# What Planners Need to Know About Portability

*Strategies to Minimize Estate Taxation in an Uncertain Landscape*

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax law, retroactive to January 1, 2010. For decedents dying after December 31, 2009, and before January 1, 2013, the law provides an exemption amount of $5 million and a maximum estate tax rate of 35%. In addition, beginning in 2011, the gift tax exemption was also increased to $5 million, bringing back estate and gift tax unification for 2011 and 2012.

The Tax Relief Act also enacted a provision that had been discussed by prior Congresses but never made its way into law: portability. Portability allows the executor of a deceased spouse to transfer any unused estate tax exemption to the surviving spouse, who must be a U.S. citizen or resident. This was accomplished by amending IRC section 2010(c) to define the applicable exclusion amount as—

- the basic exclusion amount ($5 million, in 2010, 2011, and 2012); plus
- the deceased spousal unused exclusion amount (DSUEA).

DSUEA is defined as the lesser of—

- the basic exclusion amount on the date of the surviving spouse's death, or
- the basic exclusion amount of the surviving spouse's last deceased spouse over the amount of that decedent's taxable estate plus adjusted taxable gifts.

## Computing DSUEA

The following four examples illustrate the computation of DSUEA assuming that portability becomes a permanent part of the estate and gift tax law:

***Example 1.*** Husband dies with a taxable estate of $1 million and no adjusted taxable gifts. At the time of Husband's death, the applicable exclusion amount was $5 million. When Wife dies, the basic exclusion amount is $3.5 million. This results in DSUEA of $3.5 million (the lesser of $3.5 million or $4 million); therefore, her total exemption is $7 million.

***Example 2.*** Assume the same facts as in Example 1, except that when Wife dies the basic exemption is $6 million. In this case, Wife will have an applicable exclusion amount of $10 million (DSUEA of $4 million plus her basic exclusion of $6 million).

DSUEA only applies to the "last deceased spouse." Remarriage in and of itself does not affect DSUEA; it is only affected by the death of a subsequent spouse.

***Example 3.*** Husband 1 dies having made taxable transfers of $3 million and having no taxable estate. Assuming that Wife has made no taxable gifts, her applicable exclusion amount is $7 million (her basic exclusion amount of $5 million plus the $2 million DSUEA). This is true even if Wife has remarried, as long as she predeceases Husband 2.

***Example 4.*** Assume the same facts as in Example 3, except that Wife has remarried and Husband 2 predeceases Wife, having made $4 million of taxable gifts. Husband 2 is now the last deceased spouse. Therefore, Wife's applicable exclusion amount is $6 million (her basic exclusion amount of $5 million plus the $1 million of Husband 2's DSUEA).

The technical language of the new law contains a privity requirement barring an individual from using a spouse's DSUEA. For example, Husband dies with DSUEA of $4 million. Wife remarries and dies before Husband 2 with no taxable estate. Husband 1's $4 million DSUEA cannot be ported over to Husband 2. However, some confusion is created by Example 3 in the Joint Committee on Taxation's Technical Explanation. This example seems to indicate that the unused exclusion of Husband 1 is first used to determine Wife's DSUEA that is available to Husband 2 when Wife dies. The following is an extract of the committee's example, predicated on Husband 1 dying with a $2 million unused exemption amount:

> 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. … Wife's deceased spousal unused exclusion amount … (therefore) is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of the deceased spousal unused exclusion amount of Wife.

The Joint Committee on Taxation's errata sheet confirms that the current statutory language does not support the conclusion in its Example 3 and that a technical correction is necessary to reflect congressional intent. Under the technical correction, it would be possible for the new spouse's applicable exclusion amount to exceed $10 million. The following example, given by the Joint Committee on Taxation, illustrates that point:

***Example 5.*** Assume that at the time of his death, Husband 1 has an unused exemption of $2 million and Wife's taxable estate is $1 million. Husband 2's applicable exemption would be increased by $6 million (Wife's applicable exemption amount of $7 million reduced by $1 million of taxable transfers). Husband 2's applicable exemption amount would be $11 million (Wife's unused applicable exemption of $6 million plus Husband 2's basic exclusion amount of $5 million).

The executor of the deceased spouse's estate must make an election on the deceased spouse's timely filed estate tax return (including extensions) allowing the surviving spouse to use the deceased spouse's unused exclusion amount. It should be noted that there is no downside to making this election. While the Tax Relief Act provides that by making the election, the statute of limitations on the deceased spouse's estate tax return remains open for three years after the death of the surviving spouse. The IRS can only use this extension, after the normal statute for assessing tax has expired, for the purpose of determining the unused exclusion amount; therefore, the executor of every estate should make the election to avoid a possible suit from the estate of the surviving spouse, unless the decedent's will includes a specific direction not to make the election. Even if an estate tax return is not required to be filed for the deceased spouse, one must be filed in order to make a proper election regarding the unused exclusion. The IRS has announced that the mere filing of Form 706 is an effective election of portability. If portability is not desired, an affirmative statement may be attached to Form 706 to effectively elect out of portability.

The Tax Relief Act provides that portability only applies to deaths in 2011 and 2012. Therefore, to take advantage of these provisions, both spouses must die after December 31, 2010, and before January 1, 2013. Most commentators believe that this provision will be extended and become a permanent part of the estate and gift tax law. This belief is bolstered by the fact that the drafters of the Joint Committee on Taxation, in their explanation examples, used no dates of death. Nevertheless, without the provisions being written into law, caution must be taken in planning for portability beyond 2012.

## Portability and the Gift Tax Credit

Portability applies to gift taxation as well as estate taxation. IRC section 2505(a)(1), as amended by the Tax Relief Act, provides that the applicable credit amount includes the deceased spouse's unused exclusion amount. The amount of the gift tax credit is the amount of the applicable exclusion, determined as if the taxpayer had died on the last day of the tax year.

***Example 6.*** On June 1, 2011, Wife makes a gift to her nephew of $6 million, having made no previous taxable gifts. On August 10, 2011, Husband dies, having made $1 million of taxable gifts in previous years. Wife's applicable gift tax credit amount is $9 million (her $5 million credit plus Husband's $4 million unused credit amount); therefore, the gift to her nephew will result in no gift tax. Although she made the gift to her nephew before her husband died, her gift tax credit is determined on December 31, 2011, the last day of her tax year.

Gift tax portability and the basic exclusion amount can create a number of problems if the survivor remarries, if the portability provisions are not extended beyond 2012, or if the basic exclusion amount is reduced.

***Remarriage.*** Assume that in Example 6, Wife remarries. Her remarriage will have no impact on the gift she made to her nephew, nor will there be any negative impact if Wife predeceases Husband 2. But if Husband 2 dies having used his full applicable exclusion amount, what are the consequences for Wife? Because her applicable credit amount is only $5 million (she can no longer use Husband 1's $4 million unused applicable credit amount) has she made a taxable $1 million gift? Does she have to amend her previous gift tax return? Or must one wait until her death to see the impact of her loss of Husband 1's applicable credit? The answers to these questions must await IRS guidance.

Commentators have argued about the legality and fairness of this clawback provision; should this situation arise, there will likely be litigation as to its appropriateness.

## Additional Considerations

Will portability change estate planning for married couples? One technique used to plan the estates of married couples before portability was to establish a credit shelter bypass trust in the wills of married couples. This provision provided that upon the death of the first spouse a trust was established, in that decedent's estate, to be funded with the maximum amount of the applicable exclusion. The purpose of this trust was to ensure that the unified credit of the first spouse to die was fully utilized. Generally, the assets of this trust were held for the benefit of the surviving spouse with income or principal available for their benefit. On the death of the surviving spouse, the assets in this trust were not part of that spouse's estate and passed to the heirs free of federal estate tax.

While the portability provisions are a step forward in estate planning, they are not the death knell of traditional estate-planning techniques.

***Portability repealed.*** Assume that in Example 6 Wife does not remarry but dies in a year when there is an applicable exclusion amount of $5 million but portability no longer applies. Her estate will be increased by adjusted taxable gifts of $6 million but her applicable exclusion amount will be $5 million, creating, in effect, a taxable gift of $1 million.

***Basic exclusion amount is reduced.*** Assume that a taxpayer makes a $5 million gift in 2011, having made no prior taxable gifts. The taxpayer dies in 2013 and the Tax Relief Act provisions are allowed to sunset, resulting in a $1 million applicable exclusion amount. The instructions to Form 706 set forth a "clawback" provision that would apply in such a situation. This provision states that the credit to be used against the adjusted taxable gifts is the applicable credit in the year of death, not the year in which the gift was made. In effect, this brings back into the taxable estate $4 million of the $5 million gift that was made.

With portability, the use of credit shelter planning has been questioned. Those who favor portability over credit shelter bypass trust planning have raised the following issues.

***Bypass trust planning is not needed in estates under $5 million.*** While this may be true, thought should be given to individuals living in states that have their own estate tax with exemptions below the federal exemption. A credit shelter trust for the state estate tax exemption might be wise. For example, New York State has an exemption equivalent amount of $1 million, and New York State has not adopted portability. If a married couple in New York relies on portability, they will lose the benefit of the $1 million exemption on the first death unless there is a credit shelter trust established in their estate planning documentation for the state exemption amount.

In addition, there is no guarantee that the $5 million basic exclusion amount will apply beyond 2012. Many planners recommend, even for small estates, the use of a disclaimer provision in a will whereby the surviving spouse can disclaim a portion of the estate, if necessary, to maximize estate tax reduction. The amount disclaimed will pass to a credit shelter trust for the benefit of the surviving spouse as a result of the disclaimer.

***Assets in the credit shelter trust will not receive a further step up in basis on the death of the surviving spouse.*** While this is correct, one must take into account the following factors:

- If the surviving spouse's estate will be taxable, consideration should be given to the difference between the estate tax rates and the potential income tax rates when the assets are sold after the death of the surviving spouse.
- The growth in the value of the assets in the credit shelter trust will not be subject to estate tax on the death of the surviving spouse.
- If the surviving spouse's estate is not going to be subject to estate tax, an independent trustee could be given the power to distribute the assets to the surviving spouse prior to her death, thereby obtaining a further step up in basis. However, it should be noted that IRC section 1014 requires a one-year holding period from the date of the transfer from the credit shelter trust for the estate of the surviving spouse to receive a step up in basis.

***Estate tax may be eliminated.*** Many commentators have stated that the increase in the basic exclusion amount will greatly reduce the number of taxable estates and estate tax collections will represent an even smaller percentage of federal revenue. Therefore, permanent estate tax repeal may be closer than ever before. Again, in such a scenario, the provisions of the credit shelter trust can give a trustee the right to terminate the trust and distribute the assets outright to the surviving spouse.

Many planners, however, view portability only as a perfect solution for those who have not done any planning. There are a number of benefits to be derived from traditional credit shelter planning in lieu of portability in addition to the state estate tax benefit discussed above. There is no guarantee that portability will last beyond 2012, but even if portability is here to stay, the law provides for indexing for inflation of the basic exclusion amount in 2012. Once the first spouse dies, the amount of the deceased spouse's unused exclusion amount is frozen.

To illustrate, assume Husband dies in 2011 without using any part of his basic exclusion amount. DSUEA is $5 million. If Wife dies a later year, when the basic exclusion amount is $8 million, her applicable exclusion amount would be $13 million. DSUEA does not increase over time with inflation. As previously stated, if Husband's will had a credit shelter trust, it would have been funded with $5 million on his death, and that amount and all future growth in the trust would escape estate tax on Wife's later death. A credit shelter trust also provides the following benefits over a portability strategy:

- Assets in the credit shelter trust will be protected from creditors, and it will not be subject to any Medicaid look-back period applicable to living trusts.
- The credit shelter trust can be used for generation-skipping tax (GST) planning. It should be noted that portability does not apply to the GST, so if a taxpayer relies on portability, he will lose the GST exemption available to the first spouse to die.
- If the surviving spouse remarries, the credit shelter trust can be used to protect the deceased spouse's children's inheritance. If portability is relied upon, the surviving spouse could transfer assets to Husband 2 and his issue, reducing what would otherwise go to the deceased spouse's children.

## Implications

It should be noted that there is no minimum term of marriage to qualify for portability. In addition, there are presently no anti-manipulation provisions in the Tax Relief Act, so it might be possible for people to take advantage of it to leverage their applicable exclusion amounts.

While the portability provisions are a step forward in estate planning, they are not the death knell of traditional estate-planning techniques. Portability is an excellent safe-harbor approach for people who have not properly planned their estates. Estate planners must still be conversant with the traditional approaches to estate planning and be cognizant of the limitations of portability. There are still questions to be answered regarding portability, the most important of which is whether it will apply beyond 2012. ❑

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