

# Portability: the New Malpractice

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## 1. Introduction

- a. Historically, a married couple needed to use a non-marital, or credit shelter, trust to take advantage of the applicable exclusion at the death of the first-to-die spouse as any unused estate tax exemption was lost. This type of planning often involves the retitling of marital assets to ensure that each spouse has separate assets to "use up" their entire exclusion.
- b. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act of 2010") introduced an alternative to the traditional credit shelter planning -- the ability of the first-to-die spouse to transfer his or her unused exclusion amount to the surviving spouse. The exclusion became portable; thus "portability" was created. Now, a surviving spouse is able to use the unused estate tax exemption of a predeceased spouse so the husband and wife "unit" can take advantage of the full estate tax exclusion amount of each individual.
- c. Earlier this year, Congress enacted the American Taxpayer Relief Act of 2012 which, among other things, made the portability laws permanent.

## 2. The Basics of Portability

- a. Portability is available to any decedent, regardless of the size of the estate or the decedent's reason for leaving an unused exclusion amount.
- b. The Tax Relief Act of 2010 introduced the concept of "deceased spousal unused exclusion amount" ("DSUE"). DSUE is an estate tax credit equal to the amount of the applicable estate tax exemption that is unused by the first-to-die spouse.
  - i. The DSUE is available to the surviving spouse in addition to the surviving spouse's own basic exclusion amount.
  - ii. The applicable exclusion amount for the surviving spouse is the sum of the surviving spouse's basic exclusion amount and the DSUE.
  - iii. The DSUE can be used by the surviving spouse for both gift and estate tax purposes. Portability, however, does not apply to the generation-skipping transfer tax ("GST") exemption.
- c. Note the new definitions used above:
  - i. Basic Exclusion Amount ("BEA")
    - (1) previously called the applicable exclusion
    - (2) \$5 Million in 2011 thence adjusted for inflation
  - ii. Applicable Exclusion Amount
    - (1) BEA plus the DSUE
    - (2) The BEA will adjust for inflation, the DSUE will remain constant

- d. Calculating DSUE:
  - i. Section 2010(c)(4) of the IRC defines DSUE as the *lesser* of:
    - (1) The basic exclusion amount, or
    - (2) The excess of
      - (a) the basic exclusion amount of the last deceased spouse of such surviving spouse, over
      - (b) (the amount with respect to which the tentative tax is determined under 26 USC § 2001(b)(1) on the estate of such deceased spouse.
  - ii. The DSUE is calculated based on the basic exclusion amount, as adjusted for inflation, applicable to the year in which the decedent dies.
    - (1) However, the DSUE is not adjusted for inflation when the surviving spouse uses the DSUE in later years.
- e. A surviving spouse is permitted to use only the DSUE of his or her last deceased spouse. This limitation applies regardless of whether the last deceased spouse has any unused exclusion or whether the last deceased spouse's executor makes or fails to make a timely portability election.

### 3. Exclusion Amounts & How They Work

- a. Ordering Rule
  - i. If a surviving spouse has a DSUE amount at the time that the surviving spouse makes a taxable gift, the surviving spouse will be deemed to apply such DSUE amount to the taxable gift before application of any portion of the surviving spouse's own basic exclusion amount.
- b. Successive Marriages
  - i. DSUE is defined in section 2010(c)(4) by reference to the "last" deceased spouse. Temporary regulations confirm that the "last" deceased spouse means the "most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."
  - ii. This applies without regard to whether
    - (1) the estate of the last deceased spouse filed an election to port the decedent's DSUE amount to the surviving spouse, or
    - (2) the last deceased spouse actually had any unused exclusion amount
  - iii. The act of remarriage alone by a surviving spouse who inherited a DSUE amount from a decedent spouse does not affect the surviving spouse's applicable exclusion amount

- iv. The “last” deceased spouse restriction does not prevent a surviving spouse who remarries from using the DSUE amount of his or her first deceased spouse for estate tax purposes if the surviving spouse predeceases the second spouse.
- v. A surviving spouse who uses the DSUE amount of his/her first deceased spouse for lifetime gifts (as a component of his/her own gift tax applicable credit amount) may become eligible for additional DSUE amounts if he/she remarries and survives that subsequent spouse.
  - (1) A surviving spouse can use DSUE amounts from multiple deceased spouses.
    - (a) Specifically, a surviving spouse can apply DSUE amounts from multiple spouses, as long as the surviving spouse makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual is widowed again by a subsequent spouse.

#### 4. **The Portability Election Procedure**

- a. The DSUE is not automatically transferred to the surviving spouse at a decedent's death. The executor of the estate of the first-to-die spouse must file a Form 706 for the deceased spouse's estate and elect to make that spouse's unused exclusion portable. 26 USC § 2010(c)(5).
- b. The executor or administrator of the estate of the first-to-die spouse must file a timely, complete and properly prepared Form 706 and elect portability, even if a return is not otherwise required.
- c. The 706
  - i. The 2012 Form 706, which includes a section for computing the DSUE amount so this form should be used for 2012 deaths
    - (1) In order to make the portability election, the IRS requires the DSUE amount to be calculated on the Form 706. Temp. Reg. § 20.2010-2T(b)(1).
    - (2) See attachment.
- d. Simplified 706
  - i. Temp. Reg. § 20.2010-2T(a)(7)(ii)(A) provides an important exception to the rule for estates not otherwise required to file an estate tax return. The returns filed for these estates are not required to report the exact values of most assets that are transferred under the marital or charitable deduction.
    - (1) If an executor chooses to make use of this rule, the executor must only estimate the total value of the gross estate (including the value of the property that qualifies for the marital or

- charitable deduction), based on a determination made in good faith and with due diligence.
- (a) Appraisals will not be required.
  - (2) The instructions provide ranges of dollar values, and the executor is required to identify the particular range within which the executor best estimates the total gross estate will fall.
  - (3) The exception to providing values for property qualifying for the marital or charitable deduction does not apply if:
    - (a) The value of the property relates to, affects, or is needed to determine the value of property passing from the decedent to another recipient, as would occur under a formula nonmarital gift;
    - (b) The value of such property is needed to determine the estate's eligibility for the provisions of Code Sections 2032, 2032A, 2652(a)(3), 6166 or another provision of the Code;
    - (c) Less than the entire value of an interest in property includable in the gross estate is marital or charitable deduction property (for example, if an interest in property is transferred in part to the surviving spouse and in part to a child or non-marital trust);
    - (d) A partial disclaimer or partial QTIP election is made with respect to the property; or
    - (e) The executor fails to exercise due diligence to estimate the FMV of the gross estate including the marital and charitable deduction property.
  - e. To irrevocably elect not to allow a surviving spouse to use DSUE amount, there are four options:
    - i. Not filing a 706 if it is not otherwise required
    - ii. Attaching a statement to the 706 indicating that the estate is not making the election
    - iii. Entering "No Election Under Section 2010(c)(5)" across the top of page 1 of the 706
    - iv. Checking the box on Part 6, Schedule A of the 2012 Form 706
  - f. Currently less than 1 percent of deceased estates are subject to estate tax, as less than 1 percent of the population dies with \$5 million of assets in their possession.
    - i. The portability requirements will significantly increase 706 filings.

## 5. Malpractice Issues

- a. Failure to Make Election
  - i. Unlike most tax elections, there appears to be very little downside to a fiduciary's preservation of the DSUE. However, if a fiduciary fails to make an election to preserve the DSUE, that fiduciary has created the potential for significant fiduciary liability with the risk extending many years beyond the death of the first-to-die spouse.
- b. Statute of Limitations
  - i. Notwithstanding the expiration of a statute of limitations set forth in section 6501 on an estate or gift tax assessment for a deceased spouse, the IRS may continue to examine the decedent spouse's estate tax return for the purpose of determining the DSUE amount available to the surviving spouse
    - (1) The IRS may adjust or eliminate the DSUE amount based on such examination, but it may not assess additional estate tax against a prior deceased spouse's return unless the applicable period of limitations on assessment of estate tax is still open for that estate.
  - ii. Practitioner's note: who will defend the prior returns?
- c. Valuation on the 706
  - i. If the decedent spouse's 706 can be examined until the death of the survivor, you must be able to continue to "prove" values.
    - (1) You will need plenty of evidence as far as valuations for anything that could be difficult to value.
    - (2) Practitioner's note: are your valuations easy to comprehend?
- d. Past Documentation
  - i. If the decedent spouse's 706 can be examined until the death of the survivor, the evidence needs to continue to be available.
    - (1) Are you keeping a paper copy? Suggestions have been made by some that a paper copy of the return and all documentation may be necessary due to the changes in digital files.
      - (a) Is there a chance that these digital files may not be able to be opened in 50 years?
    - (2) Is it reasonable to expect clients to keep this documentation?
- e. Addressing Cost Burden
  - i. While it is generally a good idea to preserve the DSUE for the surviving spouse, the cost of preparing and filing a Form 706 may leave some executors with a difficult decision to make, particularly where the beneficiaries of the estate of the first-to-die spouse are different than the beneficiaries of the surviving spouse.
  - ii. In drafting will or trust language regarding portability, attorneys should

be conscious of the party or parties who will assume the costs associated with the portability election.

(1) There are many ways to draft portability provisions and those provisions can either require or permit executors to make the election, with or without a surviving spouse's consent or request. Each provision can be tailored to the needs of each individual client, taking into consideration the intended beneficiaries and likelihood of the value of the estate meeting the estate tax threshold and requiring an estate tax return be filed.

(a) Options include the following:

- (i) Executor shall (may) elect portability at estate's expense;
- (ii) Executor shall (may) elect portability at spouse's expense;
- (iii) Executor shall (may) elect portability at estate's expense at spouse's request;
- (iv) Executor shall (may) elect portability at spouse's expense at spouse's request; or
- (v) Executor may elect portability at estate's expense, but shall elect portability if spouse pays.

(b) Drafters should give consideration to including language limiting liability of the executor, especially in situations where the election is discretionary.

f. See Attachment – Heinisch & Lovegrove Waiver Form

## 6. **Impact on Future Estate Planning**

a. Lifetime gifting & the DSUE

i. Lifetime gifting should be done as soon as practicable after the DSUE determination

(1) Doing so ensures that the DSUE amount derived from a first deceased spouse will not be lost if the surviving spouse is widowed again.

ii. Those preparing gift tax returns should keep in mind the ordering rules with DSUE.

(1) Advisable to attach a schedule to any gift tax return listing the source of all prior DSUE amounts and provide records that are available.

- b. Portability v. Credit Shelter
  - i. What should be considered in determining the type of estate plan to use for clients?
    - (1) cost
    - (2) benefit
    - (3) size of the estate
    - (4) size of anticipated unused exemptions
    - (5) age(s) of the client(s)
    - (6) necessity of asset protection
    - (7) marital status (including number of marriages and length)
    - (8) growth and growth potential for assets
    - (9) desire for generational planning
    - (10) state estate tax concerns
  - ii. Factors Favoring Credit Shelter Planning
    - (1) DSUE amount is not indexed for inflation
    - (2) The credit shelter trust remains exempt from estate tax regardless of how much the assets in the credit shelter trust may appreciate in value or how much income is generated by those assets
      - (a) Relying on the DSUE amount does not guard against estate tax on the appreciation of the assets received by the surviving spouse.
    - (3) An outright transfer of assets to the surviving spouse utilizing portability does not provide the myriad of non-tax benefits associated with trusts, such as
      - (a) asset protection from the claims of creditors,
      - (b) spendthrift protection
      - (c) a new spouse of the surviving spouse and protection against the diversion of assets from the first spouse's family to a new family created on remarriage of the surviving spouse, and
      - (d) investment management
    - (4) GST exemption is not portable.
  - iii. Factors Favoring Portability Planning & Reliance
    - (1) The main advantage of portability is simplicity. It allows a married couple to create a simple estate plan or avoid estate planning altogether by leaving all property to the surviving spouse while still preserving the deceased spouse's applicable exclusion amount.
    - (2) Portability provides a back-up to a planned use of the applicable exclusion amount (situations where a couple fails to

- fully implement asset retitling), or the size or nature of the assets mitigates against the full use of the applicable exclusion amount at the first death. The portability election can save applicable exclusion that would otherwise be lost.
- (3) Joint estates that will likely decline in value
  - (4) Step up in basis in the assets after the surviving spouse's death
  - (5) Portability is also an effective planning technique for assets that are likely to depreciate in value or assets, like retirement accounts, that are not well suited for trust ownership.
    - (a) Tax-deferral for qualified plans (allows for the slowest possible payout on many retirement plans by naming the spouse as beneficiary instead of a trust)
  - (6) Surviving spouse is able to make lifetime gifts using both exemption amounts