Estate tax portability: myth, miracle or malpractice?

by Leo J. Cushing, Todd Lutsky and Bryan C. Moody

Published: March 21st, 2013

On Jan. 1, Congress enacted the American Taxpayer Relief Act of 2012, which extended and modified many of the so-called Bush tax cuts of 2001.

For estate planners, the 2012 act permanently set the estate, gift and generation skipping transfer tax exemptions at $5.25 million for 2013 (and indexed for inflation thereafter); capped the highest marginal federal estate, gift and generation skipping tax at 40 percent; and made permanent the relatively new concept of portability.

The question estate planners now face is whether portability has eliminated the need for traditional estate planning for married couples.

What is portability?

In order to understand the concept of portability, it is necessary to understand how the federal estate tax exemptions operated prior to portability. There were two basic rules seemingly in conflict.

The first rule was that one spouse could leave all assets to the surviving spouse with an "I love you" will, and there would be no federal estate tax upon the first death because of the so-called unlimited marital deduction.

The second rule dealt with the couple's estate tax exemptions. While each spouse was entitled to his/her own exemption ($5.25 million for 2013), the surviving spouse was not permitted to use the exemption that was available to the first spouse upon the death of the first spouse, even though all assets could be left to the surviving spouse free of federal estate taxes.

In simple terms, the estate tax exemption was not portable. The exemption either was used when the first spouse died or it was lost forever, and the federal estate tax cost of wasting the exemption with an "I love you" plan would be as much as $2.1 million ($5.25 million x 40 percent).

Because the estate tax exemption was not portable, in a typical case involving a married couple, each spouse would adopt a revocable living trust to be funded either during life or at death with whatever the exemption amount might be.

While somewhat counterintuitive, the purpose of each trust essentially was to disinherit the surviving spouse, at least up to the amount of the exemption.

The decedent's trusts became known as by-pass or credit shelter trusts so that the surviving spouse would become a beneficiary rather than the outright owner of the assets owned by the first spouse to die.

That would allow the surviving spouse to benefit from the trust assets, but not cause such assets or any related growth to be included in the surviving spouse's estate, thereby reducing any future estate tax liability on the death of the surviving spouse.

With the introduction of portability, the surviving spouse is able to use the first deceased spouse's so-called "deceased spouse's unused exclusion," or DSUE.

In our example, if all assets were left to the surviving spouse, instead of into a by-pass trust, the surviving spouse's DSUE would be $5.25 million. On the other hand, if the first spouse to die left $2 million to children, the DSUE available to the surviving spouse would be $3.25

million ($5.25 million less $2 million left to the children).

The downsides of portability

While at first blush portability would seem to change the landscape of traditional estate planning, there are numerous downsides to portability.

First, portability is not automatic and requires that an election be made by the executor. And like everything else in tax law, nothing is as simple as it sounds. In fact, the IRS recently issued multiple pages of complex proposed regulations explaining how the election is to be made.

In general, in order to elect portability, the executor must file a timely filed federal estate tax return, generally nine months after death or 15 months if extended, when an estate tax return otherwise would not be required to be filed.

That means that portability is an election that must be filed at a time when the surviving spouse is emotionally least likely to be willing to address estate taxes.

Remember, if the election is not made, portability will be lost, which may result in increased estate tax liability upon the death of the surviving spouse. While the portability rules may be helpful for estates in which the decedent has otherwise done no tax planning, estate tax planning typically will be preferable to allowing them portability.

Second, even though the estate tax exemption is portable, the generation skipping tax exemption is not. Therefore, clients seeking to create long-term trusts for the benefit of their children and more remote descendants cannot take advantage of portability because the first spouse's generation skipping tax exemption cannot be transferred to the surviving spouse.

Third, the DSUE is not indexed for inflation. As a result, if assets transferred to the surviving spouse appreciate, the appreciation will be subject to estate taxation at the surviving spouse's death; whereas, if the trust planning mentioned above were utilized, you would no longer need to worry about making the portability election, and all the assets left in the QTIP and by-pass share would grow estate tax-free.

Fourth, portability is not applicable in either Massachusetts or Rhode Island; both states have retained the old rule of using the exemption on the first death or losing it all together.

Fifth, if portability is elected, unfortunately the estate of the first spouse to die will remain open for audit by the IRS until the surviving spouse's estate is closed for the purpose of determining DSUE.

Sixth, a remarriage by the surviving spouse could result in the loss of DSUE from the first spouse since DSUE is attributable only to the most recent deceased spouse.

For example, if a husband dies and leaves all assets to the surviving spouse, the surviving spouse would have a $5.25 million DSUE amount.

If the surviving spouse remarries and the second spouse dies prior to her and leaves, for example, $3 million to someone other than the spouse (such as his children from a former marriage), she would lose the DSUE from her first spouse and would be left with only the DSUE from the estate of the second husband.

In that case, the DSUE would be $2.25 million instead of $5.25 million, which would clearly adversely affect her estate tax liability upon her demise.

Seventh, if a fiduciary fails to make an election to preserve the DSUE, that fiduciary has created the potential for significant fiduciary liability.

Finally, any estate plan that leaves all assets to the surviving spouse relying on portability results in the loss of control over the final disposition of assets and does not protect the assets from second marriages.

Making the portability elections

The IRS recently issued temporary regulations explaining how the portability election can be made. See Temp Regs. 20.2010-2T. According to the regulations, to make the election, the estate must file a timely "complete and properly-prepared return."

To make that requirement easier for estates that are not required to file a return under Section 6018(a) (because the estate amount falls below the exclusion amount), the regulations permit the executor to estimate the gross value of the estate based on a good-faith determination of the value of the estate's assets.

For executors who are required to file an estate tax return, the executor must file the estate tax return within nine months after the decedent's date of death. When an executor is not required to file an estate tax return, the code does not specify a due date for a return filed for the purpose of making the portability election, but that is addressed in the regulations.

The temporary regulations in §20.2010-2T(a)(1) require every estate electing portability of a decedent's DSUE amount to file an estate tax return within nine months of the decedent's date of death, unless an extension of time for filing has been granted. (See Notice 2012-21 providing for an extension of time to file an estate tax return for the estates of certain decedents who died in the first half of calendar year 2011.)

That timing requirement for filing a return applies to all estates electing portability regardless of the size of the estate.

The temporary regulations provide in §20.2010-2T(a)(1) that an estate choosing to elect portability will be considered to be required to file a return under Section 6018(a).

To opt out of the election, if an estate tax return is required to be filed, the executor must make an affirmative statement on the estate tax return signifying the decision to have the portability election not apply.

If no estate tax return is required, not filing a return will be considered an affirmative statement signifying the decision not to make a portability election (with potentially very expensive and disastrous results).

The election must be made by the estate's executor. If there is no executor, however, any person in actual or constructive possession of any property of the decedent (a non-appointed executor) may make the election.

A portability election made by a non-appointed executor cannot be superseded by a contrary election made by another non-appointed executor of the same decedent's estate.

The regulations require the executor to calculate the amount of the unused exclusion on the deceased spouse's estate tax return, and they contain rules for properly calculating that amount. The rules explain how the exclusion applies in a number of specific practical situations, for example, in cases in which the surviving spouse has multiple deceased spouses.

To protect the IRS, the regulations permit it to examine the return of a deceased spouse whose spouse had elected portability, without regard to the usual three-year statute of limitation under Section 6501. Since the surviving spouse may live many years past the time the first spouse died, this rule is intended to allow the IRS to make any adjustments that allowing portability might require.

If these tax reasons were not enough to consider traditional trust planning, there are numerous non-tax reasons not to rely on portability. Most couples would like to be sure that their assets will stay within the so-called bloodlines, which can only be accomplished with traditional trust planning and careful selection of fiduciaries.

Also, in many cases, surviving spouses are not equipped to make either investment or distribution decisions, and the use of trusts create fiduciary obligations to obtain professional investment advice.

So where are we? Portability is not a myth, and it clearly would be a miracle for the surviving spouse who fails to plan.

Nevertheless, it may well be malpractice to allow a couple to rely on portability without a full explanation of the pitfalls and practicalities of portability.

Leo J. Cushing, CPA, Todd Lutsky and Bryan C. Moody practice at Cushing & Dolan in Boston.

Complete URL: **http://masslawyersweekly.com/2013/03/21/estate-tax-portability-myth-miracle-or-malpractice/**