropriate to carry out that subsection afforded comfort in interpreting the statutory language very broadly in order to reach reasonable results.

The regulations apply to estates of decedents who died on or after January 1, 2011. However, the regulations expire in three years (if the proposed regulations are not finalized before that date).

Brief Background

The 2010 Act allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount." (Commentators have generally referred to this as the "DSUEA," but the regulations use the term "DSUE amount.") The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." While the portability statutory provisions will sunset after 2012 without further Congressional action, the Administration's Fiscal Year 2013 Revenue Proposals proposed making the portability provisions permanent (and there does not appear to be any constituency objecting to the portability concept).

Even though the portability rules apply to decedents who died on or after January 1, 2011, the IRS has given limited guidance, up until issuance of the regulations. Notice 2011-42 provided that, pending further guidance, a "timely filed and complete" estate tax return would be deemed to make the election and deemed to include a computation of the DSUE amount. Notice 2012-21 granted a six month extension for filing the estate tax return to elect portability for estates of decedents who die in the first half of 2011. Other than that, planners have anxiously been awaiting guidance.

Overview of Regulatory Provisions and Observations

1. *Making the Portability Election.*
    a. *Statutory Provisions.* Section 2010(c)(5)(a) states that the DSUE amount is available to the surviving spouse only if the decedent's "executor" timely files an estate tax return on which the DSUE is computed and makes an election on the return for portability to apply.

b. *Timely Filed Estate Tax Return*. The last return filed by the due date (including extensions) controls. Before the due date, the executor can supersede the election made on a prior return. After the due date, the portability election (or non-election) is irrevocable. Temp. Reg. §20.2010-2T(a)(4).There is no discussion whether 9100 relief may be available. Presumably not because this is a statutory requirement; in any event, planners should not assume the availability of "9100 relief" to permit a late election.

c. *Election on Return*. The election is made by merely filing a "complete and properly-prepared" estate tax return unless the executor states affirmatively on the return or an attachment to the return that the estate is not electing portability. (The manner for making this affirmative statement will be in the instructions that will be issued for Form 706.) Another way of not making the election is not to file a timely return. Temp. Reg. §20.2010-2T(a)(2)-(3).

Some comments asked the IRS to give guidance about protective portability elections. For example, if there is a will contest, the DSUE amount may depend on who wins the contest. Until the contest is resolved, there may be no way of knowing who is the executor or even who is in actual or constructive possession of property unless the court appoints a temporary executor. The regulations have no discussion of protective elections.

d. *"Executor" Permitted to Make Election*. If there is a court appointed executor, that person may make the election. (The regulations do not address the situation of having multiple court-appointed co-executors. Temp. Reg. §20.2010-2T(a)(6)(i). Presumably the rules for filing estate tax returns would apply, which generally require that all co-executors join in signing the return.)

If there is no appointed executor (and presumably only if there is no appointed executor) any person in actual or constructive possession of property may file the estate tax return on behalf of the decedent and elect portability or elect not to have portability apply. Any portability election made by non-appointed executor cannot be superseded by a subsequent election to opt out of portability by any other non-appointed executor. Temp. Reg. §20.2010-2T(a)(6)(ii).

Observation Regarding Surviving Spouse. Some comments to the IRS suggested allowing a surviving spouse to file an estate tax return to make the portability election in the event that an appointed executor does not file an estate tax return. However, the IRS felt constrained by the statute's requirement that the "executor" make the election, and did not adopt this approach. It is interesting that the IRS construed the statute extremely broadly (to the extent of changing words and adding words to the statute) to reach just and reasonable results with respect to other issues, but felt constrained as to this issue. For example, consider a procedure by which the surviving spouse could file an affidavit with a return stating that the spouse had given 60-day prior written notice to the executor of an intent to file a return on behalf of the executor making the election unless the executor objected and that the executor had not objected (or perhaps stating that the executor affirmatively notified the spouse that the executor did not object to the spouse filing a return for this purpose on behalf of the executor). Does the statute really absolutely constrain a conclusion that a return filed by the surviving spouse under these circumstances on behalf of the executor is deemed to be filed by the executor for purposes of the portability election? Is that construction any more of a stretch than construing "basic exclusion amount" to mean "applicable exclusion amount" in §2010(c)(4)(B)(i) or adding DSUE amounts used from prior deceased spouses in the definition of the DSUE

amount in §2010(c)(4)? A construction allowing a surviving spouse to file a return and make the election, where the executor consents or fails to object, could be quite helpful. Many planners have questioned whether it is not more appropriate for the surviving spouse to pay the expense of filing a return for the decedent to make the portability election than for the estate to bear that expense, because the surviving spouse's recipients are the ones who will benefit from the portability election, not the deceased spouse's estate.

Observe that if there is no court appointed executor and if the spouse is in actual or constructive possession of property of the decedent, the spouse *would* be able to file a return making the portability election, and no other individual would be able to supersede that with a return opting out of the election.

e. *Computation of DSUE Amount on Return.* Until the Form 706 is revised to include a section for computing the DSUE amount, a complete and properly-prepared estate tax return will be deemed to include the computation. Estates that file returns before the Form 706 has been revised will not be required to file a supplemental estate tax return including the computation using the revised form. Temp. Reg. §20.2010-2T(c).

f. *Relaxed Requirements for "Complete and Properly-Prepared" Return.* A "complete and properly-prepared" return is generally one that is prepared in accordance with the estate tax return instructions. However, there are relaxed requirements for reporting values of certain assets. For assets that qualify for a marital or charitable deduction, the return does not have to report the *values* of such assets, but only report the description, ownership, and/or beneficiary of the property together with information to establish the right to the deduction. However, the values of assets passing to a spouse or charity must be reported in certain circumstances (where the value relates to determining the amounts passing to other beneficiaries, if only a portion of the property passes to a spouse or charity, if there is a partial disclaimer or partial QTIP election, or if the value is needed to determine the estate's eligibility for alternate valuation, for special use valuation, or for §6166 estate tax deferral. Temp. Reg. §20.2010-2T(a)(7)(ii)(A).

In any event, the executor must exercise "due diligence to estimate the fair market value of the gross estate" including the property passing to a spouse or charity. The executor must identify the range of values within which the "executor's best estimate" of the gross estate falls. Until the estate tax return is revised to include those ranges of value, the return must state the "executor's best estimate, rounded to the nearest $250,000." Temp. Reg. §20.2010-2T(a)(7)(ii)(B).

Observation: The regulations provide little further detail regarding what extent of "due diligence" is required. The Preamble to the regulations states that the inquiry required to determine the executor's best estimate "is the same an executor of any estate must make under current law to determine whether the estate has a filing obligation…" Apparently, the required due diligence means something less than obtaining full-blown formal appraisals. In most situations, the executor will need to obtain valuation information in any event to support the amount of basis step up under §1014 (or perhaps for state estate tax purposes if there is a state estate tax).

Various examples are provided in Temp. Reg. §20.2010-2T(a)(7)(ii)(C).

2. *Computation of DSUE Amount.* As mentioned above, the regulations referred to the deceased spousal unused exclusion amount as the "DSUE amount" (rather than the more commonly used abbreviation, "DSUEA").

a. *Statutory Provision.*

§2010(c)(2) APPLICABLE EXCLUSION AMOUNT. – For purpose of this subsection, the applicable exclusion amount is the sum of –

(A) the basic exclusion amount, and

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

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

(A) the basic exclusion amount, or

(B) the excess of —

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

(ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. [The last amount is the amount of taxable estate plus adjusted taxable gifts of the predeceased spouse.]

b. *Overview of Regulation.* As a prelude to the following discussion of changes made by the regulation, compare the statutory language of §2010(c)(4), quoted above, with the regulatory interpretation of that same language (the italicized words have been added or changed in the regulations as compared to the statute):

… The DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts —

(i) The basic exclusion amount *in effect in the year of the death of the decedent*;

or

(ii) The excess of —

(A) The decedent's *applicable exclusion amount*; over

(B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent [*reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s)*], which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).

Temp. Reg. §20.2010-2T(c)(1) (the bracketed language is added by §20.2010-2T(c)(2)).

In addition, the DSUE amount is increased by

[t]he DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse.

Temp. Reg. §§20.2010-3T(b), 25.2505-2T(c).

c. *Basic Exclusion Amount Limitation in §2010(c)(4)(A) Refers to Basic Exclusion Amount at Predeceasing Spouse's Death.* The regulation *very surprisingly* interprets the term "basic exclusion amount" in §2010(c)(4)(A) to mean the basic exclusion amount at the death of the predeceasing spouse. Temp. Reg. §20.2010-2T(c)(1)(i). This is very taxpayer-friendly, and ultimately allows the regulation to adopt the "Example 3" approach (discussed in Item 2d below) by regulation (even though the Joint Committee Technical Explanation ERRATA Report suggested that a statutory change might be necessary to achieve that intended result). However, the Preamble to the regulations suggests a rather unusual statutory construction in order to achieve this very desirable result.

Background and Observation. The DSUE amount is the lesser of two elements, the first of which is the "basic exclusion amount." That limitation is designed primarily to prevent an individual from amassing a number of DSUE amounts from various predeceasing decedents, by limiting the aggregate DSUE amount to the basic exclusion amount. Therefore, the surviving spouse would have his or her own basic exclusion amount plus up to one additional basic exclusion amount. From the statutory terms, most planners have assumed this term refers to the basic exclusion amount at the time that the surviving spouse makes use of the DSUE amount, either by gift or at the surviving spouse's subsequent death. This is for two reasons.

First, the definition of the "applicable exclusion amount" in §2010(c)(2) refers to the "basic exclusion amount," which obviously refers to the basic exclusion amount at the time the applicable exclusion amount is being used, either by gift or estate transfer. Section 2010(c)(2) also refers to the "deceased spousal unused exclusion amount," and that term is defined in §2010(c)(4) as the lesser of (A) the "basic exclusion amount" or an amount described in clause (B). Because of the obvious interaction of §2010(c)(2) and 2010(c)(4), the use of exactly the same term presumably would have the same meaning — i.e., the basic exclusion amount at the time the applicable exclusion amount is being used by a gift or estate transfer and not at some prior time.

Second, §2010(c)(4) defines "deceased spousal unused exclusion amount" as the lesser of "(A) the *basic exclusion amount*, or (B) the excess of — (i) the *basic exclusion amount of the last such deceased spouse of such surviving spouse*, over" an amount described in clause(B)(ii). Clause (B)(i) very specifically refers to the basic exclusion amount of the last deceased spouse, so presumably the term "basic exclusion amount" in clause (A) must refer to something different than that or it would have used the same words.

The regulations take a different approach, interpreting the term "basic exclusion amount" in clause (A) also to mean "basic exclusion amount *of the last of such deceased spouse of such surviving spouse*" even though clause (A) does not include those *italicized* words that are in clause (B)(i). Observe the dichotomy that exists under this most unusual construction. Words in clause (A) are interpreted to mean different words that are in clause (B)(i), but those same exact words in clause (B)(i) are interpreted to mean something totally different despite the fact that they are literally very precise. This quite unusual construction is employed so that the regulations can then interpret the term "basic exclusion amount" in clause (B)(i) to mean something other than the basic exclusion

amount of the last deceased spouse. (The regulations interpret that term to mean "applicable exclusion amount" as described in Item 2d below).

This all achieves a *very* desirable result, but with a rather unusual (and surprising to this author) statutory construction. The regulations adopt creative reasoning suggested by comments from ACTEC as a way to confirm the Example 3 approach by regulation.

Planning Implications. This construction of the first "lesser of" element means that there is no risk that the DSUE amount will be reduced by subsequent legislation reducing the basic exclusion amount after the first decedent's death. This removes the possibility of a "clawback" that might otherwise occur if an individual make gifts using the DSUE amount and if the basic exclusion amount were later reduced by Congressional action, requiring estate tax to be paid on the inclusion of adjusted taxable gifts in excess of the lower basic exclusion amount (which would limit the DSUE amount but for the construction in the regulation) that applied at the surviving spouse's subsequent death.

d. *Reference to "Basic Exclusion Amount" in §2010(c)(4)(B)(i) Means "Applicable Exclusion Amount;" Adoption of "Example 3 Approach" by Regulation.* The term "basic exclusion amount of the last such deceased spouse of such surviving spouse" in §2010(c)(4)(B)(i) is interpreted to mean "the decedent's applicable exclusion amount." Temp. Reg. §20.2010-2T(c)(1). This difference is critical, because an individual's "applicable exclusion amount" includes his or her basic exclusion amount plus DSUE amount (in the case of a decedent who is a surviving spouse of a prior decedent who left him or her with a DSUE amount). This adopts the position taken in Example 3 on page 53 of the Joint Committee on Taxation Technical Explanation of the 2010 Act.

As an overly simplified example, assume that H1 dies, leaving in unused exclusion amount of $2 million. Assume that W remarries and predeceases H2. In calculating the DSUE amount that H2 receives from W, can the $2 million DSUE amount that W received from H1 be added to her unused exclusion amount? Example 3 of the Joint Committee on Taxation Technical Explanation of the 2010 Act says yes, but that does not appear to be the correct answer under the statutory language. Under the statutory language, the DSUE amount from W would be her basic exclusion amount less the amount of her taxable estate and adjusted taxable gifts. The DSUE amount that she had from H1 would not enter into the calculation under the statutory language at all. Indeed footnote 1582A added to the technical explanation by the "ERRATA — 'General Explanation of Tax Legislation Enacted in the 111th Congress (ERRATA), JCX-20-11, at page 1, acknowledges that "[a] technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent." By interpreting basic exclusion amount to mean applicable exclusion amount, a computation of the DSUE amount from W would start with her basic exclusion amount plus DSUE amount from H1 (because "applicable exclusion amount" means basic exclusion amount plus DSUE amount), and the DSUE amount from H1 is included in the DSUE amount that H2 receives from W.

To reach this statutory construction, the Preamble reasons that the statute requires that the DSUE amount be computed and included on the decedent's estate tax return, but it could not be calculated at the time of the decedent's death if it depended upon the basic exclusion amount that applied at the time of a subsequent gift or estate transfer by the surviving spouse. (*Observation: A*nother way of interpreting the statutory language is that

the DSUE amount would be computed and included on the decedent's estate tax return, and having that computation would allow an appropriate adjustment to the computation of the available DSUE amount when there was an actual gift or estate transfer at a later time by the surviving spouse. Indeed, other provisions of these same regulations contemplate an adjustment to the DSUE amount after the first decedent's death if assets pass to a QDOT, despite the requirement that the DSUE amount be computed on the decedent's estate tax return. Temp. Reg. §§20.2010-3T(c)(2), 25.2505-2T(d)(2) Furthermore, the regulations also contemplate the necessity of adjusting the DSUE amount in the case of a spouse who receives and makes gifts of DSUE amounts from multiple spouses. Temp. Reg. §20.2010-3T(b).)

In any event, the IRS's very generous interpretation of the statute is most welcome and manages to reach a result that was apparently intended, as reflected in Example 3. The result is reached by regulation rather than having to wait for a statutory technical correction.

e. *Adjustment to Omit Adjusted Taxable Gifts on Which Gift Taxes Were Previously Paid.* If the decedent paid a gift tax on prior gifts, the regulations provide that those gifts are excluded from the computation of the DSUE amount. This reaches a fair result.

Under the statutory language, if an individual makes lifetime gifts in excess of the gift exclusion amount, the excess reduces the DSUE amount for that individual's surviving spouse, even though the individual had to pay gift tax on that excess gift amount.

The second "lesser of" element in computing the DSUE amount is

> the excess of-- (A) The decedent's applicable exclusion amount; over (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent…. Temp. Reg. §20.2010-2T(c)(1).

Under the statute, there is no distinction for adjusted taxable gifts that were subject to actual payment of gift tax.

The regulations add that solely for purposes of computing the DSUE amount, the amount of adjusted taxable gifts "is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s)." Temp. Reg. §20.2010-2T(c)(2). An example clarifies that this means "the amount of the gift in excess of the applicable exclusion amount for that year." Temp. Reg. §20.2010-2T(c)(5)Ex. 2.

This is a very desirable and just result, even if the construction requires that the regulation effectively read additional words into the statute.

f. *Other Credits.* Some comments filed in response to Notice 2011-82 asked for clarification as to whether the DSUE amount is determined before or after the application of other available credits. This issue is still under consideration, and the regulation reserves a space to provide future guidance. Temp. Reg. §20.2010-2T(c)(3).

The Comments by ACTEC that were filed with the IRS clarify how this issue can arise:

> The purpose of the DSUEA rules is to leave the surviving spouse the full benefit of the first deceased spouses unused basic exclusion amount, and we believe it would be both useful and appropriate for the regulations to state explicitly that the DSUEA is determined after first taking full advantage of all other available credits. The following example illustrates this rule.

Example. H and W are married and are both U.S. citizens. H dies in Year One, leaving an estate at $10 million, of which $5 million is left to H's children and $5 million to W. H has made no lifetime taxable gifts. H's gross estate includes property with a value of $6 million that was previously taxed in the estate of A, a U.S. citizen who died one year earlier. H's estate is entitled to a $X credit for the tax on prior transfers with respect to the property received from A. The DSUEA available to W with respect to H's estate is determined by reducing H's estate tax liability by $X, before using any of H's basic exclusion amount to offset that liability.

3. *Last Deceased Spouse.* The regulations reiterate that the "last deceased spouse" means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse." Temp. Reg. §20.2010-1T(d)(5). The regulations confirm that if no DSUE amount is available from the *last* deceased spouse, the surviving spouse will have no DSUE amount even if the surviving spouse previously had a DSUE amount from a previous decedent. Temp. Reg. §§20.2010-3T(a)(2), 25.2505-2T(a)(2). (However, as discussed in Item 5e below, DSUE amounts from previous deceased spouses are included to the extent the surviving spouse made gifts using DSUE amounts from prior deceased spouses.) The surviving spouse's subsequent marriage has no impact unless the subsequent spouse predeceases, and therefore becomes the new "last deceased spouse." If there is a subsequent marriage that ends in divorce or annulment, the death of the ex-spouse will not change the identity of the last deceased spouse. Temp. Reg. §§20.2010-3T(a)(3), 25.2505-2T(a)(3).

4. *When DSUE Amount Can Be Used.* The surviving spouse can make use of the DSUE amount any time after the first decedent's death. The portability election applies as of the date of the decedent's death, and the DSUE amount is included in the surviving spouse's applicable exclusion amount with respect to any transfers made by the surviving spouse after the decedent's death. Temp. Reg. §20.2010-3T(c)(1). There is no necessity of waiting until after an estate tax return has been filed electing portability. Presumably, the surviving spouse could make a gift the day after the last deceased spouse's death, and the DSUE amount would be applied to that gift.

   The surviving spouse's applicable exclusion amount will not include the DSUE amount in certain circumstances, meaning that a prior transfer may end up not being covered by the expected DSUE amount when the surviving spouse files a gift or estate tax return reporting the transfer. For example, if the executor eventually does not make a portability election, the DSUE amount is not included in the surviving spouse's applicable exclusion amount with respect to those transfers. This is the case even if the transfer was made in reliance on the availability of a DSUE amount such as if the executor had filed an estate tax return before the transfer was made, but subsequently superseded the portability election by filing a subsequent estate tax return before the filing due date opting out of the portability election. Similarly, the DSUE amount would be reduced to the extent that it is subsequently reduced by a valuation adjustment or correction of an error or to the extent the surviving spouse cannot substantiate the DSUE amount claimed on the surviving spouse's gift or estate tax return. Temp. Reg. §20.2010-3T(c)(1).

5. *Gifts by Surviving Spouse.*

   a. *Gift Tax Statutory Provisions.*

      §2505(a) GENERAL RULE. — In the case of a citizen or resident of the United States, there shall be allowed as a credit against the tax imposed by section 2501 of each calendar year an amount equal to —

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

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

b. *Generally — DSUE Amount Included in Surviving Spouse's Applicable Exclusion Amount for Gift Tax Purposes*. If the surviving spouse makes gifts any time after the last deceased spouse's death, his or her applicable exclusion amount that is used to determine the gift tax unified credit will include the DSUE amount. Temp. Reg. §25.2505-2T(a)(1).

c. *Last Deceased Spouse Determined At Time of Gift*. The "last deceased spouse" is determined at the time of the gift. The DSUE amount from that spouse is used to determine the applicable exclusion amount with respect to that gift, even if a subsequent spouse of the donor dies before the end of the year. Temp. Reg. §25.2505-2T(a)(1)(i). Without this rule, the DSUE amount from the subsequent spouse who died before the end of the year in which the gift was made would generally apply, because §2505(a)(1) (quoted above in Item 5a) says that the gift tax unified credit is based on the applicable exclusion amount that would apply "if the donor died as of the end of the calendar year."

Observation. Without this helpful special rule, surviving spouses would have been at risk in making gifts early in a calendar year utilizing their DSUE amount. The expected DSUE amount would not be available if a subsequent spouse died before the end of that calendar year. Because of a special rule discussed in Item 5e below, if a surviving spouse wishes to make gifts to utilize the DSUE amount from a deceased spouse, the donor should make the gift as quickly as possible to assure that the DSUE amount from that particular last deceased spouse is utilized.

The rule also has a potentially detrimental effect from a taxpayer-point of view. A donor who is married to an individual who is expected to die in the near future cannot make a gift utilizing an anticipated DSUE amount from that individual, even if the individual dies before the end of the calendar year. If the donor's unified gift tax credit were determined based upon the donor's applicable exclusion amount determined as of the end of the calendar year without this special rule, and DSUE amount from the deceased spouse would be available to offset gifts made by the donor-spouse any time during that calendar year.

d. *Ordering Rule*. The regulations include an ordering rule, providing that if a surviving spouse makes a gift with a DSUE amount from the last deceased spouse determined at the time of the gift, "such surviving spouse will be considered to apply such DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount." Temp. Reg. §25.2505-2T(b).

Observation. This ordering rule is important, as a result of other positions taken in the regulations. As long as the donor does not have a new last deceased spouse, the donor's applicable exclusion amount will include his or her basic exclusion amount plus the DSUE amount from the deceased spouse. However, if the donor does have a new last deceased spouse, there would be a risk that the donor would have used some of his or her own basic exclusion amount and would lose the benefit of the DSUE amount from the prior deceased spouse. (The special rule discussed in Item 5e immediately below, to add the DSUE amounts from prior last deceased spouses in calculating the DSUE amount, applies only to the extent that the DSUE amount from a prior deceased spouse was applied to taxable

gifts of the surviving spouse. Without this ordering rule, the prior deceased spouse's DSUE amount may not have been applied to previous taxable gifts of the surviving spouse, and therefore might not be added to the DSUE amount of the surviving spouse.)

e. *Gifts Utilizing DSUE Amounts From Multiple Deceased Spouses Is Permitted.* An incredibly taxpayer-favorable position in the regulations permits the use of DSUE amounts from multiple deceased spouses.

The regulations provide that, for both estate and gift tax purposes, if the surviving spouse has applied to gifts DSUE amounts from prior deceased spouses who are different than the last deceased spouse at the time of a particular gift or estate transfer,

> then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of [the surviving spouse's death][the current taxable gift] is the sum of —
>
> (i) The DSUE amount of the surviving spouse's last deceased spouse …; and
>
> (ii) The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more [taxable gifts] [previous taxable gifts] of the surviving spouse.
>
> Temp. Reg. §§20.2010-3T(b), 25.2505-2T(c) (the bracketed phrases are in the respective estate tax and gift tax regulations).

This special rule means that an individual can take advantage of DSUE amounts from multiple spouses, as long as the individual makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual is predeceased by a subsequent spouse. Without this special rule, the aggregate DSUE amount that could possibly be used would be limited to the highest single basic exclusion amount that applied at the deaths of any of the deceased spouses.

> *Example 1.* Consider the straightforward example of H1 dying with $5 million of unused exemption, and W makes a gift of $10 million after H1 dies, all covered by her gift exemption amount (which includes her basic exclusion amount plus the DSUE amount from H1). Assume W remarries H2 (who is poor and in poor health) who predeceases Wife, leaving her his DSUE amount of $5 million (for this simple example, ignore indexing increases to the basic exclusion amount). Can W make another $5 million gift without paying gift tax? Before this quite favorable regulation, the answer was no. But for this special rule in the regulations, W's gift unified credit would be (1) the estate tax applicable credit amount she would have if she died at the end of the year [§ 2505(a)(1)], less (2) the amounts allowable as credit against the gift tax for preceding years [§ 2505(a)(2)]. Assuming for simplicity that the exemption amount does not grow due to indexing, under step (1) W has a gift credit amount based on $10 million of exemption (her $5 million basic exclusion amount and her $5 million DSUE amount from H2). Step (2) subtracts the prior gift credits used, which would be the gift credit amounts on the $10 million of gifts that W made after H1 died. Therefore, there would be no remaining gift credit amount that would cover additional current gifts.
>
> *Example 2.* Consider the same example, but assume that W made only a $5 million gift before marrying H2, and that the ordering rule of the regulations

applies to allocate H1's DSUE amount against that $5 million gift. After W remarries H2 and he dies leaving her an additional $5million of DSUE amount, can W make another $5 million gift without paying gift tax? Again the answer would be no, but for the special rule in the regulations. W's gift unified credit would be (1) a gift credit amount based on $10 million of exemption (her $5 million basic exclusion amount and her $5 million DSUE amount from H2), less (2) the prior gift credits used, which would be the gift credit amounts on the $5 million of gifts that W made after H1 died. W would have a gift exemption based on her own $5 million exclusion amount, but no more. The regulation changes that result.

Observation. Of all of the surprising very favorable positions in the regulations, this is probably the biggest surprise. The "black widow" situation that underlies limiting the DSUE amount to one additional basic exclusion amount, no matter how many deceased spouses a "black widow" has, still exists to the extent that an individual is able to make gifts following the deaths of each of the deceased spouses to take advantage of the unused exclusion from each decedent.

6. *Qualified Domestic Trusts*. If a decedent who is survived by non-resident spouse transfers property to a qualified domestic trust (QDOT), the estate is allowed a marital deduction. When distributions are made from the QDOT or when trust assets are distributed at the termination of the QDOT, an estate tax is imposed on the transfers as the *decedent's* estate tax liability. Accordingly, subsequent transfers from a QDOT would reduce the amount of the decedent's unused exclusion amount.

   The regulations provide that when a QDOT is created for the surviving spouse, the executor of the decedent's estate who makes the portability election will compute a preliminary DSUE amount that may decrease as distributions constituting taxable events under §2056A are made. The surviving spouse will not be able to make any use of the DSUE amount from the decedent who created a QDOT until the date of the event that triggers the final estate tax liability of the decedent under §2056A with respect to the QDOT. That typically would not be until the surviving spouse's subsequent death, or until all of the assets of the QDOT have been distributed to the surviving spouse during his or her lifetime. Temp Reg. §§20.2010-3T(c)(2), 25.2505-2T(d)(2).

7. *Nonresidents Who Are Not Citizens.*

   a. *Decedent Nonresident*. If a decedent is a nonresident and not a citizen of the United States, that estate cannot make a portability election. No DSUE amount is available to surviving spouse of that nonresident decedent. Temp. Reg. §20.2010-2T(a)(5). The Preamble does not offer an explanation for this conclusion, but it is correct. The portability rules of §2010 are in Subchapter A of Chapter 11 of the Internal Revenue Code, which Subchapter is titled "Estates of Citizens or Residents." Subchapter B, titled "Estates of Nonresidents Not Citizens" contains no discussion of the portability concept.

   b. *Nonresident Surviving Spouse*. A surviving spouse of a decedent may not make any use of the DSUE amount for that person's last deceased spouse any time the surviving spouse is a nonresident/noncitizen for either estate or gift tax purposes, unless allowed under an applicable treaty. Temp Reg. §§20.2010-3T(e), 25.2505-2T(f). Apparently, if the surviving spouse subsequently becomes a resident or citizen, that individual then could utilize the DSUE amount for subsequent gifts or at the individual's death when the individual was a resident or citizen.

8. *Statute of Limitations For Considering Determination of DSUE Amount.* Section 2010(c)(5)(b) provides that the IRS "may examine a return of the deceased spouse" to make determinations in carrying out the portability provisions without regard to any period of limitations under §6501. The regulations confirm that the IRS may examine the returns of each previously deceased spouse whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount at the time of any transfer by the surviving spouse, regardless whether the period of limitations on assessment has expired on such returns. The IRS may adjust or eliminate the DSUE amount based on such examination, but it may not assess additional estate tax against a prior deceased spouse's return unless the applicable period of limitations on assessment of estate tax is still open. Temp. Reg. §§20.2001-2T(a), 20.2010-2T(d), 20.2010-3T(d), and 25.2505-2T(e).

Planning Observations — Gift Planning Considerations in Light of Regulations

The DSUE amount applies for gift as well as estate tax purposes. Various gift planning uncertainties for gifts by surviving spouses who have DSUE amounts were clarified by the regulations.

1. *Consider Early Gifts Utilizing DSUE Amount.* A surviving spouse may consider using the deceased spouse's unused exclusion amount with gifts as soon as possible (particularly if she remarries) so that she does not lose it if the new spouse predeceases. (Fortunately, the spouse no longer has to be concerned about the basic exclusion amount being reduced by Congress and thereby reducing the DSUE amount.)
2. *No Uncertainty Regarding Gift Using DSUE Amount Before End of Calendar Year.* The gift exclusion is the estate tax applicable exclusion amount as if the donor died at the end of the calendar year. §2505(a). Prior to the regulations, at the time of a gift during a year, the donor with DSUE amount from a previously deceased spouse would not know for sure what the exclusion amount would be at the end of the year to cover the gifts made during the year. The regulations clarify that the DSUE amount from the last deceased spouse *at the time of the gift* controls. Without this special rule, there was a risk that if the donor's new spouse died during the year leaving a lesser DSUE amount than the donor had from a prior deceased spouse, the donor's DSUE amount and therefore the gift exclusion amount would be decreased as to all gifts made during that calenday year. Accordingly, donors wishing to make large gifts, utilizing the DSUE amount, no longer need to wait until near the end of the calendar year to do so.
3. *Mechanical Timing Requirements of Estate Tax Return and Gift.* Before the regulations were issued, there was a concern that a surviving spouse might not be able to make a gift, using the DSUE amount, until after an estate tax return had been filed for the deceased spouse's estate making the portability election. However, the regulations clarify that the DSUE amount applies to all gifts during the year after the date of the decedent's death as long as an estate tax return is ultimately filed making the portability election, presumably even if the decedent's estate tax return is filed after the surviving spouse's gift tax return is filed. However, the DSUE amount could not be used to cover gifts made before the decedent's death (even if they occurred in the year of the decedent's death).
4. *No Recapture/Clawback Issue.* There is no longer a recapture/clawback concern about the possibility of having to pay additional estate tax if the spouse makes a gift after the decedent's death and if the spouse later remarries and the subsequent spouse dies, with less unused exclusion. The DSUE amounts used by gifts from prior deceased spouses that are used to cover gifts by the surviving spouse (each time before the next spouse dies) are added to the DSUE amount that the surviving spouse would have at her subsequent death. Therefore, there would not be a problem of

having adjusted taxable gifts that exceeded the surviving spouse's estate tax applicable exclusion amount, as long as all of the gifts had been covered by DSUE amounts.

5. *Can Make Multiple Gifts of DSUEAs From Multiple Deceased Spouses.* The surviving spouse can make gifts from multiple spouses, using DSUE amounts from all of those prior deceased spouses, as long as the donor makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual is predeceased by a subsequent spouse. (This was a rather surprising provision in the regulations.)