estate planning studies®

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Portability

In estate planning for married couples, the advent of portability of the federal estate tax exemption amounts may be as consequential as the arrival of the QTIP trust more than 30 years ago. Herein:

- Election of DSUE amount
- Computation of DSUE amount
- Comparison with credit shelter trust
- Advantages and disadvantages

In 1981 qualitative and quantitative limits were removed from the marital deduction, leading to a revolution in estate planning for married couples. Two phrases emerged that no one had heard before: "credit shelter trust" and "QTIP trust."

Now we have the Deceased Spousal Unused Exclusion Amount (DSUE amount). The estate planning objective of the QTIP and credit shelter trust—utilization of both spouses' federal transfer tax exemptions—is now possible much more simply, without trust planning. However, an estate tax return will be required to make the election, even if the return would not otherwise be required because the estate is small.

Last summer the IRS released the Final Regulations on portability.[1]

MAKING THE ELECTION

The portability election must be made on a timely filed estate tax return.[2] Thus, the election must be made within nine months of the date of death, plus any extensions actually granted by the IRS. However, discretionary relief may be available for estates smaller than the tax-filing threshold.[3]

In *Private Letter Ruling 201536005*, Decedent died after portability became available. The estate was small enough that no estate tax return was needed, and Decedent never made any taxable gifts during his life. Accordingly, the executrix of the estate, Decedent's wife, did not file an estate tax return.

Later, after the due date for an estate tax return, the executrix learned of the need to file a return just to make the portability election. This ruling does not specify just how late this realization came. In any event, the IRS holds that the tax code does not specify a due date for the portability election for estates smaller than the filing threshold. Accordingly, this is a regulatory election

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over which the IRS has considerable discretion. The spouse was granted another 120 days to file the return to make the portability election.

Estates large enough to be potentially taxable will need to prepare an ordinary estate tax return to make the portability election. Smaller estates will have an easier time of it. For these estates, the executor may make an estimate of the value of assets qualifying for the charitable or marital deductions.[4] The Regs. offer three examples of the application of this rule.[5]

Examples

In each example, assume that Husband (H) dies in 2015, survived by his wife (W); that both H and W are U.S. 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 exclusion under section 2521; and that H's executor timely files Form 706 solely to make the portability election.

Example 1. The assets includible in H's gross estate consist of a parcel of real property and bank accounts held jointly with W with rights of survivorship, a life insurance policy payable to W, and a survivor annuity payable to W for her life. H made no taxable gifts during his lifetime.

Executor files an estate tax return on which these assets are identified on the proper schedule, but he provides no information on the return with regard to the date of death value of these assets. To establish the estate's entitlement to the marital deduction, Executor includes with the estate tax return evidence to verify the title of each jointly held asset, so as to confirm that W is the sole beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for W's life. Finally, Executor reports on the estate return his best estimate, determined by exercising due diligence, of the fair market value of the gross estate. The estate tax return is considered complete and properly prepared, and Executor has elected portability.

Example 2. 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 outright to 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.

Executor 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. However, Executor attaches a copy of H's will and describes each asset and its ownership to establish the estate's entitlement to the marital deduction. 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 the asset, apply. Finally, Executor reports on the estate return his best estimate, determined by exercising due diligence, of the fair market value of the gross estate. The estate tax return is considered complete and properly prepared, and Executor has elected portability.

Example 3. H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that 50% of the property passing under the terms of H's will is to be paid to a marital trust for W, and 50% is to be paid to a trust for W and their descendants.

The amount passing to the nonmarital trust cannot be verified without knowledge of the full value of the property passing under the will. Therefore, the value of the property of the marital trust relates to or affects the value passing to the trust for W and the descendants of H and W. Accordingly, the general return requirements apply to all of the property includible in the gross estate, and the provisions permitting an estimate of values do not apply.

Exceptions

The estimating rules do not apply if:

• The value of the property is needed to determine the value passing from the decedent to a recipient other than the recipient of the marital or charitable deduction property;

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• The value of the property is needed to determine the estate's eligibility for the provisions of sections 2032 or 2032A;

• Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property; or

• A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

Same-sex married couples

In accordance with *U.S. v. Windsor*, 133 S. Ct. 2675 (2013), which extended the federal estate tax marital deduction to same-sex married couples, the IRS has announced that the portability election is available to them as well.[6]

Who makes the election?

Responsibility for making the portability election falls on the executor of the estate.[7] If there is no appointed executor, any person in actual or constructive possession of any property of the decedent (a non-appointed executor) may timely file the estate tax return on behalf of the estate of the decedent and, in so doing, elect portability of the decedent's DSUE amount. A portability election made by a non-appointed executor when there is no appointed executor for that decedent's estate can be superseded by a subsequent contrary election made by an appointed executor of that same decedent's estate on an estate tax return filed on or before the due date of the return (including extensions actually granted).[8]

When the estate tax return is filed, the portability election is deemed to have been made for the surviving spouse. To avoid this result, the executor would need to opt out. Alternatively, not filing an estate tax return inherently opts out of portability. The surviving spouse may not make the election unless he or she is the executor.

Once made, the portability election is irrevocable.[9]

COMPUTING THE DSUE AMOUNT

The amount of the DSUE is the lesser of the basic exclusion amount in the year that the first spouse dies, or the amount of exclusion left if the first spouse had made lifetime taxable gifts, using up a portion of the estate tax exclusion. The Regs. illustrate this rule as follows:[10]

Example 1. In 2002, having made no prior taxable gift, Husband (H) makes a taxable gift valued at $1,000,000 and reports the gift on a timely filed gift tax return. Because the amount of the gift is equal to the applicable exclusion amount for that year ($1,000,000), $345,800 is allowed as a credit against the tax, reducing the gift tax liability to zero. H dies in 2015, survived by Wife (W). H and W are U.S. citizens, and neither has any prior marriage. H's taxable estate is $1,000,000. The executor of H's estate timely files H's estate tax return and elects portability, thereby allowing W to benefit from H's DSUE amount.

The executor of H's estate computes H's DSUE amount to be $3,430,000 (the lesser of the $5,430,000 basic exclusion amount in 2015, or the excess of H's $5,430,000 applicable exclusion amount over the sum of the $1,000,000 taxable estate and the $1,000,000 amount of adjusted taxable gifts).

Example 2. The facts are the same as in *Example 1* except that the value of H's taxable gift in 2002 is $2,000,000. After application of the applicable credit amount, H owes gift tax on $1,000,000, the amount of the gift in excess of the applicable exclusion amount for that year. H pays the gift tax owed on the 2002 transfer.

On H's death, the executor of H's estate computes the DSUE amount to be $3,430,000 (the lesser of the $5,430,000 basic exclusion amount in 2015, or the excess of H's $5,430,000 applicable exclusion amount over the sum of the $1,000,000 taxable estate and $1,000,000 of adjusted taxable gifts sheltered from tax by H's applicable credit amount). H's adjusted taxable gifts of $2,000,000 were reduced for purposes of this computation by $1,000,000, the amount of taxable gifts on which gift taxes were paid.

Remarriage

The surviving spouse may immediately begin using the DSUE amount to shield taxable gifts from gift tax liability. The spouse's DSUE is consumed before his or her own unified credit is touched. The remarriage of the surviving spouse does not change this result. However, each individual only has one "last deceased spouse" from which the DSEU is computed.

This suggests that if a surviving spouse remarries, he or she should utilize any existing DSUE amount as soon as practical, to avoid having it lost at the death of the new spouse. A new DSUE would then become available. It is possible for these serial DSUE amounts to accumulate to more than double the basic estate tax exemption.

Example 1. Husband 1 (H1) dies in 2011, survived by Wife (W). Neither has made any taxable gifts during H1's lifetime. H1's executor elects portability of H1's DSUE amount. The DSUE amount of H1 as computed on the estate tax return filed on behalf of H1's estate is $5,000,000. In 2012 W makes taxable gifts to her children valued at $2,000,000. W reports the gifts on a timely filed gift tax return. W is considered to have applied $2,000,000 of H1's DSUE amount to the 2012 taxable gifts, and, therefore, W owes no gift tax. W is considered to have an applicable exclusion amount remaining in the amount of $8,120,000 ($3,000,000 of H1's remaining DSUE amount plus W's own $5,120,000 basic exclusion amount). In 2013 W marries Husband 2 (H2). H2 dies on June 30, 2015. H2's executor elects portability of H2's DSUE amount, which is properly computed on H2's estate tax return to be $2,000,000.

The DSUE amount to be included in determining the applicable exclusion amount available to W for gifts during the second half of 2015 is $4,000,000, determined by adding the $2,000,000 DSUE amount of H2 and the $2,000,000 DSUE amount of H1 that was applied by W to W's 2012 taxable gifts. Thus, W's applicable exclusion amount during the balance of 2015 is $9,430,000 ($4,000,000 DSUE plus $5,430,000 basic exclusion amount for 2015).[11]

Noncitizen spouses

The marital deduction is not permitted for bequests to noncitizen spouses, unless the bequest is made to a qualifying domestic trust (QDOT). When this happens, a DSUE is calculated for the deceased spouse, but it is subject to future adjustment as distributions are made from the QDOT.[12] In contrast to the ordinary marital trust, which is taxed in the estate of the surviving spouse, the estate tax on the QDOT will be computed as if it were transferred from the estate of the first spouse to die.

However, if the noncitizen spouse later becomes a citizen, the recomputation is no longer required.[13] The rules are illustrated by these examples:

Example 1. Husband (H), a U.S. citizen, makes his first taxable gift in 2002, valued at $1,000,000, and reports the gift on a timely filed gift tax return. No gift tax is due because the applicable exclusion amount for that year ($1,000,000) equals the fair market value of the gift. H dies in 2015 with a gross estate of $2,000,000. H's surviving spouse (W) is a resident, but not a citizen, of the United States and, under H's will, a pecuniary bequest of $1,500,000 passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT, and H's estate is allowed a marital deduction of $1,500,000 under section 2056(d) for the value of that property. H's taxable estate is $500,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $3,930,000 (the lesser of the $5,430,000 basic exclusion amount in 2015, or the excess of H's $5,430,000 applicable exclusion amount over the sum of the $500,000 taxable estate and the $1,000,000 adjusted taxable gifts). No taxable events within the meaning of section 2056A occur during W's lifetime with respect to the QDOT, and W makes no taxable gifts. At all times since H's death, W has been a U.S. resident. In 2017 W dies and the value of the assets of the QDOT is $1,800,000.

H's DSUE amount is redetermined to be $2,130,000 (the lesser of the $5,430,000 basic exclusion amount in 2015, or the excess of H's $5,430,000 applicable exclusion amount over $3,300,000 (the sum of the $500,000 taxable estate

augmented by the $1,800,000 of QDOT assets and the $1,000,000 adjusted taxable gifts)).

Example 2. The facts are the same as in Example 1 except that W becomes a U.S. citizen in 2016 and dies in 2018. The U.S. Trustee of the QDOT notifies the IRS that W has become a U.S. citizen by timely filing a final estate tax return (Form 706–QDT). Pursuant to section 2056A(b)(12), the estate tax under section 2056A no longer applies to the QDOT property.

Because H's DSUE amount no longer is subject to adjustment once W becomes a citizen of the United States, H's DSUE amount is $3,930,000, as it was preliminarily determined as of H's death. Upon W's death in 2018, the value of the QDOT property is includible in W's gross estate.

Example 3. Husband (H), a U.S. citizen, dies in 2011 having made no taxable gifts during his lifetime. H's gross estate is $3,000,000. H's wife (W) is not a citizen of the United States and, under H's will, a pecuniary bequest of $2,000,000 passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT, and H's estate is allowed a marital deduction of $2,000,000 under section 2056(d) for the value of that property. H's taxable estate is $1,000,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $4,000,000. No taxable events within the meaning of section 2056A occur during W's lifetime with respect to the QDOT, and W resides in the United States at all times after H's death. W makes a taxable gift of $1,000,000 to X in 2012 and a taxable gift of $1,000,000 to Y in January 2015, in each case from W's own assets rather than from the QDOT. W dies in September 2015, not having married again, when the value of the assets of the QDOT is $2,200,000.

H's DSUE amount is redetermined to be $1,800,000 (the lesser of the $5,000,000 basic exclusion amount for 2011, or the excess of H's $5,000,000 applicable exclusion amount over $3,200,000 (the sum of the $1,000,000 taxable estate augmented by the $2,200,000 of QDOT assets)). On W's gift tax return filed for 2012, W cannot apply any DSUE amount to the gift made to X. However, because W's gift to Y was made in the year that W died, W's executor will apply $1,000,000 of H's redetermined DSUE amount to the gift on W's gift tax return filed for 2015. The remaining $800,000 of H's redetermined DSUE amount is included in W's applicable exclusion amount to be used in computing W's estate tax liability.[14]

CREDIT SHELTER TRUSTS REMEMBERED

The advent of a portable federal estate tax exclusion has made a credit shelter trust unnecessary to fully exploit a married couple's estate tax exemptions. Does that suggest the end of credit shelter trusts? Probably not.

Existing estate plans built upon credit shelter trusts need not be discarded. With a trust, the amount that is excluded from the survivor's estate may be larger, perhaps much larger, than the DSUE amount. All asset appreciation during the surviving spouse's life avoids estate tax. There is no risk of losing the tax benefit through remarriage, as there is with portability. The trust may preserve an inheritance for other beneficiaries. If a corporate trustee is employed, the credit shelter trust also will have the benefit of professional investment management for its assets. Finally, the credit shelter trust may employ the generation-skipping transfer tax exemption, enlarging this financial resource for future beneficiaries.

Against these benefits, one must weigh the loss of the basis step-up for trust assets at the surviving spouse's death.

The surviving spouse may have substantial rights in the credit shelter trust without triggering inclusion of the trust in his or her estate. These include:

• the right to income;

• the right to withdraw the greater of $5,000 or 5% of the trust each year;

• the right to direct investment of trust assets;

• the right to withdraw pursuant to an ascertainable standard related to health, education, maintenance or support;

• the right to remove or replace trustees, within limits; and

• the power to appoint trust property to anyone

other than himself or herself, his or her creditors or estate, or the creditors of his or her estate.

One may take this planning to an even higher level with the Supercharged Credit Shelter Trust[sm], which adds income tax benefits to the equation.[15]

ADVANTAGES AND DISADVANTAGES OF PORTABILITY

For smaller estates, those below the normal estate tax filing threshold, the portable estate tax exclusion is an additional asset that the surviving spouse inherits. Larger estates that are passing entirely to a surviving spouse, and which are therefore shielded from the estate tax by the marital deduction, may take advantage of portability to double the survivor's exemption.

There are five major advantages with an estate plan that relies upon portability.

Easy to explain. An "all-to-spouse" approach is the plan that many married couples likely expect when they visit an estate planner. There is no longer any need to explain how an all-to-spouse will "wastes" an estate tax exemption.

Basis step-up at survivor's death. If the surviving spouse does not consume the assets, the eventual inheritors (perhaps the couple's children) will have the benefit of a basis step-up as they receive the assets, eliminating the imposition of taxes on capital gains.

Tax advantage not linked to specific assets. The DSUE amount is fixed at the death of the first decedent, and it can't go lower. In contrast, should the value of trust assets decline, the amount of estate tax avoided goes down as well. Also, the DSUE amount may shelter after-acquired assets from estate tax.

Example. At H's death in 2015, W inherits $3,000,000 outright from him. No estate tax is due, as the marital deduction provides full protection. An estate tax return is filed to claim the $5,430,000 DSUE amount for W. Through her career and shrewd investing, by 2025 W has a net worth of $10,000,000. She may use the DSUE to make lifetime transfers of $5,430,000 to her children (or anyone) without ever paying a federal gift tax, and without impairing her own federal estate tax exemption.

Avoiding state death taxes. Some states decoupled their death tax regimes from the federal standards after the state death tax credit was changed to a deduction. In most cases the amount exempt from taxation is lower than the federal threshold, perhaps as much as 80% lower. Estate planners in those states faced a delicate balancing process between state and federal death taxes. Sometimes it might have made sense to pay some state death tax when the first spouse died if that led to lower total death taxes over two deaths.

Using portability makes avoiding that first death tax easier. What's more, a majority of states have eliminated their death taxes altogether.[16] If the surviving spouse relocates to one of those states, the family fortune will be untouched by state death taxes.

No formulas. In order to minimize federal estate taxes, some estate plans used "reduce-to-zero" or "optimum" funding formulas. These provided the surviving spouse with only the amount of assets needed to make the marital deduction large enough so that no estate tax would be due at the first death. Such formulas create administrative complexity, uncertainty about their interpretation when major tax laws are changed, and the potential for capital gain to have to be recognized if appreciated assets were used to fund a marital or nonmarital share.

Against these advantages, one must weigh some large and small disadvantages.

Need to file an estate tax return. For those small estates that otherwise would not need to file an estate tax return, the filing requirement may increase the cost of estate administration. This situation has been mitigated to some extent by the IRS allowing estimates for marital deduction property in some circumstances, reducing the need to get valuations. The cost of filing the estate tax return will be small compared to the potential benefit. In 2015 the potential tax savings from a maximum DSUE amount comes to $2,180,000. That dwarfs the cost of a tax filing.

Potential for loss of DSUE amount upon remarriage. As noted earlier, if W survives H1, remarries and survives H2, she will lose any DSUE amount from H1 that has not been consumed by

making major lifetime gifts.

Loss of GSTT exemption. In contrast to the estate tax exemption, the generation-skipping transfer tax exemption is not portable. If the first spouse to die does not use the GSTT exemption, it is lost.

Improvidence. When assets are left outright to a surviving spouse, there is a chance that he or she may make unwise financial or investment decisions. This is simply the flip side of the advantage of using a trust with a professional trustee.

Creditor claims. Similarly, assets left outright are vulnerable to the claims of the creditors of the surviving spouse. Such creditors may include a subsequent spouse in the event of remarriage, depending upon the state of residence. The claim could be triggered by divorce, or by the subsequent spouse's inheritance claims. These problems may be remedied with a prenuptial agreement, but the hoped-for simplification in estate planning seems to be evaporating.

No indexing. If the surviving spouse lives for many years, the value of the DSUE may be eroded by inflation. Using up the DSUE amount through an early program of lifetime gifts to heirs will minimize this problem.

No guarantee of inheritance for younger beneficiaries. In second marriage situations, each spouse may wish to provide an inheritance for children of earlier marriages. Relying upon estate tax portability in the estate plan is trusting the surviving spouse to implement the plan. If the financial interests are adverse, this may not be wise.

Below is a summary of the key advantages and disadvantages of portability and the credit shelter trust.

Two strategies compared

	Portability	Credit shelter trust
Simple to explain	Yes	No
Basis step-up at second death	Yes	No
No estate tax on asset appreciation	No	Yes
Creditor protection	No	Yes
Protection of nonspousal heirs	No	Yes
Credit lost through remarriage	Possibly	No
Nontaxable estates must file an estate tax return	Yes	No
Utilize generation-skipping transfer tax exemption	No	Yes

Source: M.A. Co.

Conclusion

Estate planning for married couples remains challenging. As a general rule, the traditional approaches using trusts are likely to be the better choice for affluent couples.[17] However, the simplicity of the estate plan that relies upon the portability of the federal estate tax exclusion will be appealing to many. What's more, simplicity coupled with lower costs for drafting the estate plan may encourage more couples to stop procrastinating about seeing their estate planning advisors.

ENDNOTES

1 IRB 2015-26; TD 9725
2 IRC §2010(c)(5)(A)
3 *Private Letter Ruling 201536005*
4 Reg. §20.2010-2(a)(7)(ii)(A)
5 Reg. §20.2010-2(a)(7)(ii)(C)
6 Rev. Proc. 2014-18, 2014-7 IRB 513
7 Reg. §20.2010-2(a)
8 Reg. §20.2010-2(a)(6)(ii)
9 Reg. §20.2010-2(a)(4)
10 Reg. §20.2010-2(c)(5)
11 Reg. §25.2505-2(c)(2)(ii)
12 Reg. §20.2010-2(c)(4)(i)
13 Reg. §20.2010-2(c)(4)(ii)
14 Reg. §25.2505-2(d)(3)(iii)
15 See Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust[sm]," 21 *Probate & Property 52* (July/August 2007).
16 http://www.forbes.com/sites/ashleaebeling/2014/09/11/where-not-to-die-in-2015/
17 See generally Diana S. C. Zeydel, "Portability or No: Death of the Credit Shelter Trust?," 49 *Heckerling Institute on Estate Planning*, Chapter 3 (2015).

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