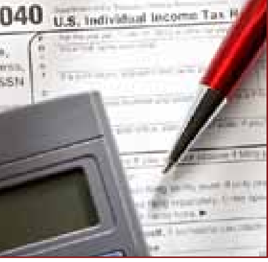


By **Stephanie G. Rapkin**

Portability: The New Estate Plan Modality

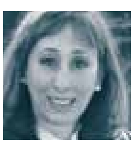
Help clients understand how to best use the deceased spouse's unused exemption amount

An idea long bandied about in tax circles[1] was that of a spousal carryover of the applicable exemption of a deceased spouse (deceased spouse's unused exemption amount (DSUEA)). Congress finally implemented this idea, albeit temporarily, in 2011 and 2012.[2] Philosophically and mathematically, portability brings to fruition the concept that a married couple is one unit for estate tax purposes, a laudable goal and, perhaps, a concept that's long overdue.

Professionals engaged in the various aspects of estate planning were reluctant to study and implement planning using portability under Internal Revenue Code Section 2010(c)(2), due to its temporary nature. However, portability is now apparently here to stay. The American Taxpayer Relief Act of 2012 made DSUEA a permanent fixture and, consequently, the new modality for estate tax planning.

The IRC defines DSUEA as:

> the lesser of—
> (A) the basic exclusion amount, or
> (B) the excess of—
>> (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over
>> (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.



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The basic exclusion is the amount of the exclusion in a given tax year. The applicable exclusion is the basic exclusion amount and, in the case of a surviving spouse, DSUEA. IRC Section 2001(b)(1) is the tentative tax calculation that takes into account gifts previously made. How it works and when it works is rather straightforward. However, there were a few confusing issues the IRC didn't address; thus, temporary regulations were released on June 18, 2012.[3] The temporary regulations also serve as the basis for the proposed regulations. The temporary regulations pertain to the use of DSUEA for both gifts[4] and estates.[5] They took effect on the release date and expire on June 15, 2015.

Educate Clients

Practitioners will now need to educate clients on how DSUEA impacts an estate plan. With a current applicable exemption of $5.25 million, even clients with sizable estates may believe that their estates will automatically be exempt from estate taxes. However, clients often aren't aware that to receive that full exemption amount for both parties, there must be an election. Clients may also assume that such an election isn't necessary predicated on the current size of their estate. The typical client's perception of the importance of estate planning is based on the estate taxes that would be owed if he died in the near future. However, for many clients, it's important to project what would occur five or 10 years from now, given reasonable rates of appreciation in the client's assets.

Example: Assume a current estate of $5 million. The husband dies in 2011. His wife, age 63, has a life expectancy of just over 23 years. Assume the assets grow at 5 percent per year. The exclusion, adjusted for inflation, increases by 2 percent per year. In 23 years, the size of the estate will have grown to $15,357,619, and the federal estate tax will be $959,048.

Applicable Exemption

Every individual has an applicable exemption (also referred to as the "basic exemption"), which is the amount that's exempt from estate, gift and generation-skipping transfer (GST) taxes. Once that amount has been reached, the remainder of his wealth, when transferred to someone other than a spouse who's a U.S. citizen, is subject to a transfer tax. Beginning in 2011, for the first time in its history, the applicable exemption has an automatic inflation adjustment component. It's set to be adjusted for inflation in increments of $10,000.[6] In 2013, the amount of the individual applicable exemption for estate, gift and GST tax has risen to $5.25 million.[7]

Ideally, an individual's applicable exemption, if not used for lifetime transfers, would be used for the individual's estate tax and in accordance with the decedent's estate-planning documents. Providing for the use of the applicable exemption in the estate-planning documents eliminates discretion and potential dissension, protects against failures and expresses the individual's goals and objectives. The applicable exemption may be used for a bypass trust created by the decedent's estate-planning documents, just as it's always been used.

With that background, it's time to explore just what the changes are to using an individual's exemption and how DSUEA works.

Porting the Exemption

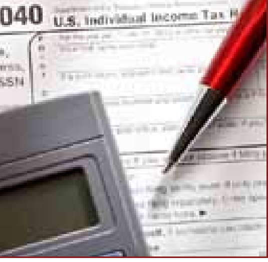
Often, spouses were unable to fully use each of their exemptions and, if they made an effort to do so, it took creative planning and artificial logistics. Under IRC Section 2010(c)(4), if a decedent fails to use his applicable exemption during life or at death, any or all of the unused applicable exemption of a last deceased spouse may now be carried over and used by the surviving spouse if an election is made to do so. This provides tremendous flexibility. The combination of both parties' exemptions may simply be applied at the second spouse's death to cover the tentative tax. For example, if the estate consists of assets that can't be divided, assets that are illiquid or a large amount of retirement assets, portability enables use of both spouses' exemptions and provides alternatives to the machinations that clients had to use previously to avoid an estate or gift tax.

A key determination for calculating DSUEA that's eligible to be carried over is to ascertain who's the "last deceased spouse." The last deceased spouse is the spouse to whom the survivor was married at the time of the gift or estate transfer. If a surviving spouse remarries and that subsequent marriage ends in a divorce or an annulment, the subsequent death of the divorced spouse doesn't end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. In other words, the divorced spouse, not being married to the surviving spouse at death, isn't the last deceased spouse, as that term is defined.[8] However, a remarriage may impact DSUEA in other ways.

An individual's applicable exemption may also be used in a split manner.

An individual's applicable exemption may also be used in a split manner so that part is used immediately on estate taxes and part is ported over. There's no IRC restriction on the dollar amount or type of assets that would impinge on this decision. It's simply a matter for discretionary determination by the executor/spouse. For example, you would want to port over only a portion of the exemption when a large percentage of an estate is tied up in an individual retirement account.

Example: Harry has a $5 million estate, with $3 million consisting of IRA accounts. Harry designates his wife, Wendy, as beneficiary of the IRA accounts. At Harry's death, $2 million of his estate passes to a bypass trust, and the remaining $3 million of IRA accounts passes to Wendy. Harry's exemption is applied immediately to the $2 million bypass trust. Harry's executor elects to use the portability for the remaining $3 million exemption. Wendy dies with a separate estate of $5 million and the $2.5 million remaining in the IRAs (a decrease due to withdrawals for the required



minimum distributions) she inherited. She has an applicable exclusion of $8 million, consisting of her $5 million and $3 million of DSUEA from Harry to apply to her estate.

Fiscal limitations. There are two important fiscal limitations that will have a significant impact on the planning and use of DSUEA. First, DSUEA won't receive an inflation adjustment. Rather, the maximum amount of a deceased spouse's exemption that may be ported is the dollar amount set by the IRC in the given year of death.[9] Second, DSUEA that's carried over may not be used for or applied to GST tax.[10] Thus, in a large estate, it's important for the client to use his own applicable exemption, either during life or in his estate-planning documents, so the exemption can be used on the individual's death for purposes of the GST tax.

The special rule for small estates doesn't apply if any property, or portion thereof, is passing to someone other than a spouse and/or charity.

Lifetime gifts. For purposes of computing the amount of DSUEA that's available and portable to a spouse, examine whether the deceased spouse made any lifetime gifts. Gifts made during life will reduce the amount of the exemption available and, concomitantly, the amount of DSUEA available for transfer to a spouse. However, if taxes were paid on the gift, the exemption amount and the corresponding amount that's portable won't be reduced. The exemption amount is reduced only by the amount of the prior exemption actually used.[11]

Example: Harry made a gift in 2003 of $3.5 million when the exemption was only $1 million. Using his $1 million exemption, he paid gift taxes on a $2.5 million taxable gift. He still has a $4.25 million exemption (or more, with the future inflation adjustment) available for future gifting, for use on his estate for estate tax or as a portable exemption to be transferred to the surviving spouse.

Election on tax return. The executor or personal representative must make the election to carry over an unused or underutilized exemption on a timely filed estate tax return.[12] If there's no appointed executor or personal representative, any person in actual or constructive possession of the decedent's property may file the return and make the election. Once made, the election is irrevocable. The temporary regulations modify this irrevocability rule slightly. According to Temporary Treasury Regulations Section 20.20120-2T(a)(4), the election is irrevocable after the due date and extension for Form 706 actually granted have passed. Thus, before that time, an election can be superseded by a subsequently filed return.

Notice 2011-82, 2011-42 I.R.B. 516, released Sept. 30, 2011, confirms that the mere process of filing a federal estate tax return (Form 706) will be sufficient to preserve any unused exclusion amount for the surviving spouse. Conversely, if the benefit of DSUEA isn't to be used and a federal estate tax return is filed, the form must either contain a writing attached stating the intention or have written on the first page "No election under Section 2010(c)(5)."[13] If the estate is less than the threshold amount required for filing a return, then the mere act of not filing such a return will result in automatically opting out of portability.

If an estate is smaller than what's statutorily required for the filing of a Form 706 return and the estate wishes to use the portability election, the temporary regulations attempt to mitigate the costs and burdens of filing by stating that the marital and charitable deduction property transferred to a spouse or charity isn't required to be valued, and an estimate is sufficient. Under Temp. Treas. Regs. Section 20.20120-2T(a)(7), the executor need only describe the property, explain the ownership and/or beneficiary of the property and establish the marital or charitable deduction. Until the new tax forms are established, there must be a separate statement attached to the return, signed under penalty of perjury, estimating the estate's total value rounded to the nearest $250,000.

The special rule for small estates doesn't apply if any property, or portion thereof, is passing to someone other than a spouse and/or charity. Thus, if 50 percent is passing to a spouse and 50 percent is passing to a

child, a full valuation is required.[14] The same holds true if there will be elections or eligibility under IRC Section 2032 Alternate Valuation, IRC Section 2032A Valuation of Certain Farm, etc., Real Property or application of IRC Section 6166 Extension of Time for Payment of Estate Tax, when the estate consists largely of interest in closely held businesses. It also won't apply if there's a disclaimer of marital or charitable deduction property or a qualified terminable interest property trust election. Finally, taxpayers using formula marital deduction provisions may not be able to use the special rule, as valuation is required to assess the formula amount passing in whatever direction is required.

Give instructions. Give the executor specific instructions on when to make the election. This eliminates the need for guessing and helps eliminate potential conflicts among family members. The executor should also be indemnified if choosing not to make the election. It would be prudent to obtain waivers releasing the executor from filing.

IRS audit. The IRS may examine the return of a predeceased spouse at any time for purposes of auditing and determining DSUEA still available for use by the surviving spouse.[15] This authority applies each time the surviving spouse makes a transfer. However, the IRS may assess additional tax on that return only if that tax is assessed within the period of limitations under IRC Section 6501 (limitations on assessment and collection) applicable to the tax shown on that return.[16] For purposes of these examinations to determine DSUEA, the surviving spouse is considered to have a material interest that's affected by the return information of the deceased spouse within the meaning of IRC Section 6103(e)(3), which enables the spouse to obtain a copy of the return, if not provided to him in some other fashion.

DSUEA for Estates

DSUEA may be used immediately after the deceased spouse's death and, in fact, even before the Form 706 is due to be filed.[17] An ideal way of postmortem planning to use the carry-over exemption, if the net worth of the parties is sufficiently large and liquid, is for the surviving spouse to use DSUEA for gifting purposes. Furthermore, if the surviving spouse makes gifts, there's an ordering rule contained in the temporary regulations. The ordering rule provides that DSUEA is used for those taxable gifts before the transferor's own exemption is used.[18]

In accordance with the rules set forth in the IRC, a surviving spouse may only use the most recent DSUEA. The last deceased spouse is the most recently deceased individual who was married to the surviving spouse at that individual's death.[19] Therefore, a surviving spouse may not use the remaining DSUEA of a prior deceased spouse following the death of a subsequent spouse. Thus, if there's a remarriage, the new spouse may have less of an exemption available for carryover than that of the prior spouse.

> DSUEA from multiple spouses can't be compiled or hoarded for estate tax purposes.

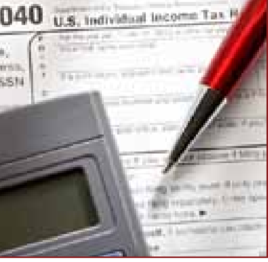
Example: Harry dies with a $5 million unused exemption, which is carried over to his wife, Wendy. Wendy then marries Frank. Frank has no exemption, having used it previously. When Frank dies, Wendy loses Harry's portability exemption, and Frank has no portability exemption to transfer to Wendy.

Consequently, if the carried over applicable exemption isn't used, it could be lost or reduced upon a remarriage. This is another reason why, in a large estate, it may be important for your client to use his exemption either for lifetime transfers or at death, or for the surviving spouse to use DSUEA, for transfers within a short period of time of receiving it. The potential loss bolsters the need for pre-marital planning for individuals with significant wealth.

Conversely, it's possible that upon a remarriage, the new spouse may have more of an exemption that's eligible to be carried over than the prior spouse's exemption that was carried over.

Example: Harry's exemption is carried over to Wendy. Wendy then marries Frank. Frank has a $5 million exemption. Frank dies. Wendy loses Harry's DSUEA, but she can elect to receive Frank's exemption of $5 million.

The potential gain is also something to consider, as



a spouse-to-be's unused exemption could be part of a contractual arrangement in a pre-marital agreement and may be valuable in the negotiation of the terms of the agreement.

When Section 2010(c)(4) was released, it appeared that there needed to be privity between spouses for purposes of the carry-over exemption. However, in reviewing the history of Section 2010(c)(4), that, apparently, wasn't Congress' intent. Technical corrections and the temporary regulations now make it clear that there needn't be privity between the parties to obtain the carry-over exemption held by the last deceased spouse.

Example: At his death, Harry has $2 million available for transfer to Wendy. Wendy has her own applicable exclusion of $5.25 million and $2 million of Harry's that was transferred to her, for a total of $7.25 million. Harry dies, and Wendy then marries Frank. Wendy dies with a taxable estate of $3 million. Frank may elect portability, and having done so, he receives from Wendy $4.25 million (her $7.25 million DSUEA minus her $3 million taxable estate) to use as he wishes. Thus, Frank ends up with some of Harry's exclusion amount.

Just as under prior law, if a decedent's estate is large enough to be in excess of the exemption, the estate shouldn't, as a general rule, leave more than the exemption amount to the bypass trust or outright to beneficiaries other than the spouse, unless there's a legitimate reason to incur an immediate tax. The surviving spouse may not use his own exemption immediately for a deceased spouse's estate at the date of death.

Example: If Harry has an estate of $6 million in 2013 and leaves it all to his children, exceeding his exemption by $750,000, an estate tax will be incurred, even though his wife has a $5.25 million exemption. No part of her exemption may be used for his estate.

This is the same premise as it was under prior law for use of the individual's applicable exemption. This seems inconsistent with the idea that DSUEA was designed to address: that spouses be treated as one taxable unit. However, there's no indication that either the Treasury or Congress will make any changes to allow the immediate use of a surviving spouse's individual exemption at the first death.

DSUEA for Gifts

DSUEA from multiple spouses can't be compiled or hoarded, but it may be used in succession, if used for gifting. Although an individual may not use multiple DSUEAs for estate transfer taxes, if a surviving spouse uses DSUEA for lifetime transfers, there can be an increase in the total amount available for use. The surviving spouse is allowed to use DSUEA of the "prior last deceased spouse," which is the last deceased spouse on the date of the gift. Thus, the amount of DSUEA could be increased to more than double the applicable exclusion amount of two individuals, depending on the number of marriages, provided that it's used for gifting.

Example: Harry dies. Wendy elects portability, so $5.25 million is carried over to her. Wendy makes gifts of $5.25 million and uses Harry's exemption to cover the transfer taxes. Wendy then marries Frank. Frank also has a $5.25 million exemption. Frank dies with his full exemption, and Wendy elects portability. Wendy subsequently makes additional gifts of $5.25 million and uses Frank's exemption to cover the transfer taxes. Wendy then dies. She has her own exemption available to cover her remaining estate.

Gifting by using the last deceased spouse's DSUEA may take place either before or after a subsequent marriage. It just needs to occur before the death of the next spouse or it's lost.

Example: Harry dies, survived by Wendy. Neither has made any taxable gifts during Harry's lifetime. Harry's executor elects portability of Harry's DSUEA, which is $5 million. Wendy makes gifts to her children, valued at $2 million. Wendy applies $2 million of Harry's DSUEA to the gifts. Wendy has an applicable exclusion amount remaining of $8 million ($3 million of Harry's remaining DSUEA, plus Wendy's own $5 million exclusion). After Harry's death, Wendy marries Frank. Frank dies. Frank's executor elects portability of Harry's DSUEA, which is computed to be $2 million. Wendy subsequently dies. DSUEA to be included in determining the applicable exclusion amount available to Wendy's estate is $4 million, determined by adding Frank's $2 million DSUEA and Harry's $2 million DSUEA that was applied by Wendy to her taxable gifts. Thus, Wendy's applicable exclusion amount is $9 million.[20]

Non-citizen Spouses

If a surviving spouse isn't a U.S. citizen, the unlimited marital deduction isn't available to him. Rather, a qualified domestic trust (QDOT) must be used to prevent an immediate estate tax. If property passes to a surviving spouse in a QDOT, the temporary regulations provide that a surviving spouse may elect portability. However, the surviving spouse may not use the ported exemption until the final distribution or termination (generally, the death of the surviving spouse) of the QDOT. At that point, the exemption from the deceased spouse is redetermined. This means that the DSUEA from a decedent will be available at the surviving spouse's death, though, it generally won't be available to the surviving spouse during life for gifting purposes.[21]

Example: Harry, a U.S. citizen, makes his first taxable gift in 2002, valued at $1 million. No gift tax is due because the applicable exclusion amount for that year ($1 million) equals the fair market value of the gift. Harry dies in 2011 with a gross estate of $2 million. Wendy, his wife, is a U.S. resident but not a U.S. citizen. Harry's will leaves a pecuniary bequest of $1 million to a QDOT for the benefit of Wendy. Harry's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT, and Harry's estate is allowed a marital deduction of $1.5 million under IRC Section 2056(d) for the value of that property. Harry's taxable estate is $500,000. On Harry's estate tax return, Harry's executor computes Harry's preliminary DSUEA to be $3.5 million (the lesser of the $5 million basic exclusion amount in 2011 or the excess of Harry's $5 million applicable exclusion amount over the sum of the $500,000 taxable estate and the $1 million adjusted taxable gifts). No taxable events within the meaning of IRC Section 2056A occur during Wendy's lifetime with respect to the QDOT, and Wendy makes no taxable gifts. In 2012, Wendy dies, and the value of the assets of the QDOT is $1.8 million. Harry's DSUEA is redetermined to be $1.7 million (the lesser of the $5 million basic exclusion amount in 2011 or the excess of Harry's $5 million applicable exclusion amount over $3.3 million (the sum of the $500,000 taxable estate augmented by the $1.8 million of QDOT assets and the $1 million adjusted taxable gifts)).[22]

A non-resident surviving spouse who isn't a U.S. citizen is barred from using DSUEA from a deceased spouse, except as allowed under any treaty.[23] It's not known if there are any treaties that would treat such spouse in the same or similar manner of a U.S. citizen. If the non-resident surviving spouse becomes a U.S. citizen prior to making a gift or bequest, DSUEA provisions become available to him.

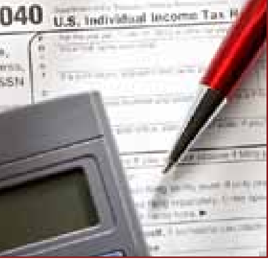
Unknown Issues

A couple of questions have gone unanswered. Presumably, the Treasury will address them in the near future.

1. Is DSUEA determined before or after the various tax credits are applied? These credits include the IRC Section 2013 Credit For Tax On Prior Transfers; the IRC Section 2014 Credit for Foreign Death Taxes; and the IRC Section 2015 Credit for Death Taxes on Remainders. The Treasury has reserved a section for this topic in the temporary regulations and is presently seeking comments on this issue.[24]
2. What happens if there's a simultaneous death of both spouses, and the order of deaths can't be determined. Would the IRS respect estate-planning documents that provide for such a situation, or would there be some other method for establishing which estate is allowed which portable exemption?
3. Might there be a change to the IRC and regulations so as to allow the applicable exemption of a surviving spouse to be used on the first estate, which truly represents the concept of spouses being one taxable unit?

Planning Ideas

Small estates need not be concerned with DSUEA, as one exemption will most likely cover any possible transfer taxes. However, mid-range estates should choose to make the election on the return, as the future size of an estate is an unknown quantity. Depending on the client's net worth, the ages of the parties, the consumption requirements and the types of investments held in a portfolio, there's always a possibility, no matter how remote, of significant growth in a surviving spouse's estate in the future. In addition to the potential for growth in an estate, there's still a possibility of future tax law changes, including reduction of the amount of the exclusion, which could negatively impact the surviving spouse's estate.



In a state where the state estate tax exemption is lower than the federal exemption, electing DSUEA may be detrimental. The state exemptions don't include any portability feature, and thus, the exemption for the state must be used or it's lost.

Larger estates need to be concerned with the benefits and detriments of DSUEA versus those of using a bypass trust. The bypass trust has the advantage of control over the assets and their ultimate distribution, various non-tax reasons such as asset protection or spendthrift protection, the guaranteed use of both spouse's exemptions and protection from tax on the appreciation if such appreciation would be so significant so as to exceed an exemption amount. It also may be used for GST tax purposes. But a bypass trust loses the step-up in basis that DSUEA provides (all assets included in the second-to-die's estate receives a step-up in basis if DSUEA is used) and has potentially significant income tax ramifications due to the progressive nature of the income taxation of trusts. The bypass is also difficult to use if the majority of the wealth is tied up in retirement assets.

Consequently, there's no right or wrong method when it comes to determining whether a bypass is a better use of an exemption than DSUEA. It's a matter of determining what's right for the particular client and the unique situation and type of assets comprising his wealth. However, with so many discretionary determinations to be made on whether a bypass is right for a client, a disclaimer provision with assets passing to a bypass might be considered. Adding the power to disclaim pursuant IRC Section 2518 to the estate-planning documents just adds another layer of flexibility.

If an estate is of sufficient size and liquidity and DSUEA was elected, gifts should be encouraged. Gifts by the surviving spouse may be outright or in trust, and all of the traditional methods for lifetime transfers are available for use with DSUEA. This postmortem technique has to be timed properly. Gifts made as soon after death as possible ensure that the portable exemption, which isn't adjusted for inflation, protects the assets from taxation on the appreciation in the survivor's estate if the estate is sufficiently large. Gifts of assets made at that time, which are likely to be sold relatively quickly after receipt by the donee, will have a basis that has been stepped up. Gifts will also protect against the possible loss of DSUEA if there's a remarriage.

Endnotes

1. 1988 American Bar Association Tax Section, Task Force on Transfer Tax Restructuring. This was just one of the many studies and white papers on this idea.
2. Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010, P.L. 111-312 Section 302(a)(1).
3. Treasury Decision 9593. 77 F.R. 36150-36163.
4. Temporary Treasury Regulations Section 25.2505-2T.
5. Temp. Treas. Regs. Section 20.2010-2T-3T.
6. Internal Revenue Code Section 2010 (c)(3).
7. For tax calculations, the 2013 applicable exemption equates to an applicable credit (also referred to as the" unified credit") of $2.045 million.
8. Temp. Treas. Regs. Section 20.2010-3T(a)(3).
9. IRC Section 2010(c)(2)(B).
10. The generation-skipping transfer tax is an additional tax imposed on property transferred to an individual who's two or more generations below the transferor. The rules may be found in Chapter 13 of the IRC. There's an exemption for the same amount that's equal to the applicable exemption of an individual. That amount is $5.25 million in 2013.
11. Temp. Treas. Regs. Section 20.2010-2T(c)(2).
12. IRC Section 2010(c)(5)(A).
13. *See also*, Temp. Treas. Regs. Section 20.2010-2T(a)(3)(I).
14. Temp. Treas. Regs. Section 20.2010-2T(a)(7)(ii)(c), Ex. 3.
15. IRC Section 2010(c)(5)(B).
16. *See also* IRC Section 7602 for the Internal Revenue Service's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry.
17. Temp. Treas. Regs. Section 20.2010-3T(c)(1) and Section 25.2505-2T(d)(1). Caution: The IRS may adjust the amount of the deceased spouse's unused exemption amount claimed as a result of a revaluation or if the executor can't substantiate the amount. A successful challenge by the IRS could result in additional tax not anticipated.
18. Temp. Treas. Regs. Section 25.2505-2T(b).
19. Temp. Treas. Regs. Section 20.2010-1T(d)(5).
20. Temp. Treas. Regs. Section 20.2010-3T(b)(2). This example doesn't take into consideration any inflation that might occur in the individual's applicable exemption.
21. Temp. Treas. Regs. Section 20.2010-2T(c)(4) and Temp. Treas. Regs. Section 20.2010-3T(c)(2). Note: It will be available in the year of surviving spouse's death for gifts made in that year, as that's the time it's redetermined.
22. Temp. Treas. Regs. Section 20.2010-2T(5), Example 3.
23. Temp. Treas. Regs. Section 25.2505-2T(f).
24. T.D. 9593; Temp. Treas. Regs. Section 20.2010-2T(c)(3).