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October 28, 2011

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Via Electronic Mail:

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Re: Comments of The American College of Trust and Estate Counsel on  
Guidance on Electing Portability of Deceased Spousal Unused  
Exclusion Amount (Notice 2011-82) Released on September 29, 2011

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College") is pleased to submit these comments on the Guidance on Electing Portability of Deceased Spousal Unused Exclusion Amount, Notice 2011-82, released on September 29, 2011. The College recognizes that drafting guidance and regulations is a difficult task. The College appreciates the Internal Revenue Service's and Treasury Department's efforts to provide guidance on the manner in which an executor of the estate of a decedent dying after December 31, 2010 makes the election under Section 2010(c)(5)(A) of the Internal Revenue Code to allow the decedent's surviving spouse to use the decedent's unused exclusion amount. The College also appreciates the opportunity to respond to the request for comments on the topics set forth at the end of Notice 2011-82 in advance of the issuance of proposed regulations.

The College is a professional association of over 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching and bar activities. Fellows of the College have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate and gift tax planning and compliance. The College offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

## Background

In Notice 2011-82, 2011-42 I.R.B. 516 (September 29, 2011), the IRS provided guidance on the portability of a deceased spousal unused exclusion amount (“DSUEA”), allowed under section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312 (124 Stat. 3302) (“TRUIRJCA”) and Section 2010(c)(5)(A).<sup>1</sup> In this notice, the Service and Treasury invited comments on the following specific issues, for consideration in forthcoming regulations:

1. The determination in various circumstances of the deceased spousal unused exclusion amount and the applicable exclusion amount;
2. The order in which exclusions are deemed to be used;
3. The effect of the last predeceasing spouse limitation described in section 2010(c)(4)(B)(i);
4. The scope of the Service’s right to examine a return of the first spouse to die without regard to any period of limitation in section 6501; and
5. Any additional issues that should be considered for inclusion in the proposed regulations.

## Specific Comments and Proposals

### **1. Determination in various circumstances of the DSUEA and the applicable exclusion amount**

Generally, the DSUEA and the applicable exclusion amount should be easily determined in accordance with the plain language of the Code. The first two examples of the operation of the DSUEA and the applicable exclusion amount included in the Joint Committee on Taxation’s Technical Explanation of the TRUIRJCA provide a good basis for examples in the regulations. Staff of the Joint Committee on Taxation, 111<sup>th</sup> Cong., 2d Sess., “Technical Explanation 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,” p. 52 (Dec. 10, 2010) (Committee Print) (“JCT Technical Explanation”). These two examples are as follows:

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<sup>1</sup> All references to “Section,” unless otherwise indicated, refer to the Internal Revenue Code of 1986, as amended.

Example 1.—Assume that Husband 1 dies in 2011, having made taxable transfers of \$3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, 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), which she may use for lifetime gifts or for transfers at death.

Example 2.—Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made \$4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is \$3 million (\$2 million for Husband 1 and \$1 million for Husband 2), only Husband 2's \$1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount (\$5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (here, Husband 2's \$1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

The College agrees with the substance of Examples 1 and 2 and recommends that they be incorporated into the proposed regulations.

The third example in the JCT Technical Explanation, however, creates a widely-acknowledged potential problem. The third example states:

Example 3.—Assume the same facts as in Examples 1 and 2, except that Wife predeceases Husband 2. 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). W 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.

JCT Technical Explanation at 52-53.

This third example appears to conflict with Section 2010(c)(4). Section 2010(c)(2) states that an individual's applicable exclusion amount is equal to the sum of his or her basic exclusion amount (\$5 million indexed for inflation after 2011) and DSUEA. Section 2010(c)(4) provides that the DSUEA is the lesser of (1) the basic exclusion amount or (2) the excess of: (i) the basic exclusion amount of the last deceased spouse of the surviving spouse over (ii) the taxable estate plus adjusted taxable gifts. Example 3 calculates Wife's DSUEA as her applicable exclusion amount less her taxable estate, rather than as her basic exclusion amount less her taxable estate.

The Joint Committee staff stated in 2011 that:

The provision adds new section 2010(c)(4), which generally defines "deceased spousal unused exclusion amount" of a surviving spouse as the lesser of (a) the basic exclusion amount, or (b) the excess of (i) the basic exclusion amount of the last 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. 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. Applicable exclusion amount is defined in section 2010(c)(2), as amended by the provision.

Joint Committee on Taxation, 111<sup>th</sup> Cong., 2d Sess., "ERRATA – 'General Explanation Of Tax Legislation Enacted In The 111th Congress'" p. 1 (March 23, 2011) ("JCT ERRATA").

The conflict between the JCT Technical Explanation and the statute puts taxpayers in an untenable position that should be addressed by regulation or other guidance.

The College believes that the present language of Section 2010(c)(4), if read literally, does not reflect Congress' intent and, in any event, makes no sense. Read literally, the statute provides for a comparison of two limiting amounts, permitting a surviving spouse to utilize the lower of those two amounts in addition to the surviving spouse's own basic exclusion amount. Those two limiting amounts are: (1) the basic exclusion amount and (2) the basic exclusion amount of the predeceased spouse reduced by the predeceased spouse's tax base (i.e., the sum of the predeceased spouse's taxable estate and adjusted taxable gifts). Because the second amount cannot be greater than the first amount, the first amount can never result in capping the amount of the deceased spouse's exclusion amount to be enjoyed by the surviving spouse.<sup>2</sup> As Example

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<sup>2</sup> One could speculate that Congress chose to make the first limiting amount at least equal to the second limiting amount – even though the first limiting amount would thereby be denied significance – in anticipation of the possibility that the basic exclusion amount might be reduced in the future. If, for example, the basic exclusion amount were reduced to \$3.5 million in 2013 and the surviving spouse died thereafter, the first limiting amount (\$3.5 million) would constitute

3 in the Joint JCT Technical Explanation indicates, and as is confirmed by the JCT ERRATA, Congress intended the calculation of the second amount to begin with the “applicable exclusion amount,” not the “basic exclusion amount,” reduced by the predeceased spouse’s tax base. When the statute is read that way, as Congress intended, the absurdity disappears. The predeceased spouse’s applicable exclusion amount could indeed be greater than the basic exclusion amount (because it could include the predeceased spouse’s DSUEA), thus permitting the first amount to have significance by capping the amount of the predeceased spouse’s exclusion to be enjoyed by the surviving spouse.

As a matter of traditional statutory construction, courts can ignore a literal reading of a statute in order to avoid an absurd result. See *Comm’r v. Brown*, 380 U.S. 563, 571 (1965), quoting *Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941) (“courts, in interpreting a statute, have some ‘scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results ... or would thwart the obvious purpose of the statute’”); *Mangels v. United States*, 828 F.2d 1324, 1329 (8th Cir. 1987) (“plain meaning rule is inapplicable ... when it yields absurd consequences and there is an alternative interpretation that reasonably effects the statute’s purpose”). Moreover, courts can cure a scrivener’s error contained in a statute. See *U.S. Nat. Bank of Oregon v. Independent Ins. Agents of America*, 508 U.S. 439 (1993); *United States v. Pabon-Cruz*, 391 F.3d 86 (2d Cir. 2004). Thus, the College believes that a court would hold that the statute should be construed in accordance with Congress’ intent. As a result, Treasury should certainly be able to achieve the same result by regulation. See *PSB Holdings, Inc. v. Comm’r*, 129 T.C. 131, 138-141 (2007).

Under the first step of analysis under *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), an agency is only foreclosed from adopting a regulation if the statute unambiguously provides a contrary result. In the context of Section 2010(c)(4)(i), given the statute’s failure to make sense on its face, as well as the reflection in the legislative history, the suggested regulation could not be invalidated under *Chevron*’s first step. Indeed, at the very least, the statute is ambiguous, thus giving Treasury the authority under *Chevron* to resolve it in accordance with Congress’ intent. In addition, it should be noted that, under Section 2010(c)(6) Treasury is expressly given the authority “to prescribe such regulations as may be necessary or

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a cap on the amount of the DSUEA available to the surviving spouse. This assumes that the second limiting amount would not also be adjusted to \$3.5 million, because, even though the first and second limiting amounts both refer to the “basic exclusion amount,” the second limiting amount adds the phrase “of the last such deceased spouse of such surviving spouse.” To the extent this is viewed as ambiguous, it is appropriate for the regulations to consider the legislative history, which reveals no indication that Congress was concerned about the possibility of future reductions in the basic exclusion amount. Indeed, the statutory language of Section 2010(c)(4) may be traced to section 304 of the “Middle Class Tax Cut Act of 2010,” Senator Baucus’s Senate Amendment to H.R. 4863, of December 2, 2010, which would have made the estate tax rules (of 2009) permanent.

appropriate to carry out this subsection.” This specific grant of authority could certainly be cited in support of the suggested regulation. See *Mayo Foundation for Medical Educ. and Research v. United States*, \_\_ U.S. \_\_ 131 S. Ct. 704 (2011) (applying JCT Technical Explanation to an interpretive tax regulation issued under Section 7805 and indicating that such a regulation should receive no less deference than a specific-grant regulation). Finally, as a taxpayer-friendly regulation, the suggested regulation could not, and would not, be challenged by a taxpayer. In fact, no taxpayer would have standing to make such a challenge. Thus, we respectfully suggest that the regulations adopt the approach we outline on this issue.

If Treasury and the Service do not believe that they have the authority to issue regulations interpreting the Code in a manner consistent with the JCT ERRATA, however, the regulations or other guidance should at least provide a safe harbor for surviving spouses who wish to make gifts and executors who must administer estates such that neither will be penalized for treating Section 2010(c)(4) as limiting the surviving spouse’s DSUEA to the lesser of the basic exclusion amount or the excess of: (i) the applicable exclusion amount of the last deceased spouse of the surviving spouse over (ii) the taxable estate plus adjusted taxable gifts. Taxpayers should not be forced to plan for two different interpretations of the portability rules, and they should be protected from penalty exposure for relying on what the Joint Committee staff states was Congress’s actual intent.

## **2. The order in which exclusions are deemed to be used**

The Code does not address the manner in which the gift tax on lifetime transfers by a surviving spouse should be deemed to be offset by the spouse’s basic exclusion amount and DSUEA. Whether this issue is important depends upon the interpretation adopted by Treasury and the Service regarding the use of the phrase “basic exclusion amount of the last deceased spouse” in Section 2010(c)(4)(B)(i). The College has suggested, as discussed above, that Treasury and the Service interpret Section 2010(c)(4)(B)(i) as actually referring to the “applicable exclusion amount of the last deceased spouse.”

If the interpretation of Section 2010(c)(4)(B)(i) recommended by the College is adopted, then the Code would make an ordering rule irrelevant and we recommend that the regulations not attempt to create one.<sup>3</sup>

Section 2010(c)(2) states that the applicable exclusion amount (from which the applicable credit amount is derived) consists of the basic exclusion amount and the DSUEA. The only point in either the estate or gift tax rules in which the basic exclusion amount is relevant is in

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<sup>3</sup> Issues related to multiple marriages, which could be among the potential issues contemplated by this question, are addressed below in the discussion of “DSUEA and gift tax payable under Section 2001(b)(2).”

computing the DSUEA. It is not used to compute the estate or gift tax directly. The estate and gift tax are always calculated using the applicable exclusion amount, unified credit, or applicable credit amount. Once an individual survives a predeceased spouse and receives a DSUEA, that amount becomes an increased applicable exclusion amount or applicable credit amount. An ordering rule would be inconsistent with this concept.

Furthermore, an ordering rule would make no difference in the computation of gift or estate taxes, other than in computing the DSUEA of a surviving spouse. This can be illustrated by the following examples:<sup>4</sup>

Example 1. H and W are married and both are U.S. citizens. Neither H nor W has ever made an adjusted taxable gift. H dies in Year One. H has no taxable estate, and W receives a DSUEA of \$5 million. W's applicable exclusion amount (from which her applicable credit amount is calculated) becomes \$10 million. W makes \$10 million of taxable gifts in Year Two. W pays no gift tax on these transfers because of her \$10 million applicable exclusion amount. In Year Three, W marries H2. In Year Four, H2 dies, leaving his entire \$5 million taxable estate to individuals other than W. W's DSUEA is now zero and her applicable exclusion amount is zero (one cannot have a negative applicable exclusion amount).

W makes \$1 million of gifts later in Year Five. In determining the tax owed by W on this gift, Section 2505(a) permits her a credit for 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.

The applicable credit amount in effect under Section 2010(c), had W died at the end of Year Five, is \$1,730,800. The sum of amounts previously allowed as a credit is \$3,480,800. The credit allowed for W against the Year Five gift tax is zero.

Example 2. Assume the same facts as in Example 1, except that the gift made by W in Year Two is \$7 million. In determining the tax owed by W on the Year Five gift, the credit available to her under Section 2505(a) is still zero (\$1,730,800 - \$2,430,800). The ratio of DSUEA and basic exclusion amount that constituted the applicable exclusion amount used to offset the tax on the Year Two gifts is irrelevant.

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<sup>4</sup> In all examples in this letter: (a) future inflation adjustments to the basic exclusion amount are ignored; (b) it is presumed that the portability rules are in effect in all years; and (c) it is presumed that the tax rates and basic exclusion amount applicable in 2011 are in effect in all years.

Example 3. Assume the same facts as in Example 2, except that W dies in Year Five, rather than making a gift in that year. W's taxable estate is \$5 million. The tentative tax on W's estate is imposed on the sum of the taxable estate (\$5 million) and the amount of W's adjusted taxable gifts (\$7 million). The tentative estate tax imposed on this \$12 million amount is \$4,180,800. This amount is then reduced by the total gift tax paid or payable with respect to adjusted taxable gifts, and by W's \$1,730,000 unified credit. The proportion of the Year Two gifts that was sheltered from tax by DSUEA is irrelevant.

On the other hand, if Treasury and the Service do not interpret Section 2010(c)(4)(i) as if it referred to the "applicable exclusion amount of the last deceased spouse," then an ordering rule is necessary to calculate accurately the DSUEA of a surviving spouse who makes a lifetime taxable gift before remarriage. The question becomes whether a surviving spouse who makes a lifetime taxable gift offsets the gift tax with DSUEA, the donor's basic exclusion amount, or some combination of the two, and, if with a combination of the two, how that combination is determined.

There are at least four general approaches (each no doubt with many variations) that the regulations could take on this issue:

(a) The regulations could require a donor to apply his or her basic exclusion amount and DSUEA to lifetime transfers, but allow a donor to elect the amount and order in which each would be applied. The donor would, consistent with present law, be required to use one or both of these amounts to offset gift tax, to the greatest extent possible; the donor could not elect to pay gift tax and reserve the use of the basic exclusion amount, the DSUEA, or both, for future transfers.

(b) The regulations could require that a donor use his or her basic exclusion amount to offset the tax on a lifetime transfer, and only permit use of the DSUEA after the donor's basic exclusion amount had been exhausted.

(c) The regulations could require that a donor use his or her DSUEA to offset the tax on a lifetime transfer, and only permit the use of the basic exclusion amount after the donor's DSUEA had been exhausted.

(d) The regulations could require that the donor use basic exclusion amount and DSUEA proportionately.

The approach that has the most to commend it is requiring that the surviving spouse use all of his or her DSUEA before using any of his or her basic exclusion amount. This approach is the most consistent with the purpose and function of the portability rules. This approach is consistent with Example 3 of the JCT Technical Explanation and would, therefore, preserve and continue an approach that many practitioners believe already to be required.

This approach also implements the purpose of the portability concept, to facilitate a decedent's making all or a substantial amount of his or her estate fully available to the surviving spouse, rather than leaving a substantial amount to a nonmarital trust, in order to take full advantage of the first deceased spouse's applicable exclusion amount. A decedent who leaves his or her estate to a surviving spouse necessarily anticipates that the surviving spouse will dispose of at least a portion of those assets by lifetime or testamentary transfer to or for the benefit of the children of the marriage and their descendants. A surviving spouse who wants to make such gifts from the property received from the first deceased spouse is, in effect, conferring the benefits on the family that the deceased spouse might have otherwise conferred through a nonmarital trust. The surviving spouse is, in effect, distributing the deceased spouse's assets and should, therefore, be able to make use of the deceased spouse's applicable exclusion amount .

This suggests that the surviving spouse should be able to use the DSUEA received from the first deceased spouse's estate before using his or her own basic exclusion amount. This rule could be illustrated by the following examples:

Example 1. H and W are married and both are U.S. citizens. W dies in Year One leaving an estate of \$5 million. W's entire estate passes outright to H, a U.S. citizen. Neither W nor H has ever made lifetime taxable gifts. W's executor files a timely Form 706 and, by not taking any of the designated actions to avoid the election, allocates W's unused exemption to H. H's applicable exclusion amount is then \$10 million (\$5 million basic exclusion amount + \$5 million DSUEA). In Year Two, H makes a \$3 million taxable gift. H must use \$3 million of the DSUEA to offset the gift tax on this transfer. Thereafter, H's applicable exclusion amount is \$7 million (\$5 million basic exclusion amount + \$2 million DSUEA).

In Year Three, H marries W2, who is also a U.S. citizen.

In Year Four, H dies, survived by W2. H leaves his entire estate outright to W2. W2 receives a DSUEA from H, calculated under Section 2010(c)(4) as the lesser of: (i) the basic exclusion amount (\$5 million) or (ii) the basic exclusion amount of the last deceased spouse (\$5 million) over the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the last deceased spouse's estate (\$3 million). W2's DSUEA is \$2 million.

Example 2. Assume the same facts, except that in Year Four, W2 dies, leaving \$5 million to her children. H's applicable exclusion amount is thereafter \$5 million (his \$5 million basic exclusion amount + \$0 DSUEA).

Example 3. Assume the same facts as in Example 2, except that in Year Two, H makes a \$6 million taxable gift. H must use all of his DSUEA and \$1 million of his basic exclusion amount to offset the gift tax on this transfer. Thereafter, H's

applicable exclusion amount is \$4 million (\$0 DSUEA + \$4 million basic exclusion amount). After the death of W2, H's applicable exclusion amount is still \$4 million.

**3. The effect of the last predeceasing spouse limitation described in section 2010(c)(4)(B)(i)**

**Lifetime taxable gifts.** The effect of the last predeceased spouse limitation in Section 2010(c)(4)(B)(i) should be clarified by regulation with respect to the treatment of taxable gifts made by a last deceased spouse on which gift tax is actually paid.

Section 2010(c)(3) states that the basic exclusion amount is \$5 million, adjusted for inflation after 2011. Section 2010(c)(4) states that the DSUEA is the lesser of (a) the basic exclusion amount or (b) the excess of the basic exclusion amount of the surviving spouse's last deceased spouse, over "the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse."

Section 2505(a) states that the unified credit, for gift tax purposes, shall be "(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." This definition applies until December 31, 2012.

The flush language of Section 2505(a) then adds that, for purposes of calculating the amounts allowable as a credit in preceding periods, "the rates of tax in effect under section 2502(a)(2) for such calendar year shall, in lieu of the rates of tax in effect for preceding calendar periods, be used in determining the amounts allowable as a credit under this section for all preceding calendar periods."

We believe that there is an ambiguity in the manner in which Section 2010(c)(4) takes into account gifts that were made in prior calendar periods on which gift tax was actually paid, where the applicable exclusion amount has been increased in later years. The requirement in Section 2010(c)(4)(ii) that the last deceased spouse's basic exclusion amount be reduced by "the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse" could be construed, absent clarifying regulations, to ignore the fact that the last deceased spouse paid a gift tax on the transfers that were above the applicable exclusion amount at that time, but which are below the applicable exclusion amount on the date of death.

Example. In 2008, the applicable exclusion amount for gift taxes is \$1 million, and H makes a \$4 million taxable gift, utilizing all of his applicable exclusion amount and

paying a \$1,335,000 gift tax. H dies in 2011, survived by W, who is a U.S. citizen. H has a taxable estate of \$1 million and the 2008 taxable gift is the only gift he has ever made. The DSUEA available to W should be \$3 million (H's \$5 million basic exclusion amount - \$1 million lifetime use of applicable exclusion amount - \$1 million taxable estate), but Section 2010(c)(4)(B)(ii) could be read as requiring that the DSUEA available to W is reduced by H's entire \$4 million adjusted taxable gift, including the portion for which no applicable exclusion amount was available and therefore gift taxes were paid.

As discussed earlier, regulations typically construe statutory language in a manner that avoids an unanticipated and arguably "absurd" result. The regulations should, we submit, construe Section 2010(c)(4)(B)(ii) as limited to those adjusted taxable gifts the tax on which was offset by the unified credit available at the time of the gift.

**Remarriage and divorce.** The regulations should also clarify the effect of the remarriage by a surviving spouse who has a DSUEA, if that later marriage is terminated by divorce or annulment. The Code appears to leave a surviving spouse's DSUEA intact even after the surviving spouse's remarriage, unless the more recent new spouse dies and is survived by the original surviving spouse. It would be very useful for the regulations to verify that the surviving spouse's DSUEA is unaffected by mere remarriage, and if that subsequent marriage is terminated by divorce or annulment, the surviving spouse's DSUEA from the first spouse remains intact unless and until it is used against lifetime taxable gifts or a taxable estate. This may be illustrated as follows:

Example 1. H and W are married and both are U.S. citizens. H dies in Year One, survived by his spouse, W. H has never made any lifetime taxable gifts, and his taxable estate is \$1 million. The DSUEA available to W on account of H's death is \$4 million (\$5 million basic exclusion amount - \$1 million taxable estate). W has previously made \$5 million in taxable gifts, so her applicable exclusion amount after H's death is \$4 million (\$4 million DSUEA + \$0 basic exclusion amount). In Year Two, W marries H2, who is also a U.S. citizen. In Year Three, while H2 is still alive, W makes a taxable gift of \$2 million. W can use her applicable exclusion amount attributable to the DSUEA she received from H to offset the gift tax on her taxable gift made in Year Three.

Example 2. Assume the same facts as in Example 1, except that before W makes her taxable gift, H2 dies. H2 is also a U.S. citizen, and his entire \$10 million estate is left outright to W. H2's gift to W qualifies for the estate tax marital deduction, and H2 has no taxable estate. W's DSUEA after the death of H2 is \$5 million – H2's unused basic exclusion amount. W may use the \$5 million DSUEA from H2 to offset the gift tax on her taxable gift in Year Three.

**DSUEA and gift tax payable under Section 2001(b)(2)**. A surviving spouse who remarries continues to have an applicable exclusion amount that includes the same DSUEA that he or she had before remarriage. The Code does not require a change in the DSUEA unless a surviving spouse both remarries and survives the later spouse. In such cases, however, the surviving spouse calculates his or her applicable exclusion amount using the amount of DSUEA received from the last spouse survived. The surviving spouse's applicable exclusion amount no longer then takes into account the DSUEA received from the first deceased spouse.

A surviving spouse in this situation may acquire a DSUEA that is smaller than that which the surviving spouse has already used to satisfy a gift tax liability. This has caused some to question whether such a reduction of a surviving spouse's DSUEA below the level that the surviving spouse has already used to offset gift taxes may produce additional estate taxes at the surviving spouse's death. This concept is sometimes referred to as a "DSUEA clawback" or "portability clawback". This could be seen as economically similar to the issues related to the "ordering" of the use of the DSUEA, but, for reasons stated above, is better addressed as a separate issue in its own right.

A deceased donor's adjusted taxable gifts are added to the donor's taxable estate in the calculation of the tentative tax under Section 2001(b)(1). The deceased donor's estate then reduces the tentative estate tax by the gift tax payable with respect to post-1976 gifts. Int. Rev. Code § 2001(b)(2).

The question distills to whether the gift taxes that are offset with applicable exclusion amount attributable to DSUEA are treated as gift taxes payable under Section 2001(b)(2), even if that DSUEA is later reduced by remarriage and survival of a later spouse. That in turn could be phrased as a question whether the total DSUEA available over a lifetime (following the death of the first predeceased spouse) should in effect be maximized or minimized. This can be illustrated by the following:

Example. H and W are married and both are U.S. citizens. H dies in Year One, and W receives a \$5 million DSUEA because of an election by the executor of H's estate. W then has a \$5 million DSUEA and a \$5 million basic exclusion amount, for a \$10 million applicable exclusion amount. Later in Year One, W makes a \$9 million taxable gift, offsetting the tax on this gift with her applicable exclusion amount. Thereafter, W marries H2, who is also a U.S. citizen. H2 dies in Year Two, survived by W. H2 leaves his \$5 million estate to his children. W's DSUEA is reduced to zero. W dies in Year Three, leaving a taxable estate of \$1 million. W's estate tax will be initially calculated on a base of \$10 million (\$1 million taxable estate + \$9 million post-1976 adjusted taxable gifts). The tentative estate tax on \$10 million would be \$3,480,800. Because W had no DSUEA, the unified credit is \$1,730,800.

"Maximizing" approach: The gift tax that "would have been payable" for purposes of Section 2001(b)(2), computed without regard to the DSUEA, is \$1,400,000,

and the estate tax is \$350,000 (\$3,480,800 - \$1,400,000 - \$1,730,800), or 35% of the \$1 million taxable estate.

“Minimizing” approach: The gift tax that “would have been payable” for purposes of Section 2001(b)(2), computed with regard to the DSUEA, is zero, and the estate tax is \$1,750,000 (\$3,480,800 - \$1,730,800), which happens to be 35% of \$5 million (and presumably \$750,000 more than the assets available to the executor to pay the tax).

The choice between these two applications of the “last such deceased spouse” limitation may depend on the policies that Congress intended that limitation to serve. We assume that the limitation to the “last such deceased spouse” is intended, at least in part, to serve the policy of simplifying portability by limiting both the number of predeceased spouse’s estates (one) that would have to be examined to verify the DSUEA and the span of time (to the most recent) that such an examination would have to reach back. The “maximizing” approach, which disregards the DSUEA for purposes of Section 2001(b)(2), would serve that policy. At the time each gift is made, there is only one predeceased spouse, the most recent, whose estate needs to be reviewed to verify the DSUEA.

The “maximizing” approach would also reduce the likelihood of an estate tax that is larger than the estate from which it must be paid, which is the result in the above example under the “minimizing” approach. Such a result would present a problem for the Service, because it is not clear that either the executor or the donees would be liable for the \$750,000 of estate taxes owed in excess of the decedent’s estate.<sup>5</sup> We do not believe that regulations can make the donees liable for additional estate taxes attributable to the increased adjusted taxable gifts. We would, however, have serious concerns about a rule that could result in an uncollectible tax liability, embarrass and frustrate some taxpayers, appear to treat otherwise similarly situated taxpayers unevenly, and appear to taxpayers as a tax policy or tax administration mistake that could reduce taxpayer confidence in the fairness of the tax system. If possible, we would prefer to avoid that result or make it less likely. That could be done by adopting the “maximizing” approach, even if the donor later remarries, survives another spouse, and receives from the last deceased spouse a DSUEA that is less than that used with respect to the gift already made. In addition, we note that the “maximizing” approach would resemble the approach of the Tax Court

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<sup>5</sup> The executor is required to pay all federal estate taxes from the total assets under the executor’s control. Int. Rev. Code § 2002; 31 U.S.C. §§ 3713(a) and 3713(b). The executor is not responsible for paying more taxes than the assets includible in the decedent’s gross estate for estate tax purposes. Treas. Reg. § 20.2002-1. A donee may be liable as a transferee for unpaid gift taxes, and for estate taxes imposed on gifts that are themselves included in the decedent’s gross estate for estate tax purposes. Int. Rev. Code §§ 6324(a)(2), 6901(a)(1). Section 2035(c)(1)(C) gives the IRS a lien for estate taxes on gifts made within three years of death. This lien does not extend to gifts made more than three years prior to death and included in the decedent’s estate tax base under Section 2001(b).

in *Estate of Smith v. Comm’r*, 94 T.C. 872 (1990), *acq.* 1990-2 C.B. 1, treating as gift taxes payable for purposes of Section 2001(b)(2) those taxes that would have been payable on the increased value of adjusted taxable gifts determined in an estate tax audit.

On the other hand, if the limitation to the “last such deceased spouse” is intended also to serve a policy of providing a proxy for an anti-abuse rule that ignores multiple marriages in certain cases, then the “minimizing” approach, in which the DSUEA enters into the calculation of the offset under Section 2001(b)(2), might seem more appropriate. In addition, there is the limitation of Section 2010(c)(4)(A), which effectively prevents the applicable exclusion amount from being greater than double the basic exclusion amount. The estate planning community has speculated about the need for both the “last such deceased spouse” limitation and the Section 2010(c)(4)(A) limitation, which seem to be redundant in a time of increasing or constant exemptions. We suggest that, if necessary, one way to acknowledge an independent role for both limitations and achieve, as closely as possible, all of the objectives we have identified, would be to adopt the “maximizing” approach to the “last such deceased spouse” limitation, while interpreting the Section 2010(c)(4)(A) limitation as applying to the aggregate of all DSUEA used by any surviving spouse, by gift or at death, since January 1, 2011, without regard to the number of intervening remarriages ended by death. As this appears to us to be the most balanced approach, with the least unintended adverse consequences, we recommend it.

In either case, the rules applicable to the use of the DSUEA by gift rather than at death should be consistent, so that Section 2505(a)(2) and the following flush language are applied consistently with Section 2001(b)(2) and (g).

**4. The scope of the Service’s right to examine a return of the first spouse to die without regard to any period of limitation in section 6501**

**General scope.** The Code is quite clear on the scope of any examination of the estate of a predeceased spouse, and the regulations should confirm and illustrate that such an examination cannot be used to assess an estate tax deficiency with respect to the estate of such predeceased spouse after the limitations period of Section 6501 has expired, but that it can be used to reduce or eliminate the DSUEA of the surviving spouse, and to assess an estate or gift tax deficiency with respect to the predeceased spouse’s estate for which the limitations period of Section 6501 has not expired.

Section 2010(c)(5)(B) states that:

Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the

deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

This language, we believe, clearly restricts the post-limitations period examinations to those issues that can affect the surviving spouse's DSUEA. We believe that the appropriate scope of the examination of the estate of the predeceasing spouse would include all issues relating to the determination of the predeceased spouse's taxable estate, which can include questions of valuation, includibility, and deductibility, but that such re-determinations can be used only to adjust the DSUEA of the surviving spouse.

The following examples illustrate what we propose is the correct operation of Section 2010(c)(5)(B):

Example 1. H and W are married and both are U.S. citizens. H died in Year One, and his executor filed a timely estate tax return reporting a gross estate of \$10 million, a marital deduction of \$6 million, and a taxable estate of \$4 million. H's estate tax return also reported that H had made no lifetime taxable gifts.

W dies in Year Two, after the expiration of the period for assessment of a deficiency with respect to H's estate under Section 6501(a). As part of the examination of W's estate tax return, H's estate tax return is examined and it is discovered that H possessed incidents of ownership with respect to a \$3 million life insurance policy, the proceeds of which were paid to H's children. No estate tax deficiency can be assessed with respect to H's estate by virtue of the examination of his estate after the expiration of the period for assessment under Section 6501(a), but W's DSUEA is reduced to zero.

Example 2. H and W are married and both are U.S. citizens. H died in Year One, and his executor filed a timely estate tax return reporting a gross estate of \$10 million, a marital deduction of \$4 million, and a taxable estate of \$6 million. H's estate tax return also reported that H had made no lifetime taxable gifts.

W dies in Year Two, after the expiration of the period for assessment of a deficiency with respect to H's estate under Section 6501(a). As part of the examination of H's estate after W's death results, it is discovered that H actually did not hold incidents of ownership over a \$3 million life insurance policy, the proceeds of which were paid to H's children. Those \$3 million proceeds had been included in H's gross estate on his estate tax return (thus constituting, as a matter of computation, half of the \$6 million taxable estate). H's estate cannot claim a refund by virtue of the examination of his estate after the expiration of the period for assessment under Section 6501(a), but W's DSUEA can be increased to reflect the removal of the \$3 million life insurance proceeds from H's taxable estate.

Example 3. Assume the same facts as in Example 1, except that the examination of H's estate after W's death results in a \$5 million increase in the value of the assets passing to

H's children. No estate tax deficiency can be assessed with respect to H's estate by virtue of the examination of his estate after the expiration of the period for assessment under Section 6501(a), but W's DSUEA is reduced to zero.

Notwithstanding the breadth of the statutory language, we believe that it would be unduly burdensome on taxpayers if questions with respect to the value of the assets, debts and administrative expenses of the predeceased spouse's estate remain open until the death of the surviving spouse. Many years may elapse until the death of the surviving spouse during which records could become unavailable and evidence become stale and unreliable. Errors in the computation of the DSUEA (including by reason of omissions from the estate tax return of the predeceased spouse) could be taken into account for purposes of determining the correct amount of the DSUEA, but it would seem unreasonable to require that the value of each item adequately disclosed on the predeceased spouse's estate tax return be re-established by the executor of the surviving spouse's estate for purposes of computing the DSUEA on the death of the surviving spouse. We believe that a limited administrative rule should presume that all information adequately reported on a timely-filed estate tax return for the predeceased spouse is correct, but that this presumption could be overcome. See, however, discussion below of what constitutes a "complete Form 706."

**Unreported taxable gifts.** Another problem may arise where the Service, in examination of the first spouse's estate after the expiration of the limitations period, discovers unreported taxable gifts. Technically, the gift tax on these gifts could still be assessable and collectable from the donees. This result can be illustrated by the following example:

Example. H and W are married and both are U.S. citizens. H dies in Year One, and his executor filed a timely estate tax return reporting a gross estate of \$10 million, a marital deduction of \$9 million, and a taxable estate of \$1 million. H's estate tax return also reported that H had made no lifetime taxable gifts.

W dies in Year Two, after the expiration of the period for assessment of a deficiency with respect to H's estate under Section 6501(a). The examination of H's estate after W's death results in the discovery of \$8 million in unreported lifetime taxable gifts by H to his children. No gift tax returns were filed for the years of these transfers, and the statute of limitations on the assessment of a gift tax deficiency has not expired under Section 6501(a). Therefore, the examination of H's estate can result in both the assessment of a gift tax deficiency and action to collect this deficiency from the donees as transferees, and the reduction to zero of W's DSUEA.

This result is harsh and may unduly inhibit the election of portability by executors. Executors are likely to believe that they should not elect portability unless they know to a virtual absolute certainty that there have been no unreported taxable gifts. Such certainty will very rarely exist.

We recommend that the regulations adopt a limited administrative exception to the Service's well-established right to assess a gift tax without an applicable limitation period on taxable gifts that were never reported on a gift tax return. This pronouncement would be similar to Notice 2009-84, 2009-44 I.R.B. 592, which was recently reaffirmed in Rev. Proc. 2011-48, 2011-42 I.R.B. 527, in the context of reexamining estate tax returns in the consideration of protective claims for refund under Section 2053. An announcement of similar forbearance with regard to portability would do much to allay the concern of many executors that electing portability will expose the estate of the first spouse to die to an extended period of tax uncertainty. Reversing the result illustrated in the previous example would mean that some tax properly owed might go uncollected, but it is necessary to do this if portability is to be comfortably available for use by most estates.

**5. Additional issues that should be considered for inclusion in the proposed regulations**

**Other estate tax credits and the DSUEA.** The Code does not state explicitly whether the DSUEA is determined before or after the application of the other available credits, such as the credit for tax on prior transfers (Section 2013), the credit for foreign death taxes (Section 2014), and the credit for death taxes on remainders (Section 2015). The purpose of the DSUEA rules is to leave the surviving spouse the full benefit of the first deceased spouse's unused basic exclusion amount, and we believe that 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 both are U.S. citizens. H dies in Year One, leaving an estate of \$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.

**Portability and nonresident aliens.** The regulations should explain the effect of portability on the estate of a deceased nonresident alien ("NRA"). Section 2102(b)(1) gives each NRA a unified credit of \$13,000, which is equivalent to a \$60,000 exemption. This credit may be used only against U.S. estate tax imposed on the NRA's estate.

Section 2010(c)(4) computes the DSUEA with reference to the deceased spouse's basic exclusion amount, which is itself based on the unified credit under Section 2010. Section 2010(c) does not refer to the unified credit under Section 2102. We recommend, therefore, that the regulations state that, generally, there is no DSUEA of the credit under Section 2102, regardless of whether the surviving spouse is or is not a U.S. citizen. This rule could be illustrated by the following example.

Example. H is a nonresident alien individual who dies in Year One. H's U.S. estate is \$10,000. H has a \$13,000 unified credit under Section 2102(b). H's executor files a timely Form 706NA and takes no actions needed to prevent the election of portability. W is H's surviving spouse. W receives no portion of H's unused \$50,000 exclusion amount as a DSUEA. It is immaterial whether W is a U.S. citizen for this purpose.

The regulations should also address the effect of certain treaty provisions on the availability of portability for the estate of an NRA. Section 2102(b)(3)(A) states that the unified credit otherwise available to an NRA is increased, to the extent required under any treaty obligation of the United States, to:

the amount which bears the same ratio to the applicable credit amount in effect under section 2010(c) for the calendar year which includes the date of death as the value of the part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

A ratable share of the full \$5 million basic exclusion amount is available to an NRA who dies leaving U.S.-situs property to an NRA surviving spouse, therefore, if an applicable treaty so provides. In such situations, it seems entirely correct that the surviving spouse also be entitled to receive the deceased spouse's unused basic exclusion amount under the portability rules.

The United States treaty with Canada, for example, provides that, with respect to the estate tax (but not the gift tax), Canadian nationals who have U.S.-situs assets are entitled to a unified credit equal to the greater of:

- (a) the unified credit allowed to the estates of U.S. citizens multiplied by the fraction of the total worldwide gross estate situated in the United States; and
- (b) the unified credit allowed to a nonresident not a citizen of the United States.

U.S.-Canada Income Tax Treaty, art. XXIX,B,2. There is no reciprocal rule for Canadian tax credits, because Canada does not have a concept comparable to the U.S. unified credit.

Section 2010(c)(1)(A) states that the applicable credit amount is tied to the applicable exclusion amount. The treaty alteration of the applicable credit amount should logically increase

the foreign national's applicable exclusion amount for purposes of computing the DSUEA. Where the treaty increases the applicable credit amount of an NRA, Section 2010(c) ought to permit the creation of a DSUEA for such surviving spouse. This should apply whether the surviving spouse is or is not a U.S. citizen, although the marital deduction would be available for assets passing to a surviving spouse who is not a U.S. citizen only if they are held in a Qualified Domestic Trust. Int. Rev. Code § 2106(a)(3).

We recommend that the regulations state that:

- (1) no DSUEA is available under Section 2010(c) with respect to the United States estate of an NRA, in the absence of relevant treaty provisions; and
- (2) a DSUEA may be created where a treaty assures an NRA of a unified credit against his or her U.S. estate tax liability equal to the same proportion of the credit available under Section 2010 that the decedent's U.S. assets bears to his or her worldwide estate (or some comparable portion). In such limited situations, the DSUEA available to the surviving spouse should be equal to the lesser of (a) the basic exclusion amount of the surviving spouse's last deceased spouse, or (b) the excess of the basic exclusion amount of the surviving spouse's last deceased spouse, over "the amount with respect to which the tentative tax is determined under section 2101(b)(1) on the estate of such deceased spouse."

These rules can be illustrated as follows:

Example 1. H, a citizen and resident of Nation A, dies in Year One, with a total worldwide estate of \$10 million and a U.S. estate of \$5 million. There is no treaty between the United States and Nation A relating to estate taxes. H is entitled to a \$13,000 unified credit against his U.S. estate tax. H leaves his entire estate outright to W, who is a U.S. citizen. W receives no DSUEA from H, because H has no applicable exclusion amount or basic exclusion amount under U.S. estate tax law.

Example 2. H, a citizen and resident of Nation B, dies in Year One, with a total worldwide estate of \$5 million and a U.S. estate of \$2.5 million. Under the treaty between the United States and Nation B, H is entitled to a unified credit against his U.S. estate tax equal to that same proportion of the basic exclusion amount that would have been available to H had he been a U.S. citizen, as the U.S. estate of H bears to his worldwide estate. The basic exclusion amount for a similarly-situated U.S. decedent would have been \$5 million, so H's basic exclusion amount and applicable exclusion amount would be \$2.5 million  $[(\$2.5 \text{ million}/\$5 \text{ million}) \times \$5 \text{ million}]$ . H leaves his entire estate to a charity for which an unlimited deduction is allowed under Section 2106(a)(2). W, who is also a citizen and resident of Nation B, receives a DSUEA from H equal to \$2.5 million, H's unused exclusion amount.

**Portability and Qualified Domestic Trusts.** We recommend that the regulations explain how the portability rules work when the surviving spouse is an NRA and the deceased spouse creates a Qualified Domestic Trust (QDOT). The U.S. estate tax is imposed on certain distributions of principal from a QDOT and on the principal of a QDOT when the surviving spouse dies. Int. Rev. Code § 2056A(b). The tax imposed on the QDOT is the additional tax that would have been imposed on the first deceased spouse's estate had the assets of the QDOT been included in his or her estate. This is not computed with reference to the other assets, deductions, or credits available to the estate of the surviving spouse.

One could argue that it is appropriate for the deceased U.S. spouse's unused exemption amount to be reserved for use against the tax imposed on a QDOT, because these assets are not themselves taxable as part of the surviving spouse's estate. Also, a surviving spouse who is not a U.S. citizen is often not subject to U.S. estate or gift taxes, and making the deceased spouse's unused exemption available to an NRA spouse could waste that exemption.

This rule, however, may work a hardship on a surviving spouse, if the QDOT assets are less than the decedent's unused exclusion amount. Therefore, it is recommended that the regulations provide that the portability rules apply in full to a U.S. decedent's unused exemption amount, except to the extent that the decedent's executor elects otherwise.

Furthermore, it is recommended that the executor of the estate of a U.S. decedent who creates a QDOT be allowed to elect portability on less than all of the deceased spouse's unused exemption amount. This may be necessary where the QDOT is unlikely to require the entire exemption amount to eliminate all of its taxes, and the surviving spouse may also be able to use some of the unused exclusion amount to offset his or her own estate taxes. This rule may be illustrated by the following examples.

Example 1. H is a U.S. citizen who dies in Year One. H's U.S. estate is \$3 million. H's will creates a Qualified Domestic Trust (QDOT) for the benefit of W, H's surviving spouse, and leaves H's entire estate to this trust. W is a nonresident alien (NRA) individual. H has a \$5 million basic exclusion amount unused. H's executor files a timely Form 706 and takes no actions needed to prevent the election of portability. W may use H's \$5 million unused basic exclusion amount as DSUEA. This exclusion amount will not be taken into account in calculating the taxes later imposed on the QDOT.

Example 2. Assume the same facts as in Example 1, except that H's executor files a statement with the Form 706 for H's estate, electing portability with respect to \$2 million of the decedent's unused exclusion amount. \$3 million of the unused exclusion amount

remains in place for calculating the taxes on the QDOT. The other \$2 million of DSUEA is available to the surviving spouse to offset his or her own estate or gift tax liabilities.

**Defining “a complete Form 706”.** Notice 2011-82 states that portability is deemed elected by the filing of a “complete Form 706”. We recognize that the Service needs a basis for determining the amount of the DSUEA available to the surviving spouse, but requiring the executor of the first spouse’s estate to file a complete Form 706, with all of the usual schedules and attachments, makes it impractical for executors to elect portability where the first deceased spouse’s estate is relatively modest. In fact, it makes it impossible to elect portability when the first spouse’s estate is very small or insolvent, because there will be no funds from which to pay for preparation of an estate tax return. This will severely frustrate the purpose of the portability rules and make them available only to relatively large estates.

We recommend that Treasury and the Service, by regulation, deem an estate tax return to be complete, for purpose of electing portability, if it includes parts 1, 2 and 4 of Form 706, without any of the additional parts, schedules, or attachments. The regulation could also require that the surviving spouse maintain records to substantiate the information reported on parts 1, 2, and 4 of the Form 706, as a condition to establishing the DSUEA at the time of later taxable gifts or the surviving spouse’s death.

We would anticipate, however, that if this rule is adopted, the regulations could also provide that the value of the assets, debts and administrative expenses of the predeceased spouse’s estate reported on such an abbreviated Form 706 would not be subject to the administrative limitation on redetermination, discussed above.

### **Conclusion**

These comments were prepared by Howard M. Zaritsky (540-854-8453) (the principal author), Jonathan G. Blattmachr (212-328-0312), M. Patricia Culler (216-274-2534), Mitchell M. Gans (516-463-5870), and Diana S.C. Zeydel (305-579-0575), members of the College’s Estate and Gift Tax Committee, and were reviewed and approved by Ronald D. Aucutt (703-712-5497) on behalf of the College’s Washington Affairs Committee. We appreciate this opportunity to comment with respect to Notice 2011-82 and would be pleased to offer additional comments if desired.

Respectfully submitted,



Mary F. Radford  
President