The Taxpayer Certainty and Relief Act of 2009: A Preview of Portability

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Portability at Last

For more than twenty years, members of the ABA have been trumpeting the estate planning simplification for modestly wealthy taxpayers that would result from portability of the estate tax exemption. Formally recommended by the ABA Tax Section's Task Force on Transfer Tax Restructuring in 1988 (41 Tax Law. 395), making the estate tax exemption portable would enable a decedent's surviving spouse to take advantage of any remaining estate tax exemption not utilized by the decedent. While the Taxpayer Certainty and Relief Act of 2009 (S. 722, "TCRA") has not yet emerged from the Senate Committee on Finance, it provides the clues as to what the final portability provisions might look like.

Limitations Under the Current Transfer Tax Regime

Under current law, any estate tax exemption that the decedent fails to use is wasted and expires upon the decedent's death. For example, using the 2009 applicable exemption amount of $3,500,000, if a decedent with few assets married to a spouse possessing $7,000,000 in assets died without proper planning, the surviving spouse would be left with an estate of $7,000,000, of which $3,500,000 would potentially be subject to estate tax upon the surviving spouse's death. With proper planning, such as utilizing an inter vivos QTIP trust, the surviving spouse could have avoided any estate tax while ensuring virtually the same ultimate disposition. If TCRA becomes law, the executor of the deceased spouse's estate could elect to allow the surviving spouse to have the unused applicable exclusion amount of the original decedent added to that of the surviving spouse, and still be able to avoid any eventual estate tax without undertaking extensive inter vivos planning, significantly simplifying the estate planning process.

Re-unifying the Estate and Gift Tax Exemptions

Aside from implementing the portability of the estate tax exemption, TCRA would make other significant modifications to the current estate and gift tax structures (as well as provide alternative minimum tax relief and other tax cuts that are not discussed here). First, TCRA would make permanent the $3,500,000 applicable exclusion amount and 45 percent maximum estate tax rate, thereby undoing the estate tax repeal scheduled for 2010 (S. 722, Pg. 17-19). The applicable exclusion amount would also be indexed annually for inflation beginning in 2011 (Pg. 18). Second, TCRA would increase the gift tax exemption amount to $3,500,000 (Pg. 21). When Congress passed the Tax Relief Reconciliation Act of 2001 (EGTRRA), it created a schedule whereby the estate tax exemption of $1,000,000 would gradually increase to $3,500,000 while the gift tax exemption of $1,000,000 remained stagnant, de-unifying the estate and gift tax exemption amounts. Under TCRA, the estate and gift tax exemption amounts would be re-unified. Third, TCRA makes permanent the $60,000 applicable exclusion amount for non-resident aliens and entitles residents of United States possessions to a potential increase in applicable exclusion amount of up to $175,000 (Pg. 19-20). Finally, TCRA repeals code sections 2011, 2057, and 2604, and increases from $750,000 to $3,500,000 the amount by which the fair market value of qualified real property can be reduced for gross estate purposes under the special use valuation rules of code section 2032A (Pg. 22).

The Portability Provisions

The portability provisions of TCRA are highly anticipated. For modestly wealthy married taxpayers whose combined estates are unlikely to exceed the total exemption amount, portability could significantly reduce the complexity and costs of estate tax planning. Taxpayers with estates likely to exceed the applicable exclusion amount, however, are likely to recognize increased tax savings by foregoing the benefits of portability in favor of effective lifetime planning. If the gift tax exemption is made equal to the applicable exclusion amount, as proposed in TCRA, taxpayers could maximize transfer tax savings by making lifetime transfers and thereby shift future appreciation to the next generation. In the alternative, taxpayers can continue to use Credit Shelter Trust planning and remove from estate tax the appreciation occurring between the first spouse's death and the surviving spouse's death.

As expected, the portability rules also contain a number of anti-abuse provisions. To begin, in order for the surviving spouse to use the deceased spouse's unused exclusion amount, the executor of the deceased spouse's estate must timely file an estate tax return whereon the unused exclusion amount is calculated and an irrevocable election is made to make the amount available to the surviving spouse (Pg. 26). Also, while the surviving spouse may take into account the unused exclusion amounts of multiple deceased spouses, the total portable amount available to the surviving spouse is limited to the applicable exclusion amount in effect for purposes other than portability at the surviving spouse's death; in other words, the same amount that would be available if the surviving spouse had only one prior deceased spouse who died earlier in the same year with a gross estate valued at zero (Pg. 25). Finally, the statute of limitations remains open for determining the amount of a deceased spouse's unused exclusion amount even after the statute has expired for purposes of examining the deceased spouse's estate tax return (Pg. 26). As a result, the statutory period for determining the unused exclusion available to the surviving spouse does not expire until the statute has run for purposes of auditing the surviving spouse's estate tax return (thus allowing the Service to undertake an audit of the deceased spouse's return and add any additional tax assessed to the surviving spouse's estate tax liability).

Troublesome Anti-Abuse Provisions

The anti-abuse provisions are likely to be the most controversial. Each of the last two anti-abuse provisions seem logical, except that both could be avoided by resorting to pre-portability estate planning techniques and foregoing the advantages that portability was intended to provide. For instance, under the proposed portability provisions, the total unused exemption amount afforded to a surviving spouse is limited to the full applicable exclusion amount of one prior deceased spouse. At the same time, if a surviving spouse was willing to forego the simplification afforded by portability, the exclusion of each predeceased spouse could be utilized through proper lifetime marital deduction planning. Exhausting the predeceased spouses' estates during lifetime also eliminates the need to make the portability election that extends the statute of limitations. The final anti-abuse provision extending the statute of limitations is particularly disturbing because it reverts back to policy firmly rejected by the substantial disclosure rules for gift tax returns, policy whereby the Service was previously able to re-examine gift tax returns for which the statute of limitations had expired and use any additional tax assessed to reduce a deceased's available exemption, thereby increasing the estate tax owed.

Weighing the Benefits

TCRA provides a number of significant improvements to the current estate and gift tax structures, one of which is the portability of the estate tax exemption. For taxpayers of modest wealth, portability could be utilized to significantly simplify lifetime estate planning. Portability would also provide a safety net for estate plans of taxpayers with modest or significant wealth that are frustrated by unexpected events. At the same time, the portability anti-abuse provisions are likely to discourage taxpayers with gross estates susceptible to valuation disputes from relying on portability as part of their estate planning. As a result, unless Congress is able to come up with other alternatives for preventing the perceived potential abuses, taxpayers will need to weigh the benefits of simplified estate planning provided by the portability of the estate tax exemption against the potential disadvantages created by the anti-abuse provisions.