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November 2, 2011

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Committee on Ways and Means  
U.S. House of Representatives  
1102 Longworth House Office Building  
Washington, D.C. 20515

Honorable Max Baucus, Chairman  
Committee on Finance  
United States Senate  
219 Dirksen Senate Office Building  
Washington, D.C. 20510

Honorable Sander Levin, Ranking  
Member  
Committee on Ways and Means  
U.S. House of Representatives  
1102 Longworth House Office Building  
Washington, D.C. 20515

Honorable Orrin G. Hatch, Ranking  
Member  
Committee on Finance  
United States Senate  
219 Dirksen Senate Office Building  
Washington, D.C. 20510

**Re: Proposed Transfer Tax Changes**

Dear Congressmen and Senators:

On behalf of The American College of Trust and Estate Counsel (“ACTEC”), please find an attached Report setting forth eight recommendations to improve implementation of existing estate, gift and generation-skipping tax laws. We believe the changes recommended in this Report would more accurately and efficiently implement what we understand to be Congressional objectives than do the provisions of current law.

ACTEC is a non-profit professional association of over 2,600 lawyers elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates. Fellows of the College have made substantial contributions to trusts and estates through lecturing, writing, teaching and bar activities. ACTEC does not take positions on matters of tax policy or political objectives. From time to time, based on the extensive experience that ACTEC members have with estate, gift and generation-skipping transfer taxes, we comment on existing tax laws and offer recommendations to improve the implementation of existing tax laws.

Should you have any question concerning this letter and the attachments, please contact me or either of the “contact individuals” listed below.

Thank you for your consideration of these comments and recommendations.

Respectfully yours,

Mary F. Radford  
President

cc: Jon Traub, Republican Staff Director, House Ways and Means Committee  
Janice Mays, Democratic Staff Director, Chief Counsel and Chief Tax Counsel,  
House Ways and Means Committee  
Lily Batchelder, Chief Democratic Tax Counsel, Senate Finance Committee  
Christopher Campbell, Republican Staff Director, Senate Finance Committee  
Russell Sullivan, Democratic Staff Director for the Senate Committee on Finance  
Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation  
Emily S. McMahon, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
Catherine V. Hughes, Attorney-Advisor, Office of Tax Policy, Department of the Treasury

ACTEC Contact Individuals:

Trent S. Kiziah, Esquire  
515 S. Flower St., Suite 2700  
Los Angeles, CA 90071  
Telephone: (213) 861-5028  
Email: Trent.Kiziah@ustrust.com

Ronald D. Aucutt, Esquire  
1750 Tysons Blvd., Suite 1800  
Tysons Corner, VA 22102-4215  
Telephone: (703) 712-5497  
Email: raucutt@mcguirewoods.com

# The American College of Trust and Estate Counsel

## Eight Recommendations to Improve Implementation of Existing Tax Laws

### I. INTRODUCTION

The American College of Trust and Estate Counsel (“ACTEC”) is a non-profit professional association of over 2,600 lawyers selected on the basis of professional reputation and ability in the field of trusts and estates. ACTEC does not take positions on matters of tax policy or political objectives. From time to time, based on the extensive experience that ACTEC members have with estate, gift and generation-skipping transfer taxes, we offer recommendations to improve existing tax laws to more clearly, simply, and fairly implement the policies those laws are intended to serve. This report describes eight such proposed changes in the following four broad subject areas.

#### A. Marital Deduction Recommendations.

##### 1. Automatic Lifetime QTIP Election

A proposal to make the QTIP election automatic for inter-vivos transfers of property interests meeting QTIP requirements, with an election out for those taxpayers not desiring a marital deduction.

##### 2. Granting the IRS Authority to Extend the Period for Making the Gift Tax QTIP Election

A proposal to extend relief to taxpayers who fail to timely make a gift tax QTIP election comparable to the relief already provided to executors who fail to make a timely QTIP election on the estate tax return.

##### 3. Allowing a Marital Deduction for Post-Mortem Reformations of Marital Property Interests

A proposal to permit post-mortem reformations of marital interests to qualify for the marital deduction in order to grant U.S. citizen surviving spouses the same relief currently provided to non-citizen spouses.

#### B. Portability

##### 1. Aggregation of Deceased Spousal Unused Exclusion Amounts

A proposal to permit aggregation of deceased spousal unused exclusion amount.

##### 2. Privity

Requests for clarity as to privity.

### 3. Requirement to File an Estate Tax Return

A proposal to permit the availability of portability to be demonstrated by an attachment to the decedent's final Form 1040, not only by the filing of an estate tax return.

#### C. Claw Back Issue

A request that Congress clarify whether a reduction in the basic exclusion amount could result in additional estate tax if the taxpayer had previously made taxable gifts.

#### D. Election Out of Taxable Terminations

A proposal to permit an executor of a deceased beneficiary's estate to elect out of taxable termination treatment by including the value of the trust assets in the beneficiary's gross estate for federal estate tax purposes.

## **II. PROPOSED CHANGES**

### **A. Marital Deduction Recommendations**

#### **1. Automatic Lifetime QTIP Election**

ACTEC recommends that the Internal Revenue Code ("the Code")<sup>1</sup> be amended to provide that the Qualified Terminable Interest Property ("QTIP") election will be deemed to have been elected by a taxpayer for any lifetime transfer to a QTIP trust or any other transfer of qualified terminable interest property except to the extent the taxpayer timely elects out of the deemed election.

Code Sec. 2523(f) allows a gift tax marital deduction for transfers of otherwise qualified terminable interest property, but only to the extent the donor spouse so elects on a gift tax return.

Code Sec. 2523(f)(4)(A) provides that the gift tax QTIP election must be made "on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer (determined without regard to section 6019(2)) and shall be made in such manner as the Secretary shall by regulations prescribe." Treas. Reg. Sec. 25.2523(f)-1(b)(4) also provides that the election must be made on a timely filed gift tax return, including extensions authorized under the Sec. 6075(b)(2) six-month automatic extension to file rule. In addition, the regulations further provide that if the donor died during the calendar year of the transfer, an election must be filed no later than the time for filing the donor's estate tax return, including extensions.

The current gift tax election requirement is similar to the rule that applied to allocations for GST tax purposes before 2001; that is, unless a taxpayer timely filed a gift tax return allocating GST exemption

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<sup>1</sup>All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise stated.

to a generation-skipping trust, the allocation would not be considered made. The Economic Growth and Tax Relief Reconciliation Act of 2001 changed that rule so that GST exemption is automatically allocated to such a trust unless the taxpayer elects out of such automatic allocation on a timely filed gift tax return. *See* Code Sec. 2632(c). The change was made because it was believed that most taxpayers who created long-term generation-skipping trusts would want GST exemption so allocated.

We believe that a similar rule should be adopted for lifetime transfers of qualified terminable interest property. It is our belief that most married persons who create interests described in Sec. 2523(f) intend them to qualify for the marital deduction. A similar automatic QTIP election already applies for transfers of joint and survivor annuities to a spouse. *See* Sec. 2523(f)(6).

Under this proposal, unless the taxpayer timely files a gift tax return and elects out of QTIP treatment, any transfer of an interest described in Sec. 2523(f) automatically will qualify for the marital deduction under that section.

We propose that Code Sec. 2523(f)(4) be amended by redesignating subparagraph (B) as subparagraph (C) and adding new subparagraph (B) to read as follows:

“(B) ELECTION DEEMED MADE.—The donor spouse shall be irrevocably treated as having made an election to which this subsection applies except to the extent the donor spouse expressly provides otherwise on a timely filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Secretary.”

## **2. Granting the IRS Authority to Extend the Period for Making the Gift Tax QTIP Election**

ACTEC recommends that the Code be amended to grant the Secretary of the Treasury (or the Secretary’s delegate) authority to extend the period for making Qualified Terminable Interest Property (“QTIP”) elections for inter-vivos transfers.

Since its enactment, taxpayers have consistently had a difficult time properly making the QTIP election on gift tax returns. The Internal Revenue Service (“IRS”) has routinely granted relief pursuant to Treas. Reg. Sec. 301.9100-2 if the relief was sought within six months of a timely filed return. In Private Letter Rulings (“PLR”) 200314012 and 9641023, the IRS ruled that it may not grant a request for an extension beyond the six-month period allowed automatically by Treas. Reg. Sec. 301.9100-2 because the time for filing a gift tax QTIP election is expressly prescribed by Sec. 2523(f)(4), and the IRS’s authority to grant discretionary extensions applies only to requests for extensions of time fixed by regulations or other published guidance. In PLR 201025021, the IRS appeared to reverse its position and grant relief for a taxpayer who had failed to timely make a QTIP election on a gift tax return and failed to seek relief within the six month timeframe. In PLR 201109012, the Treasury revoked PLR 201025021, noting that it lacked authority to grant the relief provided in the ruling. ACTEC believes the Code should be amended to specifically grant the IRS authority to grant relief beyond the six month time period.

ACTEC believes it is a matter of good policy for the Government to be able to grant relief for late gift tax QTIP elections because this relief is already available for similar errors made on the Federal estate tax and GST tax returns. The relief, known as “9100 relief,” requires the taxpayer to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government. Such relief for failures to make a QTIP election for a QTIP trust on the Federal estate tax return has been available for over twenty years. Relief for failures to make the reverse QTIP election of Sec. 2652(a)(3) for purposes of the GST tax has also been available.

Congress and the IRS have been reasonable in providing relief for errors in making elections in the transfer tax area because the number of elections has increased dramatically and the Code provisions are complex. Often, taxpayers rely on accountants and other advisors who are experienced and competent with respect to income tax matters, but prepare estate and gift tax returns only on an occasional basis. Lack of familiarity with the requirements for a QTIP election has led to numerous errors on gift tax returns. The lack of relief similar to that provided in the estate and GST tax areas has left taxpayers pursuing claims against their advisors. This remedy is unsatisfactory because damages are difficult to measure, many taxpayers are unwilling to pursue a claim against a long-time family advisor, and the statute of limitations may prevent such a claim if the error is not discovered quickly. Allowing 9100 relief for failed QTIP elections on the gift tax return would provide a much more efficient solution and discourage needless litigation. Moreover, allowing such relief would be consistent with the underlying goal of 9100 relief: to put taxpayers in the same position – not a better position – than they would have been in had they made their elections in a timely fashion.

The Government’s interests would not be prejudiced by allowing such relief. Allowing the QTIP election merely defers the imposition of the Federal gift tax until a disposition under Sec. 2519 or substitutes the imposition of the Federal estate tax at the time of the donee spouse’s death by providing for the inclusion of the value of the QTIP assets in the donee’s spouse’s gross estate under Sec. 2044. Section 2044 requires inclusion in the donee spouse’s gross estate of the value of any property held at the time of death for which a deduction was allowed under Sec. 2523(f) or Sec. 2056(b)(7). If the taxpayer applies for and is granted relief under Reg. Sec. 301.9100-3 to make a late retroactive gift tax QTIP election, a deduction would have been allowed by reason of Sec. 2523(f) and inclusion under Sec. 2044 would be required.

ACTEC proposes that Code Sec. 2523(f)(4) be amended to make it consistent with Code Sec. 2056(b)(7)(B)(v), which provides for the making of a QTIP election on an estate tax return. The amendment would eliminate the current language in Code Sec. 2523(f)(4)(A) that contains the statutory time restrictions for making the election. The time restriction would then become regulatory under Treas. Reg. Sec. 25.2523(f)-1(b)(4), and the IRS would then have the ability to grant 9100 relief in the gift tax area just as in the estate and GST tax areas. Under this proposal, Code Sec. 2523(f)(4)(A) would be amended to read as follows:

“(A) TIME AND MANNER.—An election under this subsection with respect to any property shall be made on the return of tax imposed by section 2501.”

As an alternative to the proposed change to Code Sec. 2523(f)(4), Code Sec. 2523(f) could be amended by adding at the end the following new paragraph (7), patterned after Code Sec. 2642(g):

“(7) RELIEF FROM LATE ELECTIONS.—The Secretary shall by regulation prescribe such circumstances and procedures under which extensions of time will be granted to make an election in paragraph (4) of this subsection. Such regulations shall include procedures for requesting comparable relief with respect to transfers made before the date of the enactment of this paragraph.”

If Congress were to adopt the Automatic Lifetime QTIP election set forth in Part II.A.1 of this report, the relief sought in this section would apply to those taxpayers who filed returns before the effective date of the automatic election but failed to make the QTIP election. The relief sought in this section would also permit taxpayers who inadvertently elected out of the automatic QTIP election to elect into QTIP treatment, assuming the taxpayer can satisfy the conditions for relief.

### **3. Allowing a Marital Deduction for Post-Mortem Reformations of Marital Property Interests<sup>2</sup>**

ACTEC recommends that the Code be amended to permit post-mortem reformations of marital property interests to qualify for the marital deduction.

ACTEC believes there are certain trusts and other property interests that are intended to, but do not, qualify for the Federal estate (or gift) tax marital deduction. ACTEC believes it should be possible to qualify these interests for the appropriate marital deduction after a reformation.

Currently, Code Sec. 2055(e)(3) authorizes a charitable deduction for certain trusts that are reformed in compliance with the statutory requirements. The ability to reform a trust for which a charitable deduction is otherwise not available into a trust for which a charitable deduction is allowed often eliminates adverse consequences for taxpayers. The Treasury is in the same position it would have been in if the trust had been drafted at the outset in a manner to qualify for the intended deduction. Therefore, it appears that the Treasury is not adversely impacted by the allowance of a charitable deduction after a reformation. The marital deduction does not appear to be different for purposes of such considerations.

Currently, Code Sec. 2056(d)(5), allows for reforming property interests to qualify for the marital deduction as a qualified domestic trust and obtain the marital deduction when the surviving spouse is not a U.S. citizen. Therefore, the Federal tax law already includes the ability to obtain a marital deduction by means of a reformation for assets passing to a non-citizen spouse. There does not appear to be any policy reason to treat transfers to non-citizens more favorably than transfers to citizens. The proposed change would place surviving spouses who are U.S. citizens on equal footing with those who are not

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<sup>2</sup>This proposal was previously submitted by ACTEC to members of Congress on September 22, 2010.

U.S. citizens.

The ability to obtain a marital deduction for property interests that have been reformed in order to meet the requirements of the marital deduction will benefit taxpayers. Surviving spouses can be expected to have access to an increased level of property interests as a result of reformations. A reformation will typically remove, or reduce, interests in property held by persons other than a surviving spouse in order to qualify for the marital deduction. The surviving spouse's increased rights in the property should increase benefits to the surviving spouse. This result is consistent with the now long established tax policy dating back to the Economic Recovery Tax Act of 1981 of an unlimited marital deduction<sup>3</sup>

The ability to reform interests to qualify for the marital deduction will also have a positive impact on the Federal government because fewer Federal resources will be required to address issues of qualification. The burden on the Federal courts and on the U.S. Treasury Department will be reduced as a result of allowing reformed property interests to qualify for the marital deduction. The administration of the technical rules relating to qualification for the marital deduction and the interpretation of those complicated rules consume significant Federal resources. This burden could be eliminated if property interests could be reformed to qualify for the marital deduction.<sup>4</sup>

The proposed new Code Sec. 2056(e) consists of four paragraphs. The first paragraph sets forth a general rule. The second paragraph describes interests that may be reformed. A special statute of limitations is included in the third paragraph. The final paragraph broadly defines reformation for purposes of this statute.

In order to allow for reformation after the decedent's death, the general rule set forth in paragraph (1) allows a trust to be tested for qualification under Sec. 2056(b) at a date subsequent to the date of death. This date is the later of (A) the date when the estate tax return is filed or (B) if a judicial proceeding has been timely commenced, the date provided for in the proceeding. A judicial proceeding is timely commenced for this purpose if commenced on or before the due date (determined with regard to extensions) for filing the estate tax return.

An interest that may be reformed, as described in paragraph (2), is broadly defined to be any interest that a surviving spouse has in property. Therefore, as long as the surviving spouse has some interest in property, that interest can be altered in a way that will qualify for the marital deduction.

Paragraph (3) provides for a statute of limitations of one year after the Government has been notified of

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<sup>3</sup> See Joint Committee on Taxation, "General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97<sup>th</sup> Congress: Public Law 97-34)," at 233: "Although the Congress recognized that this additional tax [the 'widow's tax' caused by the limited marital deduction under the law prior to the enactment of ERTA] could be minimized through proper estate planning, it believed that an individual generally should be free to pass his or her entire estate to a surviving spouse without the imposition of any estate tax."

<sup>4</sup> The reformation proceedings will occur in state courts.

a reformation in a judicial proceeding. This statute of limitations is appropriate in the event that a judicial proceeding in which a reformation is sought lasts longer than the statute of limitations otherwise applicable to the Government.

The fourth paragraph defines the term “reformation” to mean essentially any type of change to a governing instrument. The change may be a reformation, an amendment, a change or any other modification made by a court having jurisdiction to do so.

The interests that may be reformed are not limited to interests created by trust instruments. For instance, a surviving spouse’s interest in property created by a will or a deed could be reformed to qualify for the marital deduction.

A new subsection (j) would be added to Code Sec. 2523. This subsection would include three paragraphs, the first of which incorporates the new Sec. 2056(e), the second of which extends the statute of limitations, and the last of which broadly defines actions that are to be treated as reformations.

A second gift tax provision is also proposed. This provision, a new subsection (h) to Code Sec. 2503, would prevent a taxable gift from occurring when an interest in property is terminated by a reformation in Sections 2056(e) or 2523(j).

In these examples, the property interest described has been created by the estate plan of the deceased spouse to be effective as of the death of the deceased spouse.

1. Discretionary Income. “The trustee may pay to my surviving spouse so much or all of the income and principal from this trust as the trustee deems necessary from time to time for her health and maintenance in reasonable comfort, considering her income from all sources known to the trustee.” Because trust income is discretionary rather than mandatory, this trust does not qualify for the marital deduction.
2. Children as Current Beneficiaries. “The trustee may pay to my surviving spouse and to my children, in equal or unequal shares, so much or all of the income and principal from this trust as the trustee deems necessary from time to time for the health and maintenance in reasonable comfort of each of them, considering their income from all sources known to the trustee.” Because distributions may be made to the grantor’s children during the surviving spouse’s lifetime, this trust does not qualify for the marital deduction.
3. Remarriage. “The trustee shall pay to my surviving spouse the income from the trust in installments as my surviving spouse may prefer, but not less frequently than annually. The trustee also may pay to my surviving spouse any amount of principal of the trust as the trustee deems necessary from time to time for my surviving spouse’s health and maintenance in reasonable comfort, considering my surviving spouse’s income from all sources known to the trustee.

Notwithstanding any other provision herein, (i) underproductive property shall not be held as an asset of this trust for more than a reasonable time during my surviving spouse's life without my surviving spouse's written consent and (ii) in the event my surviving spouse remarries or cohabits with a person of the opposite gender, then these interests shall terminate and this trust shall be administered as if my surviving spouse then died." Because distribution of net income to the surviving spouse is conditional, the trust does not qualify for the marital deduction.

4. Power to Appoint During Lifetime. "My surviving spouse may appoint upon his death principal from the trust to one or more of my descendants, with the powers and in the manner and proportions as my surviving spouse may specify by his will or revocable trust making specific reference to this power of appointment. In addition, my surviving spouse may appoint during his lifetime principal from the trust to one or more of my descendants, with the powers and in the manner and proportions as my surviving spouse may specify by an instrument delivered to the trustee making specific reference to this power of appointment." Because the spouse may terminate his income interest by exercise of the granted power of appointment, the trust does not qualify for the marital deduction.

In each of these examples, the interest should be reformable to qualify for the marital deduction.

The ability to change a property interest into a form that qualifies for the estate (or gift) tax marital deduction would be beneficial to taxpayers. The flexibility created by these proposed statutory changes would facilitate post-mortem planning with more certainty and at less expense to taxpayers. A reformation may be remedial in nature or may address changed circumstances not anticipated by the decedent. The policies underlying the unlimited marital deduction and the treatment of non-citizen spouses support the enactment of these changes.

The following statutory proposals are recommended:

A. Sec. 2056(e): "(e) CERTAIN REFORMATIONS PERMITTED. —

(1) IN GENERAL.—In the case of any property with respect to which a deduction would be allowable under subsection (a) but for subsection (b), the determination of whether an interest in property of the decedent's spouse qualifies for the deduction under subsection (a) shall be made—

(A) as of the date on which the return of the tax imposed by this chapter is made,  
or

(B) if a judicial proceeding is commenced on or before the due date (determined with regard to extensions) for filing such return to change such an interest into one that qualifies for the deduction under subsection (a), as of the time when the

changes pursuant to such proceeding are made.

(2) INTERESTS THAT MAY BE REFORMED.—Any property in which the decedent’s surviving spouse has an interest may be reformed pursuant to a judicial proceeding described in paragraph (1).

(3) STATUTE OF LIMITATIONS.—If a judicial proceeding described in paragraph (1)(B) is commenced with respect to any interest, the period for assessing any deficiency of tax attributable to any failure of such interest to be reformed so that it qualifies for the deduction under subsection (a) shall not expire before the date 1 year after the date on which the Secretary is notified that the interest has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.

(4) FORMS OF REFORMATION.—For purposes of this section, “reformed” shall mean the result of a reformation, amendment, change or other modification to a governing instrument made by a court having jurisdiction to do so.”

B. Sec. 2523(j): “(j) CERTAIN REFORMATIONS PERMITTED—

(1) IN GENERAL. A deduction shall be allowed under subsection (a) with respect to any qualified reformation. For purposes of this subsection, a qualified reformation is one that complies with rules similar to the rules of section 2056(e).

(2) STATUTE OF LIMITATIONS.—If a judicial proceeding with respect to a reformation described in paragraph (1) is commenced with respect to any interest, the period for assessing any deficiency of tax attributable to any failure of such interest to be reformed so that it qualifies for the deduction under subsection (a) shall not expire before the date 1 year after the date on which the Secretary is notified that the interest has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.

(3) FORMS OF REFORMATION.—For purposes of this section, “reformation” shall mean a reformation, amendment, change or other modification to a governing instrument made by a court having jurisdiction to do so.”

C. Sec. 2503(h): “(h) ELIMINATION OF INTEREST IN MARITAL DEDUCTION PROPERTY—The termination of any interest in property of an individual by reason of a reformation pursuant to section 2056(e) or section 2523(j) shall not be treated as a transfer of property by gift for purposes of this chapter.”

## **B. Portability**

### **1. Aggregation of Deceased Spousal Unused Exclusion Amounts**

Code Sec. 2010(c)(4)(B)(i), added by Sec. 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), provides that portability may occur only with respect to the “last” deceased spouse of such surviving spouse. The insertion of the word “last” did not appear in previous tax proposals, such as the “Estate Tax and Extension of Tax Relief Act of 2006” (H.R. 5970) and the “Taxpayer Certainty and Relief Act of 2009” (S. 722). Under prior tax proposals, the surviving spouse was permitted to aggregate unused exclusion amounts of several deceased spouses. For example, assume H1 dies when the basic exclusion amount is \$5,000,000 leaving a will that devises \$1,000,000 to his son and the balance of his estate to his surviving spouse, W. Assume H1’s estate timely files an estate tax return and elects portability. H1’s unused exclusion amount of \$4,000,000 transfers to W. Now assume W marries H2. Assume H2 dies when the basic exclusion amount is \$5,000,000 leaving a will that devises \$4,000,000 to his son and the balance of his estate to W. Assume H2’s estate timely files an estate tax return and elects portability. H2’s unused exclusion amount of \$1,000,000 transfers to W. Now assume W dies when the basic exclusion amount is \$5,000,000. Under H.R. 5970 and S 722, W’s estate would have been permitted an aggregate deceased spousal unused exclusion amount of \$5,000,000 (\$4,000,000 from H1 and \$1,000,000 from H2). The aggregate deceased spousal unused exclusion amount was capped at the amount of the basic exclusion amount at W’s death (i.e., \$5,000,000 in this example). This cap would deter abuses such as multiple marriages to ill individuals to gain their unused exclusion amount. In this example, the total of applicable exclusion amounts used is no greater than \$15 million (\$1 million by H1 plus \$4 million by H2 plus up to \$10 million available to W). That is exactly three times the applicable exclusion amount that could have been used by each of the three individuals, thus suggesting that the policy of preserving but not inflating those applicable exclusion amounts is served.<sup>5</sup>

ACTEC believes that the cap set forth in H.R. 5970 and S. 722 adequately addressed the policy goal of discouraging abuses such as sham marriages. ACTEC believes the current approach will to a certain extent discourage sham marriages, but it is overbroad. As written, it could discourage legitimate marriages of individuals with smaller unused exclusion amounts and therefore defeats the purpose of other legislation that encourages marriages by granting married individuals tax advantages not available to single individuals.

Returning to the previous example in which W survives both H1 and H2, under TRA 2010, H1’s unused exclusion is lost when W has a later dying spouse. The law looks only to the “last” deceased spouse’s unused exclusion amount. Only H2’s unused exclusion amount transfers to W. If H2’s executor does not file a timely estate tax return, none of H2’s unused exclusion amount transfers to W. W loses H1’s

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<sup>5</sup> We realize that the math would not work out exactly in every case. For example, if H2’s devise to his son were only \$1 million, then only \$12 million of applicable exclusion amounts would be available (\$1 million by H1 plus \$1 million by H2 plus \$10 million for W). But \$5 million per decedent would still be the cap.

unused exclusion amount even though she does not gain H2's unused exclusion amount.<sup>6</sup> To avoid this onerous result, W may be forced to take actions she otherwise would not consider, such as making taxable gifts prior to marrying H2<sup>7</sup> or – even more questionably from a public policy perspective – avoiding marrying H2 or divorcing H2 if he becomes seriously ill.

Therefore, ACTEC recommends that, if possible, the Code be amended to take the approach of H.R. 5970 and S. 722 permitting aggregation of the deceased spousal unused exclusion amount subject to the cap of the basic exclusion amount at the deceased spouse's death. ACTEC realizes that there might be policy objections to this proposal, based, for example, on congressional intent to simplify portability by limiting to one previous estate the examination the Service must undertake to verify the amount of the portable unused exclusion amount under Code Sec. 2010(c)(5)(B). If so, then ACTEC recommends that consideration be given to permitting the estate of the surviving spouse to use the unused exclusion amount of *any* predeceased spouse, not just the *last* deceased spouse, subject to the cap. This approach would provide no more incentive to enter into a sham marriage than exists under the current statute but would eliminate an undesirable marriage penalty.

## 2. Privity

The Joint Committee on Taxation Staff's December 10, 2010 report titled "Technical Explanations of the Revenue Provisions Contained in the 'Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010' Scheduled for Consideration by the United States Senate" (hereinafter "the 2010 JCT Report") contains the following example:

“Example 3 – Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2 [In summary, H1 and W marry. H1 dies survived by W. W marries H2. W then dies survived by H2]. Following Husband 1's death, Wife's applicable exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of \$3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is \$4 million (Wife's \$7 million applicable exclusion amount less her \$3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by \$4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.”

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<sup>6</sup> The 2010 JCT Report, discussed in Paragraph 3 below, clarifies that only the *last* deceased spouse's unused exclusion amount applies, regardless of whether the last deceased spouse's executor files an estate tax return or makes the portability election.

<sup>7</sup> Without regard to the disposition of this recommendation, it is likely that ordering rules and other coordination between a surviving spouse's lifetime and testamentary uses of the deceased spousal unused exclusion amount will be needed.

The Joint Committee on Taxation on March 23, 2011 issued an ERRATA adding a footnote stating 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.”

There may be policy reasons supporting either the result in Example 3 or the result reached under the actual statute. ACTEC supports clarity, however, and encourages reconciliation of Example 3 and the current statute.

### **3. Requirement to File an Estate Tax Return**

ACTEC recommends that the Code be amended to delete the requirement that the deceased spouse’s estate file an *estate* tax return in order to make the portability election.

Currently, the estate tax return is the best method to verify the deceased spousal unused exclusion amount. Because the estate tax return must be filed within nine months (fifteen months if extended) of a decedent’s death, the deceased spouse’s records are available (or at least are more likely to be available than at a later time) to determine if the deceased spouse has made taxable gifts, reported or unreported, and to determine the value of the property included in his or her federal gross estate that passes in a non-deductible manner. From the first two pages of a timely filed and properly prepared estate tax return, the amount of the deceased spousal unused exclusion amount can be determined. Indeed, the instructions for the 2011 estate tax return provide that “[t]he executor is considered to have elected to allow the surviving spouse to use the decedent’s unused exclusion amount by filing a timely and complete Form 706,” unless the executor manifests an intention not to make the election in a statement attached to the return or written across the top of the return. This is confirmed by Notice 2011-82, 2011-42 I.R.B. 516. ACTEC considers that presumption of an election in the absence of a contrary expression of intent to be a welcome simplification.

The more time that passes between the deceased spouse’s death and the determination of the deceased spousal unused exclusion amount, however, the greater the likelihood that the deceased spousal unused exclusion amount will be improperly determined. Over time, pertinent documents that would assist in properly determining the deceased spousal unused exclusion amount may be destroyed. Once the documents evidencing gifts and non-deductible transfers are destroyed, the surviving spouse’s estate might have no evidence that any of the deceased spouse’s basic exclusion amount was used.

Code Sec. 2010(c)(5) requires the timely filing of an estate tax return by the deceased spouse’s executor. Unfortunately, this requirement will cause many taxpayers to lose the benefits of portability. Under current law, only about 8,200 deceased spouse’s estates would have been required to file an estate tax return in 2009.<sup>8</sup> The portability filing requirement could force approximately a million estates a year to

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<sup>8</sup>In 2009, only 8,238 estates exceeded \$5,000,000, the current basic exclusion amount. Data obtained from [www.irs.gov/taxstats/indtaxstats/article](http://www.irs.gov/taxstats/indtaxstats/article).

file an estate tax return in order to take advantage of portability, even though only 8,200 may meet the filing threshold.<sup>9</sup> Many married individuals, especially those well below the filing threshold, will be unaware of the need to file what turns out to be an informational return. Imposing the administrative cost and burden of an informational estate tax return upon a million estates a year appears to partly defeat the purpose of simplification that portability is intended to serve.

Concerns about inaccuracies are not unwarranted. Within a reasonable period of time after the deceased spouse's death, the IRS needs to be provided information on the deceased spousal unused exclusion amount. In a report presented to the Senate Finance Committee on April 3, 2008,<sup>10</sup> ACTEC proposed that adequate information be set forth on the deceased spouse's final income tax return in order to provide the IRS with the information necessary to determine the deceased spousal unused exclusion amount.<sup>11</sup> The instructions to the Form 1040 could be amended to address the information that would be needed for that purpose. Since a final income tax return is required for many taxpayers, it is more likely that individuals filing a final income tax return for the deceased spouse will become aware of the need to include the necessary estate tax information on the final Form 1040, provided the Form 1040 instructions highlight the change in the law. An additional schedule to the final Form 1040 can be prepared and attached by the tax preparer to the final Form 1040. Indeed, the final Form 1040 will often (though not necessarily always) be a joint return signed by the surviving spouse, along with the executor if there is one.

ACTEC understands the need for timely tax information to avoid inaccuracies, but still believes the best approach to obtaining that information without unduly burdening a majority of taxpayers would be to permit a simple attachment of a schedule to the final Form 1040 as an alternative to the preparation of an estate tax return that most taxpayers are not required to file and many taxpayers will likely not file. This proposal contemplates that portability could also be documented by the filing of an estate tax return for the deceased spouse. Indeed, that would be the primary method for demonstrating the availability of portability in the small minority of cases in which an estate tax return is required. Whether portability is demonstrated by an estate tax return or the final income tax return, however, ACTEC supports the

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<sup>9</sup> The U.S. Center for Disease Control reports 921,539 married individuals died in the United States in 2006 (most recent data available). Assuming a similar number of deaths of married individuals in 2011 and each year thereafter, nearly a million estates a year would need to file estate tax returns to elect portability even though less than 8,200 exceed the filing threshold of \$5,000,000. Data obtained from [www.cdc.gov](http://www.cdc.gov) and [www.taxpolicy.com](http://www.taxpolicy.com).

<sup>10</sup> The Senate Finance Committee held a hearing on federal estate tax reform on April 3, 2008. Shirley L. Kovar, then Chair of ACTEC's Transfer Tax Study Committee, testified before the Senate Finance Committee and presented a Report on Portability prepared by a sub-committee of the Transfer Tax Study Committee chaired by Trent S. Kiziah (now chair of the Transfer Tax Study Committee). Mr. Kiziah, along with Ronald D. Aucutt and Dennis I. Belcher (the latter also testified at the Hearing), attended the hearing and joined Ms. Kovar at a break-out session with staff members following the hearing.

<sup>11</sup> Of course, even this proposal would not cover all married individuals, because some individuals fall below the income tax filing threshold.

approach embraced by the instructions for the 2011 estate tax return and Notice 2011-82 that if sufficient information is provided to permit the calculation of the deceased spousal unused exclusion amount, the portability election should be presumed unless the executor manifests a contrary intent.

### **C. Claw Back Issue**

There has been substantial discussion in the professional community concerning the tax issues that may arise if the estate tax exemption is decreased in the future. There is concern that an estate tax may arise upon an individual's death if the exemption is decreased from its current level and that person has made substantial lifetime taxable gifts. ACTEC believes that taxpayers should be able to make lifetime gifts with certainty as to the tax ramifications of those gifts. Under current law, taxpayers cannot be certain of the tax impact of significant lifetime gifts.

Arguably, the inclusion of taxable ("claw back") gifts in the computation base of the estate tax should affect only the tax *rate* on the decedent's taxable estate at death.<sup>12</sup> If a taxpayer dies without any assets because the taxpayer has gifted all of his or her assets during life, no estate tax should be due. It is not clear that result would occur if the estate tax exemption is decreased in the future.

On the other hand, ACTEC believes that similarly situated taxpayers should generally pay the same amount of tax. For example, it could be argued that the taxpayer who makes no taxable gifts during lifetime and dies with \$6,000,000 should pay the same amount of estate tax as the taxpayer who makes a \$5,000,000 gift before death and dies with only \$1,000,000. However, it could also be argued that it is appropriate to tax the taxpayers differently if the estate tax exclusion amount is decreased between the time of the gift and death. Thus, the taxpayer who takes advantage of the gift tax exclusion by making taxable gifts before the estate tax exclusion amount is decreased can be treated differently than the taxpayer who does not make a taxable gift without a cry of unfairness. Tax rates and exclusions change from year to year in the income tax arena with substantial frequency, although typically not with consequences in future years from the use of a benefit conferred by statute for previous years.

ACTEC does not take positions on tax policies, and resolving the claw back issue may require Congress to weigh different tax policies. ACTEC, however, recommends that Congress address the issue, in order to provide certainty.

### **D. Election Out of Taxable Terminations**

ACTEC recommends that the Code be amended to permit an executor to elect out of a taxable termination occurring by reason of the death of an individual by electing to include the value of property that would be subject to the generation-skipping transfer ("GST") tax in the decedent's gross estate for

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<sup>12</sup> See H.R. REP. NO. 94-1380, 94TH CONG., 2D SESS. 13 (1976), explaining how the Tax Reform Act of 1976 (P.L. 94-455) avoided claw back for gift tax purposes with respect to pre-1977 taxable gifts.

federal estate tax purposes. If the requirements for the election are satisfied, the elected property would be subject to federal estate tax and the transfer of the property would not be subject to GST tax.

Congress intended for the GST tax to complement the gift and estate tax provisions of the Code by imposing the GST tax on transfers that are subject to gift or estate tax with respect to the transferor but which avoid imposition of those same taxes at the level of a lower generation.<sup>13</sup> Thus, Sec. 2652(a)(1) defines the transferor to mean the decedent for a transfer subject to estate tax, or the donor for a transfer subject to gift tax. Under Sec. 2612, a transfer is not a taxable termination, a taxable distribution, or a direct skip unless the transfer is to a skip person (or, in the case of a taxable termination, there are no more non-skip persons having an interest in the property), and by definition in Sec. 2613 a person assigned to the next generation level below the decedent or the donor is not a skip person. Prior to the passage of the Technical and Miscellaneous Revenue Act of 1988, Sec. 2611(b)(1) expressly stated that any transfer from a trust (other than a direct skip) would not be considered a generation-skipping transfer to the extent that the transfer was subject to gift or estate tax with respect to a person in the first generation below the grantor of the trust. This rule was deleted as unnecessary because the same result is achieved by determining the identity of the transferor after applying the estate and gift taxes – (i.e., the transferor move-down rule would apply, such that the original transferor would be treated as having moved down a generation level).

In the context of taxable terminations, taxpayers often try to avoid the GST tax because the effective cost of the gift or estate tax, which are subject to a different exemption regime, will be lower than the GST tax. Sometimes the opposite is true, such as in a state with its own estate tax on top of the federal estate tax.

To avoid subjecting assets to the GST tax arising from a taxable termination, various planning techniques have been used to expose the assets to estate taxes with respect to the estates of non-skip persons. More simple provisions allow trustees to make outright distributions to beneficiaries who are non-skip persons, or give a third party a special power to appoint trust assets to such beneficiaries, in order to increase the gift or estate tax base of such beneficiaries. More complicated provisions may involve granting a general (or in the case of the so-called “Delaware tax trap,” limited) power of appointment that will cause the value of the trust assets to be included in such beneficiaries’ gross estates.

The sophisticated estate planning advice that is required for use of these techniques disadvantages taxpayers with smaller estates who do not obtain such advice and rewards taxpayers who obtain such advice, without achieving any known policy objective of the transfer tax system. The statutory provisions have created incentives for estate planners to engage in complicated estate planning because they could be subject to claims of violation of professional duties in failing to take advantage of clear statutory provisions that reduce transfer tax liability. This unnecessary planning serves only to increase taxpayers’ compliance costs without any significant increase in tax revenues.

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<sup>13</sup> General Explanation of the Tax Reform Act of 1976, Staff of Joint Committee on Taxation, 94<sup>th</sup> Cong., 2d Sess. At 565 (1976).

Simplification could be accomplished with minimal loss of federal tax revenues if the executor of a non-skip person's estate were allowed to make an election to include in the decedent's gross estate the value of property that otherwise would be subject to GST tax. The possibility of making such a post-mortem election would eliminate the necessity of drafting complicated will and trust provisions designed to draw the value of property into the decedent's gross estate.

An election out of a taxable termination would (1) avoid complicated drafting to avoid the GST tax; (2) avoid complex trust administration to implement the complicated drafting; and (3) place the transfer tax choice in the hands of the proper party (the decedent's executor) at the proper time (when the decedent dies).

ACTEC proposes that the Code be amended by enacting a new code Section 2033A to read as follows:

“Sec. 2033A. PROPERTY INCLUDIBLE BY ELECTION.

(a) GENERAL RULE.—The value of the gross estate of the decedent shall include the value of qualified property to the extent elected by the executor pursuant to this section, if the value of such property is not includible in the gross estate under any other section of this chapter.

(b) QUALIFIED PROPERTY.—For purposes of this section, “qualified property” means property that would be the subject of a taxable termination resulting from the death of the decedent, if the executor did not elect to include the value of such property in the gross estate of the decedent pursuant to this section.

(c) PROPERTY INCLUDES INTEREST THEREIN.—The term “property” includes an interest in property.

(d) SPECIFIC PORTION TREATED AS SEPARATE PROPERTY.—A specific portion of property shall be treated as separate property.

(e) TIME AND MANNER OF ELECTION.—

(1) The executor shall make the election for qualified property under this section at any time on or before the date prescribed for filing the estate tax return for the decedent's estate (determined with regard to extensions), regardless of whether such a return is required to be filed. An election under this section includes a partial election.

(2) The Secretary shall prescribe the manner in which the executor shall make the election referred to in paragraph (1).

(f) QUALIFIED PROPERTY TREATED AS PASSING FROM DECEDENT.—Qualified property for which an election is made under this section shall be treated as passing from the decedent for all purposes under this title.”

ACTEC proposes that Code Sec. 2207B be amended to permit the executor to recover the estate taxes paid as a result of an election made under Sec. 2033A.

As a conforming amendment, ACTEC proposes that Code Sec. 1014(b) be amended by inserting the following paragraph at the end thereof:

“(11) Property included in the gross estate of the decedent under section 2033A (relating to property electively included in the decedent’s gross estate).”

ACTEC proposes that Sec. 2662(a)(2) be amended to read as follows:

“(2) the return shall be filed—

(A) in the case of a direct skip (other than from a trust), on or before the date on which an estate or gift tax return is required to be filed with respect to the transfer,

(B) in the case of a generation-skipping transfer that results from the death of an individual, on or before the date on which an estate tax return would be required for the decedent’s estate, regardless of whether such a return is required, and

(C) in all other cases, on or before the 15th day of the 4th month after the close of the taxable year of the person required to make such return in which such transfer occurs.”

ACTEC believes that the election to include in the decedent’s gross estate the value of property that would otherwise be subject to a taxable termination will simplify the transfer tax system.

### **III. CONCLUSION**

ACTEC believes the changes recommended in this Report would more accurately and efficiently implement what we understand to be Congressional objectives than do the provisions of current law.

These recommendations were prepared by members of ACTEC’s Transfer Tax Study Committee under the supervision of the chair of the committee, Trent S. Kiziah (213-861-5028), and were reviewed and approved by Ronald D. Aucutt (703-712-5497) on behalf of ACTEC’s Washington Affairs Committee. We appreciate this opportunity to provide these recommendations and would be pleased to offer additional comments if desired.