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PLANNING WITH PORTABILITY

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On December 17, 2010, the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (the "TRA") was signed into law, which introduced the new system of portability that permits the unused gift and estate tax exemption of a decedent to be transferred to the decedent's surviving spouse. The Department of Treasury introduced temporary regulations regarding portability in June 2012 and final regulations on June 15, 2015 (effective as of June 12, 2015). Under portability, if a spouse dies and uses less than their entire estate and gift tax exemption amount, then the unused balance can be transferred to the surviving spouse. In general, this change is favorable to tax payers but adds a level of complexity for planners and advisors.

Some have said that portability eliminates the need for complicated estate planning or the retitling of assets between spouses. In some situations, this may be true but, for others, the addition of portability may not change the overall planning.

Mechanics of Portability

The TRA amended the amended the definition of "applicable exclusion amount" contained in I.R.C. §2010(c)(2) to provide that the amount that a person may exclude from transfer taxes (estate or gift) after 2010 ("applicable exclusion amount") is the sum of the individual's "basic exclusion amount," plus (in the case of a surviving spouse) the "deceased spousal unused exclusion amount" (sometimes referred to as the "DSUE amount"). The "basic exclusion amount" is defined as $5 million, indexed for inflation after 2011. The "deceased spousal unused exclusion amount" is defined as the lesser of: (a) the basic exclusion amount; or (b) the excess of the basic exclusion amount of the last such deceased spouse of such surviving spouse; over that spouse's taxable estate. In other words, when one spouse dies, if the taxable estate is less than $5 million (indexed for inflation), the unused exemption may pass to the surviving spouse and will not be wasted.

Benefits of Portability

A. Easy. When portability was enacted, it was touted as the plan for everyday people that couldn't afford (or didn't want to pay for) high-priced lawyers and accountants. Of course, the percentage of taxpayers that die with assets in excess of the applicable exclusion amount ($5.43M currently) is very small (less than 1%). The overwhelming majority of married taxpayers have joint assets less than the basic exclusion amount, and thus portability doesn't alter their planning (which is typically outright to surviving spouse). However, for estates in excess of $5.43M, portability can simplify planning (to the extent such simplification is appropriate – see below).

B. Basis Adjustment. With so few taxpayers subject to the estate tax, there is an increased focus on income tax planning. Portability allows for a basis adjustment not only upon the first to die, but also upon the death of the surviving spouse (beware – Code Section 1014(a) provides for an adjustment up or down).

C. Reduced Administrative Costs. As noted below, the traditional planning to minimize estate taxes involves the funding of a "credit shelter trust" in an amount up to the basic exclusion amount. Trust planning requires the filing of an annual income tax return, and should involve careful consideration of annual tax planning (to take advantage of beneficiaries with lower marginal income tax brackets). Credit shelter trusts, like all trusts other than revocable trusts, also require annual accountings, and have fiduciary obligations of a trustee to beneficiaries that may have inconsistent desires (think of the surviving spouse as trustee/primary beneficiary, with the children of the deceased spouse's first marriage as the remaindermen).

D. Fewer Concerns with Non-Probate Assets. With far fewer tax concerns now that the basic exclusion amount is so high (relatively), clients often tend to focus on the avoidance of probate. Using a credit shelter trust for estate tax minimization requires that the trust be funded, typically through either a revocable trust or assets passing through probate. With portability, it is relatively unimportant how assets pass to the surviving spouse, which favors joint ownership of assets (which is how most couples prefer to hold their assets).

Limitations of Portability

A. Not Indexed for Inflation. As mentioned above, the gift and estate exclusion amounts (as well as the generation skipping transfer ("GST") tax exemption amount) are indexed for inflation – presently $5.43 million. Thus, every year, everyone's exclusion is increased (which over many years can really add up). The amount of exclusion transferred to a surviving spouse through portability is fixed at the time of the first spouse's date of death.

For example, if A and B are married, with each of them owning $5 million in assets, and A dies leaving all of A's assets to B and B dies five years later (assuming portability is still in effect at that time), the assets A left to B may have appreciated in value causing B's estate to exceed $10 million and exposing B to an estate tax. If, instead, A had left A's assets to a properly structured "credit shelter" trust for the benefit of B, all of the assets owned by that trust at B's death would pass estate tax free.

B. Does Not Apply to GST. Portability only applies for estate and gift tax purposes and not for the generation-skipping transfer tax. Hence, in our previous example, even if A's assets had not appreciated in value at all, B would only be able to apply one generation skipping transfer tax exemption to the assets at death and could not avail the family of the use of A's generation skipping transfer tax exemption.

C. Requires the Filing of an Estate Tax Return. In order for portability to apply, the estate of the first deceased spouse must timely file a properly-prepared and timely filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and no election can be made after the "time prescribed by law (including extensions) for filing such return." This is required irrespective of whether such a return would

otherwise be necessary. Thus, if the estate of the first to die is only a few hundred thousand dollars, in order for the exemption to be portable to the survivor, a detailed (and often costly) federal estate tax return must be filed. I.R.C. §2010(c)(5)(A).

If no executor is appointed, then any person in actual or constructive possession of the decedent's property may file the return and affect the portability election. I.R.C. §2203. If an individual wants to ensure that portability is elected for the individual's surviving spouse, then she or he should provide a direction in her or his Will for the executor to make this election.

If the surviving spouse is not named as the executor and if the appointed executor does not get along with the surviving spouse (e.g., if the executor is the child from a decedent's first marriage who does not have a good relationship with the surviving spouse) then it may be challenging to force the executor to file an estate tax return that is otherwise unnecessary. Some commentators have suggested that this could also be provided for under a marital/nuptial agreement; however, absent a direction in the Will, it is unclear whether such a provision will be binding. It is hoped that the IRS will issue additional guidance on this point. Irrespective of the binding effect of a portability provision in a marital/nuptial agreement, advisors should consider including a provision addressing whether the surviving spouse will be entitled to use the deceased spouse's Deceased Spousal Unused Exclusion (DSUE).

Similarly, if the surviving spouse is the named executor and, for example, is the beneficiary under a large QTIP Trust with the remainder to children from a prior marriage, the surviving spouse may be indifferent to a portability election that will only benefit the prior-marriage children, the expense of which will only reduce the assets available to the surviving spouse. While the efficacious result may be to make the portability election as the expense of the prior-marriage children, family dynamics may require a specific action by the prior-marriage children to seek to force the election.

D. DSUE Amount Can Be Lost or Reduced. If surviving spouse remarries and outlives his or her new spouse, the DSUE amount from the first deceased spouse will be replaced with the DSUE amount of the last deceased spouse. Treas. Reg. §§20.2010-1(d)(5), 25.2505-2(a) and 20.2010-3(a). This limitation can be somewhat minimized, if the surviving spouse utilizes the DSUE amount with lifetime planning (beware the Black Widow). Treas. Reg. §25.2505-2(b) provides that when a surviving spouse makes a gift, she or he will be considered to have applied the DSUE amount to the gift prior to using his or her exemption. For example, if a surviving spouse has a $5 million basic exclusion and a $3 million DSUE amount, and she or he makes a $4 million gift, the surviving spouse will be deemed to have used the entire $3 million DSUE amount and $1 million dollars of basic exclusion.

For new clients, remember to ask about and to review any estate tax returns for predeceased spouses.

E. Planning for Non-Citizen Spouses. A noncitizen, nonresident surviving spouse cannot use the DSUE amount of a predeceased spouse except as allowed by treaty. There is no guidance as to what language under a treaty would be required to allow the use of portability. The Regulations provide that when a surviving spouse is not a citizen of the United States as of the decedent's death but later becomes a U.S. citizen, the DSUE amount of the surviving spouse's last deceased spouse becomes available to the surviving spouse on the date the surviving spouse becomes a U.S. citizen – so long as the executor of the deceased spouse timely elected portability. Treas. Reg. §25.2502-2(d)(2). The same is true when assets pass to one or more qualified domestic trusts ("QDOT") for the benefit of the surviving spouse. Treas. Reg. §25.2502-2(d)(3).

F. Statute of Limitations on the Review of Deceased Spouse's Return. The IRS is permitted to examine the estate tax return of the deceased spouse at any time, for purposes of determining the DSUE amount, which would seem to include the composition and value of the assets included in the deceased spouse's estate. I.R.C. §2010(c)(5). This could require the estate of the deceased spouse to maintain records for many years until after the surviving spouse receives a closing letter.

Benefits of Using a Credit Shelter Trust

A. Appreciation of Assets Ignored. As mentioned above, the DSUE amount is not indexed for inflation. By contrast, any assets devised to a credit shelter trust will remain outside of the estate of the surviving spouse, irrespective of how much they appreciate over time. For example, if husband devises $5 million to a credit shelter trust in 2015 and the value of the credit shelter grows to $20 million by the time wife dies in 2025, the credit shelter assets will remain outside the wife's estate and the wife will still be able to apply her exemption to her assets. If the credit shelter assets had been included in the wife's estate, the inclusion would have generated an estate tax and used up the spouse's exemption.

B. Application of the GST Tax Exemption. As noted above, there is no portability for GST tax. Therefore, when portability is used, the first deceased spouse's GST tax exemption is wasted. Any assets in excess of the surviving spouse's GST tax exemption may be exposed to a significant transfer tax in the future.

C. Income Tax Planning and Flexibility. A credit shelter trust may allow for distributions to be made both to the surviving spouse as well as others, including descendants. This allows the trustee to consider whether to distribute income and principal to various beneficiaries with different needs and tax brackets. For example, if one of the grandchildren has a catastrophic event (e.g., is diagnosed with cancer), the assets of the credit shelter trust can be used to help cover the grandchild's expenses without incurring any gift tax. Similarly, if some of the beneficiaries are in lower tax brackets than the trust, the trustee may allocate the trust income among the beneficiaries to achieve the most income tax favorable result. When portability is used, these options are not available. The income earned on the assets will be taxed to

the surviving spouse and the payments to the grandchild would be subject to transfer tax.

D. Protection of Assets. The assets owned in the credit shelter trust should offer a layer of protection against the creditors of the beneficiaries and will ensure that any assets remaining upon the death of the surviving spouse pass to whomever the first deceased spouse intended. Sometimes surviving spouses do not remain single and it is not uncommon for the surviving spouse to include his or her new lover or spouse in the estate plan.

E. State Estate Tax. Many states having their own transfer tax regimes do not allow for portability. However, if the assets were left to a credit shelter trust, they would remain outside the surviving spouse's estate for both federal and state estate tax purposes. Only Delaware and Hawaii allow for portability of the state estate tax.

F. Proper Management of the Assets. The deceased spouse can better ensure that the assets are properly managed and not squandered. This can be particularly important when the surviving spouse has never been involved with the finances or asset management.

G. Basis Planning. Some have argued in favor of portability so as to ensure a second basis step up on the assets upon the surviving spouse's death. However, the utilization of a credit shelter trust does not preclude a second basis step up. In fact, it may make an extra level of basis planning available. A disinterested trustee can be given the power to grant the surviving spouse a general power of appointment as to a portion of the credit shelter trust or as to specific assets. Similarly, the surviving spouse could be given a limited power of appointment so as to trigger the Delaware tax trap as to a portion of the trust or as to specific assets. While many of the assets in the credit shelter trust will have appreciated, some may have depreciated. By allowing only the appreciated assets to be included in the surviving spouse's estate (and only up to the spouse's remaining estate tax exemption), a greater level of control is available for basis planning at the second death.

Variations on Themes

A. Marital Trusts. Most plans for high net worth clients currently seek to avoid as much estate tax as possible (with a credit shelter trust) and defer any potential tax liability as long as possible (with the remainder passing either outright to a surviving spouse, or to a "QTIP Trust" for the surviving spouse). With the use of portability, a QTIP Trust can provide the "best of all worlds" for some taxpayers – (i) income stream for spouse; (ii) asset protection; (iii) basis adjustment on death of each spouse, and (iv) use of GST exemption (through "reverse-QTIP election"). Can still elect portability.

B. Disclaimers. Added flexibility for clients that want to own all assets jointly, think that portability will shield any tax liability, but aren't certain. In the event that surviving spouse should choose to disclaim, upside is protection of appreciation from estate taxation, but downsides are the forced probate and the ongoing administrative costs of

the disclaimer trust. Surviving spouse may not exercise a power of appointment over trust assets.

C. Providing for General Power of Appointment. Taking an opposite approach to that of disclaimer trusts – fund the credit shelter trust, but provide a trust protector with the power to grant the beneficiary a general power of appointment over all or some portion of the trust to force inclusion (and basis adjustment).

Three Pools of Clients What to do?

A. Couples with Less Than $5 Million. For these clients, portability may often make sense. Indeed, many of these clients will already own most or all of their assets jointly, leaving the credit shelter trust unfunded at the first death anyway. Given the relative modest size of the estate, appreciation and GST tax are less of a concern and may be outweighed by the simplicity of portability and the second basis step up. In fact, there may be no reason to use portability if it is anticipated that the estate of the surviving spouse will be less than the applicable exclusion amount. Cautious planners may still provide for a disclaimer trust or a Clayton QTIP election on the first death in case the asset picture (or tax laws) change dramatically between the estate planning being implemented and the first death.

B. Couples with Over $10 Million. For the high net worth clients, the credit shelter/marital trust plan will likely still be the best planning option available, as it allows for the GST tax exemption to be allocated at the first death and removes any appreciation from the surviving spouse's estate (as well providing the other benefits mentioned above).

C. Couples with Between $5 million and $10 Million. These clients will be the most challenging to plan for, as each couple will have unique facts and assets to review and analyze. Planners will have to look at the assets involved to try and assess both the income tax exposure if there is a loss of a second basis step up, as well the transfer tax exposure if assets appreciate significantly and any GST tax resulting from the loss of the first exemption. For these estates, providing for a disclaimer trust or a Clayton QTIP election on the first death may be appropriate.