PORTABILITY—A DRAMATIC ESTATE TAX CHANGE

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Portability of a deceased spouse's unused exemption amount to reduce a surviving spouse's estate and gift tax can provide some complications.

Recently enacted "portability" provisions authorize estates of decedents dying in 2011 or later to elect to transfer their unused $5 million exemption from federal estate tax (increased for inflation) to a surviving spouse. This new provision will be valuable in estate planning for moderately wealthy as well as for wealthy taxpayers, but it is not as simple as it may seem.

Most persons have learned that $5 million ($5.25 million as increased for inflation in 2013) is now exempt from federal estate tax. Presumably, a married couple's exemption would be twice that amount, or $10 million (now $10.5 million as adjusted for inflation). Until the recently enacted Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, followed by the American Taxpayers Relief Act in 2012, however, the exemption of the first spouse to die would have been lost if that spouse simply left everything to the survivor. Under those facts, there would have been no estate tax on the first death by virtue of an unlimited marital deduction allowed for property passing outright to a spouse, or to certain trusts for a surviving spouse. All of the couple's assets would then be taxed to the survivor, however, offset only by the survivor's own exemption on the survivor's later death.

As a result, the typical estate plan was to leave the federal exempt amount on the first death to a "credit shelter trust" for the survivor's benefit, with the balance passing either outright to the survivor, or to another kind of trust that qualified for a marital deduction. No federal estate tax would then be due on the first death, because the credit shelter trust was sheltered by the exemption, and the balance was sheltered by a marital deduction. The credit shelter trust was structured so as not to be subject to estate tax on the survivor's death, even though the survivor was a beneficiary.

A number of variations were sometimes used to shelter the exempt amount from taxation in both spouses' estates. For example, the credit shelter trust was sometimes designed to benefit only children, grandchildren, and more remote issue, but not the spouse. It was sometimes designed to benefit the spouse as well as issue. Under another version, the exempt amount may have been left outright to children or to persons other than a spouse, or may have been used during lifetime by means of large gifts, i.e., gifts exceeding annual exclusion amounts, referred to as "adjusted taxable gifts."

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EXHIBIT 1
Completing Form 706 for the surviving spouse's estate

A portion of a 2012 estate tax return is illustrated below. The illustration assumes a decedent who died in 2012, with a DSUE from a former deceased spouse of $2 million.

The tentative estate tax is first determined using Table A of the instructions to Form 706 on the total of (1) the present decedent's taxable estate, and (2) "adjusted taxable gifts." Gift taxes that would have been paid using current rates are then applied to the decedent's adjusted taxable gifts and then subtracted. (Adjusted taxable gifts are defined as the total of gifts in excess of annual exclusion amounts made by the decedent after 12/31/76. Gift taxes that would have been paid on these adjusted taxable gifts based on present tax rates are determined using schedules contained in instructions to Form 706.)

A credit is then determined, which will reduce the tentative estate tax determined as above, on a dollar for dollar basis. The computation of the credit below (from Form 706, Part 2) follows:

Line		
9a	"Basic exclusion amount"[(a)] ($5,000,000 for 2011, adjusted for inflation in 2012)	$5,120,000
9b	"Deceased spousal unused exclusion"[(b)] (DSUE" amount from previous spouses, determined in Part 6 Schedule D of the Instructions); here assumed to be	$2,000,000
9c	"Applicable exclusion amount" (Total of 9a and 9b)[(c)]	**$7,120,000**
9d	"Applicable credit amount" (Calculate the tax on line 9c using the Tax Table A in the Instructions)[(d)]	$2,472,800
10	Subtract adjustment (20% of specific exemptions claimed on gifts after 9/8/76 and before 1/1/97, maximum $6,000)	0
11	Allowable applicable credit amount	$2,472,800

(a) See Section 2010(c) here and below. See also Temp. Reg. 20.2010-IT(d)(3).

(b) Temp. Reg. 20.2010-IT(d)(4). See also Temp. Regs. 20.2010-2T(c) and 20.2010-3T(b).

(c) Temp. Reg. 20.2010-IT(d)(2).

(d) Temp. Reg. 20.2010-IT(d)(1).

As discussed below, this may still be preferred in many cases, but a simpler alternative is now available as well.

To fund a credit shelter trust under a will of the first spouse to die, it is usually necessary to have sufficient assets in each spouse's sole name, since only then may assets pass to a trust as directed by the decedent's will. Assets held in joint names, TOD (transfer on death) accounts, and in "Totten trust accounts" (accounts that name a beneficiary), pass outright to the beneficiary named on the account. IRAs, pension benefits, and insurance pass by way of separate beneficiary designations rather than pursuant to the decedent's will.

In addition, a number of states, including New York, have their own death taxes, with exemptions that are far less than the federal exemption. For example, New York imposes a separate estate tax on taxable estates of more than $1 million. A credit shelter trust of a New York decedent funded with the full $5.25 million federal exemption for decedents dying in 2013 will be subject to New York estate tax of $420,800 on the death of the first spouse.

Lack of planning was often a trap for the unwary or for those who simply wanted to leave everything outright to a surviving spouse without suffering adverse tax effects.

Portability—the basics

Portability allows a deceased spouse's unused exemption, (referred to as the "deceased spousal unused exclusion amount," or the "DSUE' amount, for short) to be portable, and used to reduce a surviving spouse's gift and estate tax. In simple terms, a decedent's unused exemption is the part of a

[1] See Temp. Reg. 25.2505IT(d)(2).

[2] Temp. Regs. 20.2010-IT(d)(5), 20.2010-3T(a), 25.2505-2T(a).

[3] Adjustment for inflation is being ignored here and in later examples for ease of illustration. The masculine and feminine were used in some places only for purposes of illustration. The results apply interchangeably.

[4] Temp. Reg. 20.2010-2T.

[5] Rev. Rul. 2004-64, 2004-2 CB 7.

decedent's $5 million exemption (adjusted for inflation) that is not used to shelter gifts, trusts (including a credit shelter trust), and bequests to persons other than a spouse from estate and gift tax.

Portability of a decedent's DSUE may be used by a surviving spouse, however, only if the deceased spouse dies in 2011 or in a later year, and only if an election is made by the deceased spouse's executor to allow use of the decedent's DSUE. The election may be made by a person in possession of the decedent's property if no executor is appointed, for example, when everything is in the spouses' joint names, or when all of the decedent's assets pass under a revocable trust.

Portability allows the survivor to use the maximum exemption that would have been available to the deceased spouse, even if the decedent's estate is too small to use the full exemption allowable under law. For example, the deceased spouse's exemption of $5 million (adjusted for inflation) may be used by the survivor, even if the deceased spouse's estate had been $1 million, or even zero.

Portability applies in determining the survivor's gift tax as well as in determining estate tax payable by the survivor's estate. The following list details how the DSUE portable to a decedent's surviving spouse is determined. The numbers are the lines from Form 706, Part 6, section C for decedents dying in 2012.

1. Applicable exclusion amount of decedent (Basic exclusion amount of $5,120,000 in 2012 plus DSUE received by decedent from former spouses' gifts and estate.
2. Enter gift tax paid on adjusted taxable gifts.
3. Divide amount on Line 2 by 35% (the top tentative tax rate in 2012). Adjusted taxable gifts are thus in effect reduced by gifts that were taxed solely for purposes of computing the decedent's DSUE.
4. Add lines 1 and 3 (applicable exclusion amount plus gifts on which gift tax was paid).
5. Subtract the decedent's taxable estate plus adjusted taxable gifts.
6. Tentative DSUE.
7. DSUE is lesser of Line 6 or basic exclusion amount of $5.12 million.

The DSUE of a decedent who leaves a qualified domestic trust (QDOT) under Section 2056A for a spouse who is not a U.S. citizen, is initially determined as above, but is redetermined when the non-citizen spouse dies, or when all QDOTs terminate, if sooner. The decedent's DSUE generally cannot be used until then. However, the decedent's DSUE as redetermined above may be applied to the surviving spouse's taxable gifts made in the year of her death, or in the year the QDOTs terminate, if sooner, and in subsequent years during the surviving spouse's life.[1]

See Exhibit 1 for an example showing completion of Form 706 for the survivor's estate when portability had been elected by a predeceased spouse.

Last deceased spouse

Portability applies only to the unused exclusion amount of the survivor's *last* deceased spouse [2] who died in 2011 or later, provided the executor of that *last* deceased spouse (or a person in possession of the decedent's property if there is no executor) elected portability. The meaning of the term "last deceased spouse" is of crucial importance.

Example 1: H1 dies after 2011, leaves his entire estate to Mary, his wife, and his executor makes a portability election. No estate tax will be due by virtue of an unlimited marital deduction, and Mary and her estate will have full use of H1's unused exclusion amount (DSUE) of $5 million.[3] Mary then marries H2. Mary will still have full use of H1's DSUE even though she is married to H2, while H2 is alive. H1 is still Mary's last deceased spouse. Mary may use H1's DSUE against gifts she may make; and, if she dies before H2, Mary's executors may still use H1's DSUE in determining Mary's estate tax.

Example 2: The facts are the same as Example 1, but in this example, H2 dies *before* Mary, and leaves his exempt amount of $5 million to his children by his first marriage. H2 is now Mary's last deceased spouse, and accordingly she will no longer have the use of any DSUE from H1. Unfortunately in these circumstances, Mary will not have the use of a DSUE from anyone, since H1 was not her last deceased spouse when she died, and H2, who was her last deceased spouse, had no unused exclusion amount. It was all absorbed by the bequest H2 made to the children of his former marriage.

Example 3: As in the examples above, Mary marries H2 after H1 dies. While H2 is alive, H1 will still be Mary's *last* deceased spouse even though she is now married to H2. Mary can protect her DSUE received from H1 by making large gifts before H2 dies. Additionally, the DSUE of Mary's *last* deceased spouse (H1) will be applied first against gifts she makes, before any of her own exclusion amount is used.

DSUEs of multiple spouses may be used in some instances.

Example 4: H1 dies with a DSUE of $5 million and his executor makes a portability election. Mary marries H2 as before, and while H2 is living, she makes gifts to her children of $3 million. $3 million of H1's DSUE will be applied first against such gifts because H1 is still Mary's last deceased spouse. H2 subsequently dies before Mary, but his taxable estate is only $2 million. He leaves that to his children by a prior marriage, but his executor still makes a portability election. Mary will have a DSUE of $3 million from H2, i.e., the difference between $5 million and the $2 million of his exemption used against bequests to children of his former marriage. Mary will now have the benefit of applicable exclusion amounts of $11 million, consisting of $3 million from H1, $3 million from H2 and her own applicable exclusion amount of $5 million.

Electing portability

For decedents dying in 2011, Portability was elected simply by filing a complete federal estate tax return on or before its due date, including extensions.[4] Filing an estate tax return for the decedent on Form 706 still applies in order to elect portability, even if a return would not otherwise be required.

For decedents dying in 2012 and thereafter, some relief is provided, in that the value of assets qualifying for a marital or charitable deduction need only be estimated on the return. However, information must be included to justify the asset's eligibility for a marital or charitable deduction, as applicable. In addition, Part 6 of the 2012 return provides a place for opting out of the portability election in Section A. The DSUE amount of the present decedent portable to his surviving spouse is calculated in Section C of Part 6. Part 6 also includes a place to summarize DSUE amounts received by the present decedent from prior spouses. See illustration above in "portability-the basics" section.

The portability election is made by the executor. If there is no actual executor, the election may be made by a person in possession of assets of the decedent, for example, the trustee of a revocable trust, or a joint owner of assets held in joint names with the decedent. This may present some difficulty, inasmuch as a complete estate tax return must still be filed to make the portability election. The last election made prior to the time an estate tax return is required to be filed, including extensions, governs and is irrevocable. There are no provisions for electing portability once the time to file an estate tax return, including extensions, has expired.

There are only a handful of reasons to elect out of portability, one of which may simply be animus toward the surviving spouse. There are other reasons as well, however, including the expense of preparing an estate tax return when one would not otherwise have been required. In addition, returns for which portability is elected may be examined at any time to verify that the DSUE used, and valuations as well as deductions may be changed as a result. If the examination occurs before the period of limitations for assessing additional estate tax expires, the decedent's estate may face a claim for additional estate tax.

When should portability be used?

There is no answer written in stone, and each case is sui generis. However, the following issues should be considered.

Portability is particularly useful for a moderately wealthy couple whose combined wealth is less than two times the basic exclusion amount, i.e., two times $5.25 million in 2013 or $10.5 million in total. However, in states such as New York, and in other states that have a separate estate tax, a credit shelter trust is still advisable on the first death to shield assets from state death taxes, but only in an amount equal to the state exemption (e.g., $1 million in New York, if no adjusted taxable gifts were made).

In larger estates, creating a credit shelter trust for the full federal exemption (currently $5.25 million in 2013), will result in a New York estate tax of more than $400,000 on the first death, which could be avoided with portability. Again, a trust for the state exempt amount is still advisable, along with a procedure for postmortem planning, allowing additional amounts to be disposed of by a credit shelter trust. This may be accomplished by means of disclaimer provisions. A "Clayton trust" is also particularly useful for postmortem planning. This involves the creation of a qualified terminable interest property (QTIP) marital trust, a part of which will be converted to a credit shelter sprinkling trust if a QTIP marital deduction is not made on a timely basis.

Despite the state issues above, a credit shelter trust for the full exempt amount should be considered when the spouse likely to survive is young enough to live for a significant time, e.g., 15 years. That is because with portability, the basic exclusion amount used in determining the first spouse's DSUE is fixed on the first spouse's death, and appreciation from then on will not be sheltered. On the other hand, all appreciation of assets in a credit shelter trust following the first death will escape estate tax in the survivor's estate.

If the survivor is likely to be elderly, or sickly, it may be advisable to leave assets outright, which will then benefit from a step-up in basis on the survivor's later death as well as from portability. This may outweigh the benefits of shielding future appreciation from estate tax in the survivor's estate. Again a credit shelter trust for the amount exempt from state estate tax should be considered in states having a separate estate tax.

When most of the family wealth is owned by just one of the spouses, portability will avoid the need to transfer assets to the poorer spouse during lifetime to fund a credit shelter trust on the poorer spouse's prior death. Portability should also be considered if a couple's wealth is made up largely of IRAs, retirement benefits, and other assets not ideally suitable to be held in trust.

An interesting plan should be considered for couples with substantial wealth. Relying on portability, the deceased spouse would leave his estate outright to his spouse, and portability would be elected. The surviving spouse would then make an inter vivos gift of the decedent's $5 million exclusion amount to a grantor trust, thus avoiding New York or other state death taxes. (New York does not have a gift tax.) The survivor would also benefit by the ability to make continuing tax-free gifts by payment of income tax on trust income.[5] This arrangement is not advisable, however, for a surviving spouse who wishes to rely on the availability of income otherwise available to her with a credit shelter trust.

Trust assets held in a credit shelter trust may be shielded from the survivor's creditors, which will not be the case if assets pass outright to the survivor in reliance on portability.

Caution is advised about relying on portability if the survivor is young and is likely to remarry. The new spouse will become the survivor's last deceased spouse if he dies first, and portability of the first spouse who died will be lost. The new spouse, who is now the survivor's last deceased spouse, is likely to use his exclusion amount through bequests to children of a prior marriage. This will leave the survivor with only her own $5 million exclusion.

Portability is also dangerous in the context of a second marriage when assets are left outright to the survivor. Under these circumstances, there is no foolproof way to control how the survivor will dispose of these assets. A QTIP trust qualifying for a marital deduction would be preferable in that case, since the decedent's wealth would then pass on the survivor's death under the provisions of the QTIP trust and portability could still apply..

There are dangers even with a QTIP trust in a second marriage situation. That is because children of the first deceased spouse will bear the estate tax attributable to inclusion of the QTIP trust in the survivor's estate under Section 2207A. A more favorable tax result could be obtained without portability by using a credit shelter trust on the first death to provide for the surviving spouse. In that case, there would be no additional estate tax chargeable to children of the first marriage when the second spouse dies.

Lifetime gifts are still an important alternative to portability as well as to the creation of a credit shelter trust on the first death. Assets subject to lifetime transfers may qualify for valuation discounts based on lack of control, lack of liquidity, and discounts for minority interests. Aside from these valuation discounts, many assets have declined in value since the economic downturn in 2008, and may be used for gift tax purposes at these lower values. As in the case of portability, there will not be any New York estate or gift tax on assets used for lifetime gifts.

Conclusion

Portability adds another level of flexibility to an estate plan, and is a valuable addition to the estate planner's toolbox. It is more complicated than it may seem at first, but is valuable in the hands of a skilled practitioner.