ESTATE PLANNING TECHNIQUES

Portability: Its Limitations and Complexities

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) (the Act) includes new rules, denoted as "portability," that allow a surviving spouse to use for gift tax and/or estate tax (but not generation-skipping transfer (GST) tax) purposes the portion of the estate tax exemption that his or her deceased spouse did not use. Although the basic concept appears to be simple, its application has important limitations and can be extremely complex and misleading in certain instances.

The Basic Concepts

The basic rules regarding portability are fairly straightforward. First, it is important to note that the portability rules only apply if the deceased spouse dies after 2010, and that the Act's sunset provisions will eliminate these rules after 2012, absent further legislation. Thus, the portability rules will apply only for two years (2011 and 2012), unless Congress extends them.

Second, a person cannot accumulate and use the unused exemption amounts from more than one previously deceased spouse. A person can only use the unused portion of the exemption of the person's "last deceased spouse" for estate tax purposes (Code Sec. 2010(c)(4)). However, as discussed below, it may be possible in certain circumstances for a person to use for gift tax purposes the unused portion of the exemption of more than one spouse.

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Third, a person's ability to use the unused portion of the exemption of the person's deceased spouse is not automatic. The executor of the estate of the deceased spouse must elect to permit the surviving spouse to do so on a timely filed federal estate tax return for the estate of the deceased spouse (Code Sec. 2010(c)(5)(A)). Absent such an election, the surviving spouse will not have the ability to use the unused portion of the deceased spouse's exemption.

Importantly, this requirement means that the executor of the estate of the first spouse to die must file such a return and make such election, even if the gross estate of the deceased spouse is less than the minimum filing requirement, in order to enable the surviving spouse to use the unused portion of the deceased spouse's exemption.

Fourth, the Internal Revenue Service (IRS) can examine the federal estate tax return that is filed for the estate of the first spouse to die for the purpose of determining the amount of the unused exemption of the deceased spouse, even if the statute of limitations for assessing estate taxes against the estate of the deceased spouse has expired (Code Sec. 2010(c)(5)(B)).

Fifth, although a person's $5,000,000 exemption for gift tax and estate tax purposes is indexed for inflation from a base year of 2010, with adjustments starting in 2012, the unused portion of the deceased spouse's exemption is not indexed for inflation for the period after the death of the deceased spouse for purposes of portability.

Finally, although the portability rules apply for both gift tax and estate tax purposes, those rules do not apply with respect to the GST tax exemption.

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The Statutory Framework

The enactment of the portability rules was accomplished by amending Section 2010(c) of the Internal Revenue Code to provide that the "applicable exclusion amount" (i.e., the estate tax exemption) is the sum of the "basic exclusion amount" (which is $5,000,000, indexed for inflation, as described above), plus the "deceased spousal unused exclusion amount." The "deceased spousal unused exclusion amount" is the lesser of (a) the basic exclusion amount (i.e., $5,000,000, as adjusted for inflation), or (b) the excess of (i) the basic exclusion amount of the surviving spouse's last deceased spouse, over (ii) the combined amount of the taxable estate plus the adjusted taxable gifts of the deceased spouse (Code Sec. 2010(c)(4)).

How the Statute Works

As stated above, the "deceased spousal unused exclusion amount" is the lesser of (a) the deceased spouse's basic exclusion amount, or (b) the excess of (i) such person's basic exclusion amount, over (ii) the combined amount of the taxable estate plus the adjusted taxable gifts of the deceased spouse.

Assume, for example, that a husband (H) died in March 2011 and used only $3,000,000 of his $5,000,000 basic exclusion amount, and that H's surviving spouse, W, dies in December 2011. W's applicable exclusion amount is the sum of her own basic exclusion amount of $5,000,000, plus the $2,000,000 of H's unused applicable exclusion amount, for a total of $7,000,000.

Similarly, assume, for example, that a husband (H-1) and a wife (W) are married; that H-1 died in March 2011 and used only $3,000,000 of his $5,000,000 basic exclusion amount; that W later marries H-2; that W then makes a taxable gift of $5,000,000 (as to which no gift tax is payable due to W's basic exclusion amount); that W dies in September 2011 with no taxable estate; and that H-2 dies in December 2011. The statute provides that H-2's applicable exclusion amount is the sum of his basic exclusion amount, or $5,000,000, plus the lesser of (a) W's basic exclusion amount, which is $5,000,000, or (b) the excess of W's basic exclusion amount of $5,000,000 over the combined amount of the taxable estate plus the adjusted taxable gifts of W, which is also $5,000,000 due to the $5,000,000 gift that W made. Thus, the lesser of these two amounts is zero, and the lesser of W's basic exclusion amount of $5,000,000 and zero is zero. Therefore, the amount of W's spousal unused exclusion that is available to H-2 is zero.

However, on March 23, 2011 the Congressional Joint Committee on Taxation issued an errata to the General Explanation of the Act [JCX-20-11], stating that the intent of the Act was such that, in the foregoing example, the unused exclusion amount of W that would be available after her death to H-2 would be the lesser of (a) W's basic exclusion amount, which is $5,000,000, or (b) the excess of W's applicable exclusion amount, which is $7,000,000, over the amount thereof that W used, which is $5,000,000, resulting in an excess of $2,000,000, rather than zero. Thus, the errata indicates that the Congressional intent was such that in the foregoing example the total exclusion amount available to H-2 at his death would be $7,000,000 (H-2's own basic exclusion amount of $5,000,000 plus the unused portion of W's applicable exclusion amount, which is $2,000,000), rather than only $5,000,000. The errata further states that a technical correction may be necessary to replace the statutory reference to the "basic exclusion amount of the last such deceased spouse of such surviving spouse" with a statutory reference to the "applicable exclusion amount of the last such deceased spouse of such surviving spouse" to reflect this intent.

Also, as noted above, the surviving spouse can only use the unused exclusion amount of such person's last deceased spouse.

For example, assume that H-1 died in March 2011 and used only $3,000,000 of his $5,000,000 basic exclusion amount; that H-1's surviving spouse, W, marries H-2 in September 2011; that H-2 dies in October 2011 and uses only $4,000,000 of his $5,000,000 basic exclusion amount; and that W dies in November 2011. W's applicable exclusion amount will be the sum of her own basic exclusion amount of $5,000,000, plus the unused portion of H-2's applicable exclusion amount, or $1,000,000, for a total of $6,000,000. Thus, W's remarriage to H-2 has in effect caused her to lose the benefit of $1,000,000 of H-1's $2,000,000 unused applicable exclusion amount.

In addition, as previously mentioned, it appears that for gift tax purposes a person may be

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able to use the unused portion of the basic exclusion amount of more than one spouse, even though such person could not do so for estate tax purposes.

Assume, for example, that H-1 died in February 2011 and used only $4,000,000 of his $5,000,000 applicable exclusion amount; that H-1's surviving spouse, W, makes a gift of $6,000,000 in May 2011; that W later marries H-2 and that H-2 dies in November 2011 using only $3,000,000 of his $5,000,000 applicable exclusion amount; and that W makes a gift of $3,000,000 in December 2011. When W makes the gift of $6,000,000 in May 2011, she will not pay any gift tax, as her applicable exclusion amount is the sum of her basic exclusion amount of $5,000,000, plus H-1's unused exclusion amount of $1,000,000, for a total of $6,000,000. When W makes the gift of $3,000,000 in December 2011, her applicable exclusion amount will be the sum of her own exclusion amount of $5,000,000, plus H-2's unused exclusion amount of $2,000,000, for a total of $7,000,000, less the sum of $6,000,000 due to the prior gift that W made, for an applicable exclusion amount of $1,000,000, which W can use with respect to the $3,000,000 gift in December 2011. Thus, W appears to be able to use both the $1,000,000 of H-1's unused exclusion amount and $1,000,000 of the $2,000,000 of H-2's unused exclusion amount.

However, it is possible for a surviving spouse to make a series of gifts that will cause such person to use more than his or her basic exclusion amount and the unused exclusion amount of such person's deceased spouse, resulting in a "negative credit" amount for the surviving spouse.

To illustrate, assume that H-1 died in March 2011 and used $2,000,000 of his $5,000,000 basic exclusion amount; that W makes an $8,000,000 gift in September 2011 (all of which will be sheltered from gift taxes by W's $5,000,000 basic exclusion amount, plus H-1's $3,000,000 unused exclusion amount); that W marries H-2 in October 2011; that H-2 dies in November 2011 using $3,000,000 of his basic exclusion amount; and that W makes a gift of $1,000,000 in December 2011. W's applicable exclusion amount is the sum of her $5,000,000 basic exclusion amount, plus H-2's $2,000,000 unused exclusion amount, for a total of $7,000,000, but then reduced by the credit equivalent that W used for her prior gift of $8,000,000, resulting in a net applicable exclusion amount of minus $1,000,000. Presumably, such negative amount of $1,000,000 may then be subject to gift taxes.

Another possibility that exists is that the portability rules may result in a person's tax-free gifts in part being subject to estate taxes at the person's death.

For example, assume that H-1 dies in March 2011 and uses $2,000,000 of his $5,000,000 basic exclusion amount; that W then makes an $8,000,000 gift; that W then marries H-2, who dies later in 2011 using $3,000,000 of his $5,000,000 basic exclusion amount; and that W dies in December 2011. W's applicable exclusion amount will be her own $5,000,000 basic exclusion amount, plus H-2's unused exclusion amount of $2,000,000, for a total of $7,000,000. The difference between W's gifts of $8,000,000 and her applicable exclusion amount of $7,000,000, or $1,000,000, may be subject to estate taxes at W's death. However, commentators have not been uniformly in agreement as to the estate tax treatment of such amount in this example, and the IRS hopefully will address and clarify this issue by regulations or other formal guidance.

Planning Opportunities

As explained above, a person's applicable exclusion amount is the sum of such person's basic exclusion amount, plus the unused exclusion amount of such person's last deceased spouse. Thus, the possibility exists that a surviving spouse could remarry, and that the person whom the surviving spouse marries could obtain a transfer tax benefit from the unused exclusion amount of the previously deceased spouse of the surviving spouse.

Assume, for example, that H-1 died in March 2011 and used only $3,000,000 of his basic exclusion amount; that W then marries H-2; that H-2 then makes a gift of $5,000,000 to his children, thereby using his entire basic exclusion amount; that H-2 then makes a gift to W of $2,000,000 (which would qualify for the gift tax marital deduction and, therefore, would not be subject to gift taxes); and that W dies in December 2011, predeceasing H-2, and W bequeaths $5,000,000 to her children and $2,000,000 to the children of

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H-2. W's applicable exclusion amount is the sum of her own basic exclusion amount of $5,000,000, plus the unused portion of H-1's basic exclusion amount, or $2,000,000, for a total of $7,000,000. Thus, W's entire gross estate of $7,000,000 will pass free of estate taxes. This result occurs due to the fact that, even though W has married H-2 after the death of H-1, W predeceased H-2, and H-1 therefore is W's last deceased spouse at the death of W.

It is important to note that one might expect the IRS to contend that there was a prearranged plan between W and H-2, when H-2 made the gift of $2,000,000 to W, that W would bequeath such amount to the children of H-2 and, therefore, that the "step transaction" doctrine should apply to treat H-2's transfer of $2,000,000 to W as a transfer by H-2 to his children. If the IRS were to succeed in that contention, then H-2 would be required to pay a gift tax on such transfer of $2,000,000 to his children. This risk would be reduced, although probably not entirely eliminated, as the amount of time that passes between the date of H-2's gift to W and the date of W's death increases. It would become increasingly difficult for the IRS to successfully argue that the "step transaction" doctrine should apply as the amount of time that elapses between those two events increases.

It also is important to note that W, in the foregoing example, may decide not to comply with H-2's desire that W bequeath to H-2's children the amount that H-2 gave to W, and that W instead could decide to bequeath such amount to her own children. In such event, H-2's children would suffer a substantial disadvantage from such planning.

For these reasons, one should proceed with such planning with extreme caution.

Therefore, many sound reasons exist for the continued use of bypass trusts, even where the combined wealth of a married couple is less than $10,000,000.

The Future of Bypass Trusts

Traditionally, estate planning documents for spouses having combined assets of more than the applicable exclusion amount of one person would commonly contain provisions under which the estate of the first spouse to die would create a so-called "bypass" trust for the benefit of the surviving spouse, in order to effectively utilize the applicable exclusion amount of both spouses, rather than provisions under which the first spouse to die would leave his or her entire estate to the surviving spouse, outright and free of trust. Some proponents of portability have contended that where the combined assets of a married couple are less than $10,000,000, the necessity of the first spouse to die to create a bypass trust for the benefit of the surviving spouse is eliminated, thereby simplifying the estate planning documents for such persons. However, significant reasons continue to exist for the use of bypass trusts, even in cases where the value of the combined assets of a married couple is less than $10,000,000.

First, as noted above, the portability provisions of the Act will expire after 2012, absent further legislation. Thus, there is no assurance that portability will continue beyond 2012.

Second, the first spouse to die, by creating a bypass trust for the surviving spouse, can ensure that the balance in such trust remaining at the death of the surviving spouse will pass to the person or persons whom the first spouse to die wants to inherit such remaining balance, rather than giving the surviving spouse the opportunity to bequeath such assets to other persons.

Third, a bypass trust affords a degree of creditor protection for the assets in the bypass trust that the surviving spouse would not have with respect to such assets if they were bequeathed to the surviving spouse, outright and free to trust.

Fourth, the appreciation in value of the assets bequeathed to a bypass trust will not be subject to estate tax in the estate of the second spouse to die, whereas the appreciation in value of assets be-

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queathed to a surviving spouse, outright and free of trust, will be subject to estate tax on the death of the surviving spouse. Note, however, that the assets in a bypass trust will not receive a so called "stepped-up" basis at the death of the surviving spouse, whereas the assets that the surviving spouse owns at his or her death will receive a stepped-up basis at that time.

The new portability rules in the Act are subject to significant limitations and entail substantial complexities and uncertainties. A thorough understanding of these rules is important in order to effectively apply them.

Therefore, many sound reasons exist for the continued use of bypass trusts, even where the combined wealth of a married couple is less than $10,000,000.

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Prenuptial Agreements

When negotiating and drafting a prenuptial agreement, consideration should be given to the desirability of including a section in such agreement regarding portability.

Assume, for example, that one party to the intended marriage owns assets that have a value substantially in excess of the applicable exclusion amount and that the other party owns assets having a value significantly less than such amount. In such case, the wealthier party may want a provision in the agreement that requires the executor of the estate of the less wealthy party, if the wealthier party survives the less wealthy party, to timely file a federal estate tax return for the estate of the less wealthy party and to elect on that return to permit the wealthier party, as the surviving spouse, to use the unused portion of the exclusion amount of the less wealthy party. Such a provision could provide a substantial tax benefit to the wealthier party, if he or she survives the less wealthy party.

As noted earlier, the executor of the estate of the less wealthy party will be required to prepare and file a federal estate tax return for such estate, even though the amount of the gross estate of the less wealthy party is less than the minimum filing requirement for such tax return, in order to make the required election.

Conclusion

As can be seen from the foregoing, the new portability rules in the Act are subject to significant limitations and entail substantial complexities and uncertainties. A thorough understanding of these rules is important in order to effectively apply them.

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