PORTABILITY – INHERITING THE SPOUSE'S ESTATE TAX EXEMPTION

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As part of the American Taxpayer Relief Act of 2012 (Pub.L 112-240, "ATRA"), enacted January 2, 2013, the legislation made permanent the estate tax opportunity of "Portability." Portability is shorthand for the transfer of the Deceased Spousal Unused Exclusion Amount ("DSUEA"). Since January 1, 2011, when a spouse dies, the surviving spouse can acquire the deceased spouse's remaining unused estate tax exemption. This is a great tool. In its simplest application, if the estate tax exemption remains at its current $5,340,000 in 2014, and a spouse dies and leaves all his or her property to the survivor, then the survivor may have an estate tax exemption as great as $10,680,000. All that would be necessary is to file a timely estate tax return for the deceased spouse and elect to give the survivor the unused exemption. It gives the frugal client an apparently good excuse to forego the creation of a two trust structure (the so-called "A-B Trust"), which requires the increased cost of its maintenance during the period only one of them is living. <u>An important fact to keep in mind is that there was no Portability benefit possible if a spouse died before 2011.</u>

Pros and Cons of Portability.

Like using a hammer and hitting your thumb, care must be taken to avoid applying this tool when ill-advised. **The competing benefits are**:

> **<u>with Portability</u>:** (1) simplicity and (2) basis step up of the deceased spouse's property on death of the survivor;
>
> versus:
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> **<u>with a Bypass Trust</u>**: (1) asset protection and/or (2) asset control (e.g., second marriages when there are children of a prior marriage), (3) maximization of generation-skipping potential for descendants' estate tax purposes, (4) sheltering future appreciation of deceased spouse's property from estate tax by avoiding inclusion in the surviving spouse's estate; (5) generally no need to file an estate tax return if under the filing threshold; and, (6) if a return is filed, the statute of limitation contesting the value of the deceased spouse's estate will prevent the IRS from second guessing that value.

So there are more considerations that may compel implementing or retaining the existing Bypass Trust technique, even though Portability has certain benefits. These will be discussed further below. The estate plan may permit the survivor or others to **"wait and see"** if concerns may appear or recede subsequently to the signing off on the plan, and **elect different options** at the passing of the first spouse.

Bypass Trust Discussion.

For wealthier spousal clients, the traditional technique has been to provide that the decedent's property interest and rights were held in a bypass trust (a/k/a, the "credit shelter trust"). The surviving spouse could be the sole trustee. The trust was available to the survivor for any one or more of: (1) the income of the trust, (2) the annual option to withdraw up to five percent of the value of the trust, plus (3) amounts distributed for the health, education, maintenance and support of the spouse. The spouse could have the right to appoint or distribute the property to any one or more persons or trusts, but not to or for the spouse, the estate of the spouse and the creditors of either. This bypass trust was funded up to the maximum amount of the deceased spouse's estate tax exemption, otherwise it was wasted.

In spite of all those powers none of the trust assets are includable in the estate of the survivor, and are not generally reachable by his or her creditors.[1] The bypass trust gives the survivor the right and power to access the trust if his or her assets are depleted. Appreciation in the trust escapes estate tax as well.

All is great, except that since the assets are not included in the estate of the survivor, the bypass trust's basis in those assets do not step up to fair market value at the survivor's death.

New Reasons to Revisit Existing Estate Plans Now.

Congress and the President surprised most of the estate planning community on New Year's Day by enacting American Family Relief Act of 2012 ("ATRA") and making permanent the high estate and gift tax exemption amounts with yet further increases due to inflation. The current estate tax exemption is $5,340,000 for each decedent. Many older estate plans were based upon an assumption that the combined estates of spouses would exceed the estate tax exemption, which prior to 2000, was $675,000, and as late as 2008 had only increased to $2,000,000. As stated above, bypass trusts were created to hold the deceased spouse's interest for the survivor to shield the deceased spouse's property from estate tax. Now for the majority of those estates, there is no further need for the complexity and expense of maintenance of such a trust in the event of the death of one spouse, because for most no estate tax will be due.

[1] Not all states provide for the availability of all these powers and rights and remain effective for asset protection purposes, so the powers of the surviving spouse may be narrower.

With Portability - Simplicity.

Furthermore, ATRA retained the wonderful tool of “Portability.” Now, as a result of exercise of the portability election granted by Code Section 2010(c), whatever portion of the $5,340,000 estate tax exemption was not used by the deceased spouse can be “ported” to the survivor. All that is necessary is that a timely estate tax return be filed for the deceased spouse’s estate. Information is still required to be provided in the return, but substantially less to the extent the property passes to the survivor. The estate tax exemption of the first spouse to pass away can be added to the exemption of the surviving spouse, so that even if all the family’s assets are held by the surviving spouse, up to $10,680,000 is exempt from estate tax (using 2014 numbers), even under the simplest planning. The additional exemption amount is referred to as the “deceased spousal unused exclusion amount,” or DSUEA.

With Portability - Basis Step Up.

An additional important benefit of ownership of all assets by the survivor is that the basis of the assets held at death is re-set or “stepped up” to the fair market value at the later death of the survivor. This offers an opportunity to substantially reduce income taxable gain upon the sale of inherited assets by children or other beneficiaries.

Reasons to Avoid Portability.

There are still very good reasons to create bypass trusts. Some of them include:

> (1) asset protection, (2) assure that the deceased spouse’s property ultimately passes to descendants, (3) protection against decline of mental prowess of the survivor, (4) for larger estates, a larger portion of the family estate that can be held in trust over many generations free of estate taxes of descendants, (5) assure the finality of the deceased spouse’s estate tax return, and (6) assure appreciation in value avoids estate tax in the survivor’s estate.

The first four of these desires can still be realized using portability with a Qualified Terminable Interest Property Trust (a “QTIP Trust”) and still have the tax free “step up” in basis to reduce future income taxes.

Easily Overlooked Reason to Avoid Portability: Statute of Limitations Doesn’t Run on the DSEUA.

Generally, the federal estate tax return, Form 706, of the decedent is subject to audit or dispute by the IRS only if it initiates procedures within three years of the filing of the return.[2] However, this limitation does not apply to prevent the IRS from much later disputing the DSUEA of the deceased spouse's estate transferred to the surviving spouse for purposes of determining her available gift and estate tax exemption ("applicable exclusion amount" in Codespeak).[3] This could result in an increase in estate tax incurred by the surviving spouse's estate upon her death, if the IRS successfully asserts that the DSUEA is less than as reported in the deceased spouse's estate tax return. It could also result in an unanticipated gift tax if large gifts are made by the surviving spouse.

> Example: A husband dies in 2012 survived by his wife. His estate leaves all his property to her and makes an election to give her his DSUEA. The surviving spouse acquired her deceased spouse's DSUEA, reported as $5,125,000. She passes away in 2023 with a $12,465,000 taxable estate and her own $5,340,000 estate tax exemption (assuming that the exemption has not increased from 2014) along with the $5,125,000 DSUEA. Her estate's Form 706 reports this and pays the estate tax of $800,000 [$12,465,000 less $10,465,000 reported applicable exclusion amount = $2,000,000 taxed at 40% (the estate tax rate)]. The IRS successfully disputes the DSUEA, and establishes that the DSUEA is $4,125,000, not $5,125,000, increasing the taxable estate of the surviving spouse by $1,000,000. The result is an increased estate tax due of $400,000 with interest from the unextended due date of the surviving spouse's estate tax return until paid.
>
> If, instead, the deceased spouse's estate planning had placed $5,125,000 in a bypass trust for his wife,[4] and the estate timely filed a Form 706, then the power of the IRS to dispute the amount that will avoid inclusion in the surviving spouse's federal gross estate terminates at the end of the three year period starting with the filing of the deceased spouse's estate's Form 706. There still would be no estate tax due upon his death, but the statute of limitations will run on all aspects of his estate tax return. As discussed elsewhere, the trade-off is that the bases in the trust assets will not step up to fair market value upon her death, although increases in trust value will escape estate taxation in her estate.

Another Easily Overlooked Portability Issue: GST Exemption is not "Portable."

This is important to estates of married couple exceeding $5,000,000 using a generation-skipping dynastic-type trust for descendants. One important, but overlooked issue is that the GST Exemption is not subject to Portability. In other words, although the surviving spouse's estate tax exemption may be $10,680,000 in 2014 if all of her

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[2] Code Section 6501(a). The period is longer if there is underreporting of assets or no limitations if the return is fraudulent. Code Section 6501(c)(1) and (e)(2).
[3] Code Section 2010(c)(5)(B); Temp. Reg. Section 20.2010-3T(d).
[4] In Arizona and most other states, she can be the trustee, can receive amounts for her health education and support, possess the noncumulative power to receive 5% of the value of the trust annually, and distribute the property to all but herself, her estate, and her and its creditors, and the trust will not be includable in her gross estate and will be asset protected.

deceased husband's estate were given to her, and her GST Exemption remains unchanged at $5,340,000 in 2014. Therefore upon her death only that amount can be put into a generation-skipping dynastic-type trust, and the rest must be distributed to outright or in trust solely for the benefit of her children or other nonskip persons. Otherwise, whether or not there is a federal estate tax liability, a 40% Generation-Skipping Transfer Tax will be owed when such property is distributed to skip persons.

Reverse QTIP Election to Preserve GST Exemption.

There is a way to avoid the GST Exemption limitation and still obtain a step up in basis of the deceased spouse's assets on the survivor's death by using Portability. The assets of the deceased spouse (up to the deceased spouse's GST Exemption) are transferred to the decedent's trust as before. The trust is designed to be a QTIP Trust, which requires the income of the trust to be distributed to the survivor. A QTIP election is made pursuant to Code Section 2056(b)(7) to cause the amount to be a marital deduction to the deceased spouse's estate, but what is left in the trust is includable in the survivor's estate. A reverse QTIP election is made pursuant to Code Section 2652(a)(3) by the deceased spouse's estate. This causes the trust to be treated for GST purposes as though no QTIP election had been made. The deceased spouse's GST Exemption is allocated to the trust even though the trust is includable in the surviving spouse's estate. The surviving spouse can wait to decide whether to make a reverse QTIP election for up to fifteen months after the death of the other spouse.

Yet Another Overlooked Issue with Portability – Black Widow Problem.

If surviving spouse acquiring the DSUEA of a deceased spouse remarries and survives a second spouse, then at the death of the latter, the unused portion of the DSUEA of the first spouse is lost, but the DSUEA of the second spouse is available. As far as estate planning for the first marriage goes, that issue can be avoided or mitigated by creating an A-B Trust plan in the first marriage, instead of relying on Portability, or gifting after the first spouse's death as discussed below.

Keeping Your Options Open.

Some believe that the required income distribution from the decedent's trust if a QTIP election is not made is too high a price to pay for this freewheeling flexibility to elect or not elect QTIP status. The income right causes wealth to be shifted back to the survivor The dilemma is that if the income right is unacceptable if the QTIP election is not made, <u>then either</u> the surviving spouse cannot retain a power to change the residual beneficiaries, or the timing or mode of distributions to them, of the decedent trust, <u>or</u> the surviving spouse cannot have the authority to make that decision, and only an independent third party may have it.

Disclaimer Trust – 9 Months to Elect.

If the surviving spouse is to have the power to decide whether to take the portability route and have an income interest necessary for QTIP treatment, the trust is drafted so all he or she has to do is elect QTIP treatment, since by default the decedent trust provides for income distribution to the survivor. If the spouse determines not to take the portability route, she can disclaim the income right, and if she does so she must also disclaim any powers of appointment. For a spouse to make a qualified disclaimer, and not be deemed to have transferred property to the trust for gift or estate tax purposes, he or she cannot retain any power to determine any other person's rights in the trust, although she can be a beneficiary and the trustee. Code Section 2518(b)(4). Therefore, the surviving spouse cannot retain any power of appointment. This choice must be made within 9 months after the death of the first spouse.

Clayton Trust – 15 Months to Elect.

A third party can be given the power to elect between: (1) QTIP treatment with an income right to the survivor, or (2) no QTIP treatment and no income right to the survivor (although the surviving spouse can retain the right to the 5% power and HEMS distributions). The power can be safely granted in the form of a "Clayton Trust" power. It is advised that a third party (not the surviving spouse) be the personal representative of the estate or, if there is no estate, almost always the trustee of the living trust of the deceased spouse, and must have the sole power to make the election. If the surviving spouse is the fiduciary possessing solely or sharing the power then (i) she may be making a taxable gift equal to the actuarial value of the right to income if she does not make the QTIP election, and (ii) possibly risking estate tax tax inclusion if she retains a power of appointment. The fiduciary makes the choice by either electing QTIP or not electing QTIP treatment. If he doesn't elect, then the will or trust provides that there is no income right of the surviving spouse. If he does elect QTIP treatment then there is an income right. This is expressly authorized by Reg. Section 20.2056(b)-7(d)(3). **This choice must be made with the timely filing of the estate tax return, which may be filed as late as <u>15 months</u> after the death of the first spouse.**

Avoid General Trust Protector Power as an Option.

Do not rely on a Trust Protector or an Independent Trustee having more power to change the terms of the Clayton Trust other than through the QTIP Trust election power granted in the regulations if a marital deduction is important.

Factors Pointing Toward Portability and Not A-B Trust.

Factors pointing toward not creating a Decedent's Trust (whether Bypass or QTIP), giving property outright to the surviving spouse, and using Portability:

no likelihood of creditor concerns;
no step children;
neither spouse has signs of impending serious loss of mental acuity;

stable asset value;
very elderly couple;
gifts to descendants are outright gifts to children;
not likely to remarry; and
well below the $10,680,000 (in 2014) combined taxable estate value.

(Remember, Portability of a deceased spouse's unused estate tax exemption was and is not available if the spouse died before 2011.)

Prenuptial Agreements to Get DSUEA - Could Save Millions.

Because of Portability's temporary availability prior to 2013 it wasn't perceived as practical to draft prenuptial agreements (a/k/a "antenuptial agreements") to address it, and devote the energy to craft detailed technical provisions that might be meaningless. Now that it is permanent, there is a rapidly developing knowledge base regarding how to apply the law and maneuver to acquire and use the deceased spouse's unused estate tax exemption, the DSUEA, effectively.

How does this affect those advising a client about to be married or remarried? One area that may be affected is the drafting of a prenuptial agreement.

In the prenuptial agreement a spouse may get a contractual commitment that if the other spouse dies, his or her estate will file an estate tax return and elect to give the surviving spouse the available exemption. In 2014 the estate tax exemption is $5,340,000. Since the amount of the exemption transferable may be north of $5,000,000, and the federal estate tax rate is 40%, the potential benefit to the beneficiaries of a wealthy surviving spouse's estate can be more than $2,000,000 in after-tax dollars. Under present law if the estates of the parties are a couple million each or less, then Portability is not likely to be valuable. On the other hand, if future legislation reduces the estate tax exemption, then the threshold is lower than when the prenuptial agreement was signed. So maybe the portability covenant is made even with spouses with smaller estates.

On the defensive side, here is one fact pattern to consider in determining the importance of this issue in prenuptial agreements or postmarital agreements:

> Example: $10,000,000 net worth 50 year old client wants a prenuptial agreement because she is marrying her yoga instructor who has adult 2 kids from a prior marriage. The agreement keeps everything separate. It doesn't provide for any portability election. Husband dies and names his children as beneficiaries and PR of his estate. They say they won't file an estate tax return and won't elect to pass the exemption (unless she pays them big bucks). She could possibly open a probate if they don't, but then she has to administer it. She might be able to file Form 706 if she has received any property by surviving her spouse. Litigation may result.

Inheriting from the Inheritor; Remarriage Issues.

A surviving spouse who acquires a DSUEA cannot add that to his or her exemption to pass to a second spouse if the second spouse survives. Only the personal unused exemption of the first surviving spouse can be passed to the new surviving spouse. But that does not mean that there is not a way to use the first spouse's DSUEA even if the first surviving spouse remarries. If a gift is made by a surviving spouse, the DSUEA acquired from the deceased spouse is used before the surviving spouse's potential $5,340,000 exemption (for 2014).

Example: How to Pass the Baton, and (Perhaps) Hold More than One: Where the situation warrants, the newly remarried surviving spouse gifts to her children an amount equal to the $5,000,000 DSUEA she acquired from her husband, their father. Then upon either her death or the second spouse's death, the survivor can acquire the DSUEA of the deceased of them, unaffected by the gift.

The lifetime gift she makes may be done in a way to still let her have the practical use and ownership of the property. She might gift the $5,000,000 into an irrevocable trust in which she remains the trustee. She retains the right to the income and the rights to amount for her health and support. What remains at her death is given to her children. Under the "estate freeze" rules of Internal Revenue Code Section 2702, she has made a taxable gift of the entire $5,000,000. Now let's assume that she survives her second husband. Under the applicable tax regulations, upon her death all of the first husband's $5,000,000 DSUEA applied to the gift is retained, which, pursuant to the regulations, is added to the second spouse's DSUEA and her estate tax exemption for purposes of avoiding estate tax. The combined effective gift and estate tax exemption she and her estate could utilize may be as much as $15,750,000!

Example: Dropping the Baton?: On the other hand, if a surviving wife has acquired a large DSUEA from her first husband, and remarries and survives the second, she will lose the unused amount of the first DSUEA to the extent not applied in lifetime taxable gifts made by her prior to the second death, and can only have the DSUEA of her second husband if his estate elects to give it to her. This is potentially very costly if his DSUEA is less than the first DSUEA remaining and she has an estate that will be subject to estate tax. There is no way to avoid this, except by making gifts during lifetime to use up the first DSUEA, or by planning not to survive the second spouse when married to him, or just not getting married.

Non U.S. Citizen Surviving Spouse.

The DSUEA of the deceased spouse cannot be used by a non-citizen surviving spouse if a Qualified Domestic Trust (the "QDOT") is established for her, except upon the occurrence of certain events. The DSUEA can be used upon the earlier of (i) the year of the termination of all QDOTs for the surviving spouse or (ii) the year of death of the surviving spouse. The DSUEA then can be used for taxable gifts made by the surviving spouse in that year (the year of termination or death, if earlier) and subsequent years, and can be used on the estate tax return of the surviving spouse. The amount of the DSUEA available is generally the DSUEA that would have been available for a U.S. citizen surviving spouse, except that it is reduced by the value of the QDOTs remaining at the death of the surviving spouse. Temp. Reg. Section 25.2505-2T(d)(2); Temp. Reg. Section 20.2010-2T(c)(4); Temp. Reg. Section 20.2010-3T(c)(2).

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