June 11, 2013

Room 5205
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Comments on Revenue Procedure 2001-38 in Context of Portability Planning

Ladies and Gentlemen:

These comments and recommendations pertain to Revenue Procedure 2001-38 and are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law Section (RPTE). These comments represent the views of the RPTE Section only and have not been approved by the ABA’s House of Delegates or Board of Governors and therefore do not represent and should not be construed as representing the position of the ABA.

The attached submission was prepared by members of the Estate and Gift Tax Committee (the “Committee”) of the Income and Transfer Tax Planning Group of RPTE, Richard S. Franklin, Lester B. Law, and George D. Karibianian. These comments were reviewed by Jonathan G. Blattmachr, Ellen K. Harrison and Carlyn McCaffrey on behalf of the Section’s Committee on Government Submissions.

Although the attorneys who participated in preparing these comments have clients who may be affected by the legal issues addressed by the comments, no such member (or firm or organization to which any such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

The Committee and the RPTE Section appreciate the opportunity to submit these comments, and we respectfully request that the Service consider our recommendations. Members of the Committee are available to meet and discuss these matters with the Service and its staff and to respond to any questions. The
principal contacts for discussion are listed below.

Richard S. Franklin
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Very truly yours,

\[signature\]

Tina Portuondo
Chair, Section of Real Property, Trust and Estate Law

cc: Cara Lee T. Neville, Secretary, American Bar Association
Thomas M. Susman, Governmental Affairs, American Bar Association
The following comments and recommendations pertaining to Revenue Procedure 2001-38 are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law Section. These questions and observations have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

The following submission was prepared by members of the Estate and Gift Tax Committee (the “Committee”) of the Income and Transfer Tax Planning Group of the Section of Real Property, Trust and Estate Law (the “Section”) of the American Bar Association, Richard S. Franklin, Lester B. Law, and George D. Karibjianian. These comments were reviewed by Jonathan G. Blattmachr, Ellen K. Harrison and Carlyn McCaffrey on behalf of the Section’s Committee on Government Submissions.

If you have any questions, please feel free to contact any of the persons listed below:

<table>
<thead>
<tr>
<th>Contact Persons</th>
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<tbody>
<tr>
<td>Richard S. Franklin</td>
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</tbody>
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Although the members of the Section who prepared these comments have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these comments. Section members, including the authors are interested in the way that these rules affect the way they manage their practices and business units.

The Section requests that the Treasury re-examine Revenue Procedure 2001-38 in the context of portability planning and amend this procedure to make it clear that intentional qualified terminable interest property (QTIP) elections that are not necessary to reduce estate tax will be valid if the electing estate also makes a portability election. As explained below, this change will permit smaller estates to have the same planning benefits from portability that are available to larger estates and will prevent the Internal Revenue Service (the “Service”) from being whipsawed by surviving spouses who seek relief under the procedure after having taken advantage of portability.

A. Background on Procedure

The Service issued this revenue procedure in 2001 in response to numerous requests for relief by surviving spouses whose predeceased spouses’ estates had made QTIP elections pursuant to Code § 2057(b)(7) \(^2\) when the marital deduction was not necessary to reduce the Federal estate tax. The

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\(^2\) All references to the “Code” shall be to the Internal Revenue Code of 1986, as amended.
procedure notes that in some cases QTIP elections were mistakenly made for by-pass trusts.\(^3\) Once made a QTIP election is irrevocable and causes the following tax consequences for the surviving spouse: (i) a QTIP election causes the assets held in the trust at death to be included in the surviving spouse’s gross estate under Code § 2044, (ii) dispositions of any part or all of the surviving spouse’s income interest in a QTIP trust causes the spouse to be treated as making a gift pursuant to Code § 2519, (iii) the surviving spouse will become the transferor of the QTIP property for generation-skipping transfer (“GST”) tax purposes, unless a reverse QTIP election is made pursuant to Code § 2652, and (iv) the assets held in the trust at the death of the surviving spouse may receive a basis adjustment under Code § 1014.

Revenue Procedure 2001-38 clearly defines the situations to which it is intended to apply.\(^4\) The procedure only applies to QTIP elections under Code § 2056(b)(7) where, based on final estate tax values, the election was not necessary to reduce the Federal estate tax liability to zero by reason of unused unified credit (hereinafter referred to as “applicable QTIP elections”). Rev. Proc. 2001-38 specifically does not apply to (a) protective elections; (b) situations where a partial QTIP election was needed to reduce estate tax liability to zero and the executor made the election with respect to more property than was necessary; or (c) elections that are stated in terms of a formula designed to reduce the estate tax to zero. For example, if the decedent’s unused applicable exclusion amount is $5,250,000 and the estate has a value of $5,255,000, Rev. Proc. 2001-38 will not apply if the executor makes a partial QTIP election of $5,254,000 even though the amount elected exceeds the amount necessary to reduce Federal estate tax to zero. In this example, portability would apply to $5,249,000 of the deceased spouse’s unused applicable exclusion amount.

Rev. Proc. 2001-38 states that if a QTIP election is within its scope the election will be ignored for federal estate, gift and GST tax purposes. The collateral consequences of nullifying the QTIP election are that the property for which the election is ignored will not be subject to transfer tax in the surviving spouse’s estate (under Code § 2044), the spouse will not be treated as having made a taxable gift pursuant to Code § 2519 if any part or all of such spouse’s income interest is disposed of during life,\(^5\) the spouse will not become the transferor of the trust for generation-skipping transfer tax purposes, and the assets in the QTIP trust will not acquire a new basis upon the death of the surviving spouse under Code § 1014.

Despite the procedure’s blanket statement that a QTIP election within its scope will be ignored, it is not clear whether the procedure applies automatically or whether its application requires some action on the part of the surviving spouse. The Service sets forth the procedure described below that must be followed to establish that an election is within the scope of the revenue procedure:

“To establish that an election is within the scope of this revenue procedure, the taxpayer must produce sufficient evidence to that effect. For example, the taxpayer may produce a copy of the estate tax return filed by the predeceased spouse’s estate establishing that the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. Such information, including an explanation of why the

\(^3\)Rev. Proc. 2001-38, Sec. 2. The procedure uses the term “credit shelter trusts”; such term is synonymous to the term “by-pass trusts” which we use in this document. See also, PLR 2011120001 (3/25/2011)(erroneous QTIP election for by-pass trust ruled void).

\(^4\)Rev. Proc. 2001-38, Sec. 3.

\(^5\)A gift may occur under a Code section other than Code § 2519, but such issues are not the focus of these comments.
The existence of this required procedure suggests that a surviving spouse or his or her estate must apply for the nullification of an applicable QTIP election pursuant to Rev. Proc. 2001-38. However, the revenue procedure is not explicit as to whether the Service could ignore an applicable QTIP election when the taxpayer does not ask for the application of the procedure. Rev. Proc. 2001-38 is a remedial procedure intended to permit surviving spouses to avoid the loss of the benefit of the applicable exclusion amounts of their predeceased spouses. However, with the advent of portability, the unused applicable exclusion amount of the spouse who dies first is not lost if an applicable QTIP election is made as long as the portability election also is made. Therefore, Rev. Proc. 2001-38 should be modified to clarify that nullification of an applicable QTIP election is not available when the portability election is made. This modification would protect not only the interests of the taxpayer, but also the interests of the Government, as explained below.

Even if Rev. Proc. 2001-38 is not amended as we suggest, well-advised executors of larger estates could obtain the benefits of portability by making partial QTIP elections that exceed the amount necessary to reduce Federal estate tax to zero because such elections are excluded from the relief provisions of Rev. Proc. 2001-38. Thus, amending Rev. Proc. 2001-38 would provide the same benefits of portability to estates that do not exceed the available applicable exclusion amount that are available, with sophisticated planning, to larger estates.

B. Planning With QTIPs After Portability

1. In General

Portability may change how some married taxpayers plan their estates in the future. With portability, a married couple may use both spouses’ applicable exclusion amounts at any time through the date of the surviving spouse’s death. The first spouse to die (the “deceased spouse”) may permit his or her surviving spouse to take advantage of portability by leaving property outright to the surviving spouse or by leaving it in a trust that qualifies for the QTIP election. Either approach, if the executor of the surviving spouse elects portability, will enable the surviving spouse to use the deceased spouse’s full applicable exclusion amount. For the reasons discussed below, many will prefer to use a QTIP trust rather than an outright bequest and rather than a bequest to a by-pass trust.6

2. Advantages of QTIP Trust Over Outright Bequest

The QTIP trust provides the following advantages over an outright bequest:

- The QTIP trust enables the deceased spouse to maintain control of the ultimate disposition of the QTIP property following the surviving spouse’s death.
- The QTIP trust permits the executor for the deceased spouse to make a reverse QTIP election pursuant to Code § 2652. In the case of an outright bequest the

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6 The term “by-pass trust” generally refers to a trust established by the estate of a deceased spouse for the benefit of his or her surviving spouse and others that will not be subject to estate tax at the death of the surviving spouse.
deceased spouse’s GST exemption, if not used during life, will be lost because portability does not extend to the GST exemption.

- The QTIP trust can be drafted to provide some degree of creditor protection for these trust assets.

3. Advantages of QTIP Trust Over By-Pass Trust

A deceased spouse could achieve all of the advantages of the QTIP that are described above by establishing a by-pass trust. But a QTIP trust may be preferred because of either or both of the following QTIP advantages:

- The assets in the QTIP trust may receive a basis adjustment at the death of the surviving spouse.
- The QTIP trust will enable the estate of the deceased spouse to avoid paying state estate taxes on any difference between the state estate tax exclusion amount and the Federal exclusion amount.

Example: H and W are United States citizens domiciled in the District of Columbia. Each of H and W has $4 million of assets (total $8 million), and they have no debts. They have made no taxable gifts. The District of Columbia (“DC”), which has an estate tax, provides an estate tax exemption amount of $1 million. The District of Columbia does not have a separate “DC only” QTIP marital deduction (as some states have). H and W have an estate plan that provides for the passing of the deceased spouse’s unused applicable exclusion amount to a by-pass trust for the surviving spouse’s benefit and the balance of the estate passes to a QTIP trust for the surviving spouse’s benefit. If H dies first, a by-pass trust will be funded with his $4 million estate. This requires a payment of $280,400 in DC estate taxes, resulting in a net by-pass trust funding of $3,719,600.

To avoid the payment of the DC estate tax upon H’s death, H’s estate plan could be restructured to pass all of his assets to W in a form that qualifies for the federal estate tax unlimited marital deduction. H’s executor could file an United States Estate (and Generation-Skipping Transfer) Tax Return (“Form 706”) and elect portability, thereby passing his unused applicable exclusion amount to W. If H’s assets appreciate in value during the period between the time of his death and W’s death, having the assets included for Federal estate tax purposes in W’s estate may result in lower income taxes as a result of there being a step-up in basis as to all of their aggregate assets.

But for Rev. Proc. 2001-38, an alternate solution would be for the couple to restructure their estate plans to provide that the deceased spouse’s property would all pass to a QTIP trust for the benefit of the surviving spouse. In the context of the above example, the QTIP trust would provide the advantages of enabling the use of $4 million of H’s GST exemption by making the reverse QTIP election pursuant to Code § 2652, allowing H to control the ultimate disposition of the QTIP assets upon W’s death, and enabling H’s assets to be owned in a spendthrift trust for W’s benefit. These latter benefits are those typically associated with a traditional by-pass trust. The idea would be that following H’s death, a Form 706 would be filed for H’s estate on which both the QTIP and portability elections would be made. W’s applicable exclusion amount would include her basic exclusion amount and H’s unused applicable exclusion amount of $5.25 million. H’s estate would avoid paying $280,400 in DC estate taxes. Upon W’s subsequent death, if the aggregate values of

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7 See e.g., Franklin & Walls, State Death Tax Planning, Trusts & Estates (September 2011).
her estate and the QTIP trust are not in excess of her applicable exclusion amount, no Federal estate tax will be payable\(^8\) and a basis adjustment for the QTIP assets as well as the estate assets may be available. Thus, if Rev. Proc. 2001-38 did not apply to this situation, the couple might accomplish more of their estate planning goals.

### 4. New Regulations Allow For QTIP Planning – Was Rev. Proc. 2001-38 Intended to be Modified?

With the issuance of the temporary portability regulations in June 2012, the Treasury seems to contemplate that an applicable QTIP election could be made (i.e., an election that is within the scope of Rev. Proc. 2001-38) to enable portability of the deceased spouse’s applicable exclusion amount. Prop. Reg. § 20.2010-2T(a)(7)(ii)(C), which concerns the special rules for not reporting the value of certain marital or charitable deduction property, provides examples, of which example (2) states as follows:

(C) Examples. The following examples illustrate the application of paragraph (a)(7)(ii) of this section. In each example, assume that Husband (H) dies in 2011, survived by his wife (W), that both H and W are US citizens, that H's gross estate does not exceed the excess of the applicable exclusion amount for the year of his death over the total amount of H's adjusted taxable gifts and any specific exemption under section 2521, and that H's executor (E) timely files Form 706 solely to make the portability election.

... Example (2). (i) Facts. H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that H's entire estate is to be distributed to a QTIP trust for W. The non-probate assets includible in H's gross estate consist of a life insurance policy payable to H's children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no taxable gifts during his lifetime.

(ii) Application. E files an estate tax return on which all of the assets includible in the gross estate are identified on the proper schedule. In the case of the probate assets and the IRA, no information is provided with regard to date of death value in accordance with paragraph (a)(7)(ii)(A) of this section. However, E makes a QTIP election and attaches a copy of H's will creating the QTIP, and describes each such asset and its ownership to establish the estate's entitlement to the marital deduction in accordance with the instructions for the estate tax return and §20.2056(a)-1(b) (except with regard to establishing the value of the property). In the case of the life insurance policy payable to H's children, all of the regular return requirements, including reporting and establishing the fair market value of such asset, apply. Finally, E certifies on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate

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\(^8\)Generally, DC estate tax would be payable by W's estate if W is a DC resident at the time of her death.
in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

Example (2) illustrates a situation in which the gross estate of the decedent was less than the basic exclusion amount so that the QTIP election was unnecessary. Thus, this election would be within the scope of Rev. Proc. 2001-38.

It is not clear whether Example (2) was intended solely to illustrate the special rules for not reporting the value of certain marital or charitable deduction property or whether the Treasury intended to limit the application of Rev. Proc. 2001-38.

5. Whipsaw Potential

For the reasons set forth above, Rev. Proc. 2001-38 should be modified so that taxpayers can use a QTIP trust, make a QTIP election and still obtain the same benefits of portability as would be available for an outright bequest to the surviving spouse.

Moreover, modifying Rev. Proc. 2001-38 to prevent nullification of an applicable QTIP election when a portability election is made prevents a whipsaw. For example, if a QTIP election is made and the surviving spouse uses the deceased spouse’s unused applicable exclusion amount to shelter taxable gifts made during his or her lifetime, subsequent nullification of the QTIP election pursuant to Rev. Proc. 2001-38 would provide an unintended windfall. Similarly, depending upon circumstances at the time of the death of the surviving spouse, the surviving spouse’s estate could attempt to invoke Rev. Proc. 2001-38 if it determined that the tax benefits of portability were less than the benefit of nullifying the QTIP election. For example, if the surviving spouse remarried and survived his or her second spouse, continued use of the first deceased spouse’s unused applicable exclusion amount would be lost. The estate of the surviving spouse could invoke Rev. Proc. 2001-38 to avoid the loss of the benefit of the applicable exclusion amount of the first deceased spouse.

Conclusion

Amending Rev. Proc. 2001-38 to state explicitly that applicable QTIP elections will not be nullified if portability also has been elected will permit taxpayers to take advantage of portability without forgoing the tax and non-tax benefits of using a QTIP, prevent the Service from being whipsawed (when portability is elected and the relief provided by the revenue procedure is sought), and provide the same benefits to smaller estates that, with sophisticated planning, are available to larger estates.

The risk is low that an executor will make both of these elections unknowingly. The portability election itself provides adequate relief from any unintended QTIP election.