What Portability Means to Trust and Estate Professionals

By Marc S. Bekerman

One issue that has received much discussion over the last several years is the concept of allowing the estate of a surviving spouse to use the unused estate tax applicable exemption amount from the estate of his or her predeceased spouse. This concept has often been referred to as portability of the applicable exemption amount (frequently referred to as "portability" herein) and can serve in many cases to simplify estate plans of persons with significant wealth while also allowing some taxpayers to avoid traps for the unwary. This article will review the concept of portability and its potential effect, should it be enacted.

Background

Interaction of Marital Deduction and Use of Applicable Exemption Amount

An estate must take a deduction on its estate tax return for any bequest to the surviving spouse that qualifies for such marital deduction. Mandatory use of the marital deduction directly reduces the use of the applicable exemption amount because the applicable exemption amount is applied only after calculating the estate tax due. As a result, if the entire estate passes to a qualifying spouse in a qualifying manner, the estate tax owed will be zero before application of the applicable exemption amount. The complete loss of the applicable exemption amount is the goal of much tax-based estate planning and what portability seeks to avoid.

Effect of Portability on Estate Plans

As described above, it is currently necessary to have property pass free of the marital deduction on the death of the first spouse in order to use that spouse's applicable exemption amount. These bequests can either be to beneficiaries who do not qualify for the marital or charitable deduction (that is, to a beneficiary who is neither a spouse nor a qualifying charity) or to a qualifying beneficiary in a nonqualifying form (that is, to a trust for the benefit of a spouse or charity that does not qualify under the Internal Revenue Code for the applicable deduction).

Frequently, an estate plan will create a credit shelter trust or bypass trust under the will of the first spouse to die to ensure that at least some of his or her applicable exemption amount is used. These trusts usually are funded either by application of a formula that forces the funding in an amount calculated after the death of the first spouse or by giving most of the estate to the surviving spouse and allowing the surviving spouse to disclaim an appropriate portion to be determined within nine months of the death of the first spouse. Usually the disclaimed property passes into a trust under the terms of the decedent's will, often called a disclaimer trust,

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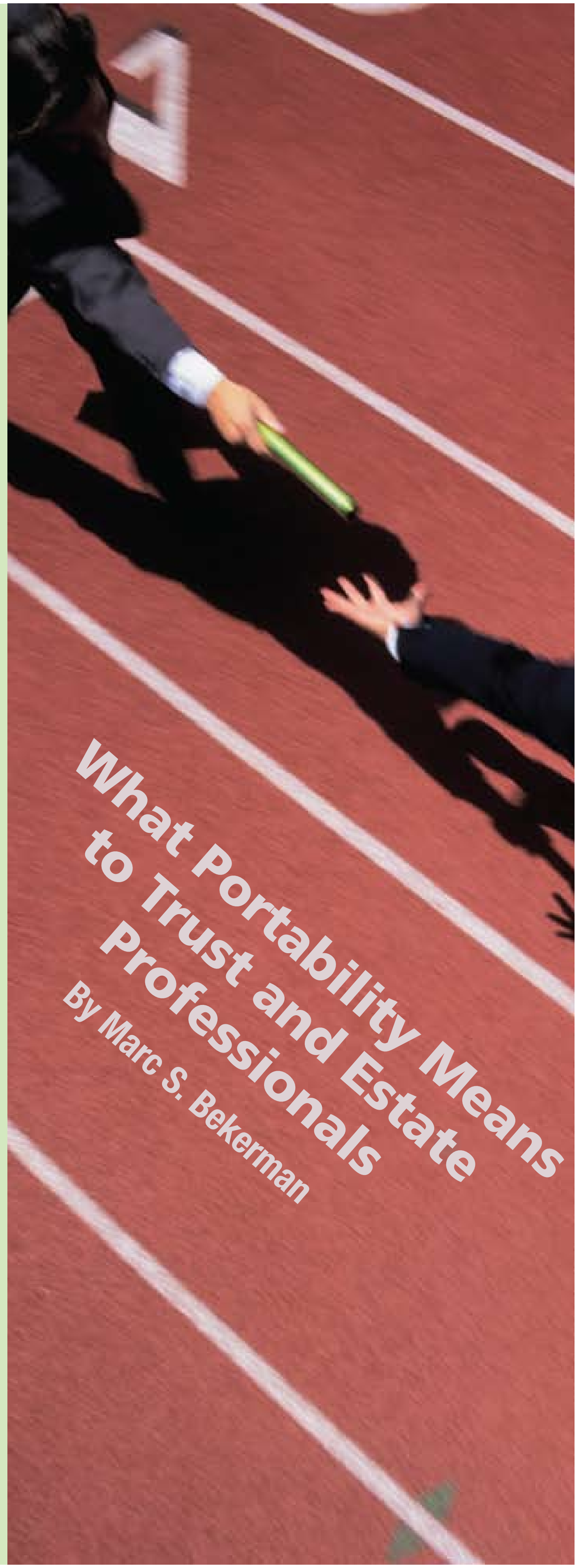

that acts as the credit shelter trust. It is easy to see the advantages and disadvantages to both funding approaches depending on the facts and circumstances present, although an analysis of the respective approaches is outside the scope of this article. Because both funding approaches have their weaknesses, however, some practitioners have informally commented that credit shelter trusts will no longer need to be considered should portability be enacted. The author disagrees with this position and, as will be discussed subsequently, believes that trusts will continue to be useful vehicles for estate planning even if portability is enacted.

> Portability will permit greater flexibility in uncertain planning times when use of disclaimer planning is not desirable, for whatever reason.

How Portability Might Work

The discussion of how portability will work is theoretical at this point, since no legislation has been enacted that would implement the concept as part of the Internal Revenue Code. The following examples can provide a framework for discussion and analysis.

> **Example 1**—The wife dies in 2009 with an estate of $10 million in which all assets are held with her husband as joint tenants with right of survivorship. To use any of the wife's applicable exemption amount of $3.5 million, the husband will have to disclaim some portion of the joint property so that such property is payable to the wife's estate (as opposed to payable to the husband by operation of law). Further, if the wife's estate is payable in its entirety to the husband, either under the terms of her estate plan or the local intestacy law if there are no estate planning instruments, the husband will have to execute a second disclaimer to permit property to pass to other beneficiaries of the estate. This scenario is often referred to as a double disclaimer and is not an uncommon situation on the death of the first spouse when most assets are payable to the surviving spouse by operation of law.
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> **Example 2**—The wife dies in 2009 leaving an estate of $5 million, all of which is titled in her own name. Under the terms of the wife's last will and testament, the entire estate is payable to her surviving spouse. Assume that the applicable exemption amount is $3.5 million and provisions allowing for portability have been enacted and are applicable and that the surviving spouse dies in a subsequent year when the applicable exemption amount is still $3.5 million with a total estate of $6 million (including any amounts inherited from the predeceased spouse). On the death of the first spouse, no applicable exemption amount is used because the entire estate qualifies for the marital deduction, thereby having a $3.5 million applicable exemption amount still unused. On the death of the second spouse, the husband's estate will have his $3.5 million applicable exemption amount available along with the unused $3.5 million exemption from the wife's estate. As a result, the entire $6 million could pass free of estate tax to the beneficiaries of the husband's estate.
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> **Example 3**—Same facts as Example 2, except that the wife's last will and testament divides her estate equally between her surviving spouse and her children. On the wife's death, $2.5 million of her applicable exemption amount is used and the balance of the entire estate qualifies for the marital deduction, thereby having a $1.0 million applicable exemption amount still unused. On the husband's death, his estate will have his $3.5 million applicable exemption amount available along with the unused $1.0 million exemption from the wife's estate. As a result, $4.5 million could pass free of estate tax to the beneficiaries of the husband's estate (presumably his estate is smaller than in Example 2 as a significant portion of his inheritance was diverted to the children on the death of the first spouse).

Advantages of Portability

Portability as a Savings Provision

Example 1 above shows how portability of the applicable exemption amount can provide a convenient crutch for either a couple's failure to plan or failure to follow through on a plan. On the wife's death, the entire estate passes to the husband by operation of law and qualifies for the marital deduction. As discussed above, the only way to use any of the wife's applicable exemption amount would be through the use of disclaimers. Disclaimers, however, can raise a number of complicated issues depending on the type of assets owned by the husband and the wife, the type of assets sought to be disclaimed by the husband, the husband's capacity at the time of the wife's death, the husband's willingness to take the necessary steps in a prompt manner after the wife's death, and whether the husband seeks assistance in the administration of the wife's estate.

In contrast, portability of the applicable exemption amount would allow the wife's entire exemption amount to be available on the husband's death. As a result, portability would eliminate the need for any disclaimers in the wife's estate.

Portability as a Planning Technique in Uncertain Times

Portability also will permit greater flexibility in uncertain planning times when use of disclaimer planning is not desirable, for whatever reason. For example, when there is a question about the applicable exemption amount, it is often difficult to determine how much money should pass to the credit shelter portion of the estate plan.

Example 4—The husband and the wife each own $3.5 million in assets titled in their own names and have estate plans that fund the credit shelter trust at the full applicable exemption amount available. At the 2008 applicable exemption amount level of $2 million, the surviving spouse would receive approximately 42% of the estate of the first spouse to die, which would likely satisfy any right of election. With the 2009 applicable exemption amount level of $3.5 million, however, the surviving spouse would receive zero because the entire estate would pass to the credit shelter trust. As a result, the surviving spouse might choose to exercise his or her right of election, resulting in some unused applicable exemption amount in the estate of the first spouse to die. If the credit shelter trusts were funded by formula because use of disclaimers was not appropriate for some reason under these facts and circumstances, portability could simplify planning this estate.

Reduction in Estate Planning Costs

Many supporters of portability believe that it would reduce the costs of estate planning because fewer trusts would need to be created and a couple might not need tax-based estate planning until after the death of the first spouse to die. As will now be discussed, however, the author believes that there should not be a reduction in estate planning.

Concerns Regarding Portability

Clients Should Plan, Even Though Portability Can Impair Planning

As just indicated, some believe that persons with moderate wealth may be able to completely forego estate planning until the death of the first spouse. Unfortunately, this may result in couples incorrectly assuming that they fall into this category. Further, certain techniques will not be available on the death of the first spouse. In addition, there are still valid nontax reasons to consider using trusts in the estate of the first spouse to die. Finally, as will be discussed below, use of current planning techniques such as credit shelter trusts can still be in the family's best interest for tax purposes.

Outright Bequests to the Surviving Spouse May Not Adequately Ensure That Issue of the First Spouse to Die Ultimately Receive Their Wealth

Historically, it was less common for a surviving spouse to remarry, for a number of reasons. One characteristic of the modern American family, however, is the increased likelihood of marriage after the death of a spouse. Leaving an entire estate outright to a surviving spouse can place at risk the future inheritance of the decedent's issue. If the surviving spouse remarries, he or she may choose to leave some portion of the estate, including the whole thereof, to the new spouse. Further, if the surviving spouse fails to secure a pre-marital agreement, his or her entire estate may be subject to either community property laws or a right of election. Finally, trusts are often used for asset protection purposes as well. If the surviving spouse should acquire creditors for any reason, the property inherited outright from the predeceased spouse would be subject to the claims of such creditors.

Often the intent of the first spouse to die is to benefit the surviving spouse as the primary goal with benefitting their issue or other beneficiaries as a secondary goal. The first spouse to die frequently seeks to provide for his or her children after assuring the continued comfort and support of the surviving spouse. The most effective method for this in large estates is through the use of trusts whether or not portability of the applicable exemption amount is available.

Leaving the Entire Estate to the First Spouse to Die May Increase the Overall Estate Tax Payable

If the entire estate of the first spouse to die qualifies for the marital deduction, all of these assets will be included for estate tax purposes in the estate of the surviving spouse whether the transfer is by outright bequest or in trust. Although all growth and income from the marital bequest will be included in the estate of the surviving spouse to the extent that he or she has not spent down any distributions, the exemption of the estate of the first spouse to die will not increase. Under an analysis similar to the time value of money, the longer the surviving spouse lives, the more the value of the exemption will decrease. This result can be avoided through the use of planning similar to current credit shelter planning, whether funded by formula or disclaimer, which allows the use of some portion of the exemption of the first spouse to die at the time of his or her death, thereby maximizing its value and not seeing the value diminish over time.

> Some believe that persons with moderate wealth may be able to completely forego estate planning until the death of the first spouse.

Credit Shelter Trusts Can Better Provide for the Decedent's Issue Than the Surviving Spouse

A credit shelter trust established under the estate plan of the first spouse to die can be a better vehicle for providing for children in two ways. First, the surviving spouse may be unwilling or uncomfortable to make significant gifts from his or her own assets. The same spouse, however, may be willing to make such gifts from a separate trust. Further, appointment of trustees (whether or not the surviving spouse is such a trustee) can allow others chosen by the deceased spouse to make such decisions.

In addition, establishing a credit shelter trust for gifting to issue can have tax savings. If the surviving spouse does not wish to trigger gift tax liability, he or she will be limited to annual exclusion gifts and his or her lifetime gift exemption. This is especially true if the applicable exemption amount that is transferred to the surviving spouse is considered only for estate tax purposes. A credit shelter trust, however, could make distributions to beneficiaries with no gift tax implications to the surviving spouse, whether or not the surviving spouse is making gifts from his or her personal assets.

Issues to Be Considered in Portability

Ordering of Use of Applicable Exemption Amount and Cascading Applicable Exemption Amounts

One issue to address is the ordering of the use of the applicable exemption amounts in the estate of the surviving spouse. This is important when the surviving spouse has remarried and is illustrated by the following example.

One of the most significant questions regarding portability is how to evidence precisely how much of the unused applicable exemption will be available on the death of the surviving spouse.

Example 5—The wife dies in 2009 leaving an estate of $5 million, all of which is titled in her own name. Under the terms of the wife's last will and testament, the entire estate is payable to her surviving spouse. The husband has remarried and is survived by wife no. 2. If the husband's last will and testament directs his $6 million estate be divided equally between wife no. 2 and his children, the estate will have a marital deduction of $3 million and will use $3 million of the husband's available applicable exemption amount.

In administering the husband's estate, the executor would need to determine whether the $3 million of applicable exemption amount used to shelter the gift to the children comes from the wife's $3.5 million applicable exemption amount that passed to the husband on the wife's death, from the husband's own $3.5 million applicable exemption amount, or from some combination of the two. This could be especially important if the legislation permitting portability takes steps to eliminate the possibility of cascading applicable exemption amounts.

Cascading Applicable Exemption Amounts

Cascading applicable exemption amounts would occur when unused exemption amounts are passed to future surviving spouses. This is illustrated by Example 5 when wife no. 2 obtains $4 million of applicable exemption amount to be used in addition to her current $3.5 million (the maximum $4 million is calculated by combining the husband's applicable exemption amount of $3.5 million with the wife's applicable exemption amount of $3.5 million, reduced by the $3 million passing to the husband's issue). A similar argument could be made against allowing unlimited marital deductions because property received by a surviving spouse could be given to a future spouse free of any estate or gift tax. It is important to understand that nothing in either the portability scenario or the marital deduction situation allows property to pass free of tax to a nonspouse, noncharitable beneficiary without using some applicable exemption amount. As such, it is the author's belief that this is not a policy issue as much as a recordkeeping question.

Suggestions in Administering the Estate of the First Spouse to Die

One of the most significant questions regarding portability is how to evidence precisely how much of the unused applicable exemption will be available on the death of the surviving spouse. If an estate tax return is required on the death of the first spouse, this is somewhat easier because the computation will be provided to the IRS in the ordinary course of estate administration. Depending on the disposition of the estate, such a return may very well not be reviewed at the audit level and yet still bind the IRS in future proceedings by expiration of the statute of limitations.

When no estate tax return is required on the death of the first spouse, however, the issue becomes somewhat more problematic. For example, because a mere inventory of assets will be insufficient, it may become a common practice to prepare either an estate tax return or a formal accounting in each and every estate of the first spouse to die in an attempt to substantiate amounts that will be declared on the death of the surviving spouse.

Example 6—The wife dies in 2008 with a gross estate of $850,000 according to the inventory filed with the local court. If one-half of the estate is payable to the surviving spouse and one-half payable to the wife's issue, it would be easy to conclude that the decedent has used $425,000 of her exemption amount and the balance would be available on the death of the husband. But, if there were $20,000 in funeral expenses, administration expenses, and debts equally payable from each share, in fact only $415,000 of the exemption would be used allowing for an additional $10,000 to be used on the death of the husband.

One concern is that portability is not intended to complicate or make more expensive the administration of the estate of the surviving spouse. As such, the burden on the estate of the surviving spouse to demonstrate its entitlement to any additional applicable exemption amount from the estate of a predeceased spouse (similar to showing entitlement to a credit for tax paid on prior transfers) must balance with seeking to avoid accountings and estate tax returns that would otherwise be unnecessary. If the estate of the first spouse is not administered properly, or portability as enacted creates certain requirements, portability could have the ironic effect of causing more estate tax returns to be filed.

Portability of Gift Tax Exemptions and Exclusions

One issue mentioned above is whether the deceased spouse's annual gift tax exemption and lifetime gift tax exclusion should be portable. The Internal Revenue Code currently permits spouses to split lifetime gifts made by either of them through an appropriate election on the couple's gift tax return. As such, we already have for practical purposes portability of the gift tax exemption amounts, both the annual exclusion and lifetime gift exemption, so long as the gifts are made before the death of the first spouse. Once the first spouse dies, however, any unused gift tax exemption is no longer available to the surviving spouse to make lifetime gifts.

The author believes that the annual exclusion should die with the decedent because it is his opinion that death brings to an end certain tax benefits even between spouses. A similar analysis would be to allow a surviving spouse to continue to file his or her personal income tax returns as married, filing jointly for the rest of their lives. The annual exclusion is largely meant to shelter "de minimis" amounts of gifts from the transfer tax system. Once the potential donor has died, it seems inappropriate to create a fiction to continue in perpetuity that the deceased donor is continuing to make annual gifts to the donees as selected by the surviving spouse.

This leaves the issue of whether the unused lifetime gift exemption should be made available to the surviving spouse. As a preliminary point, the Internal Revenue Code provides that any use of the lifetime exemption amount, currently $1 million, reduces the applicable exemption amount available to a decedent's estate for estate tax purposes at death. The following example illustrates this point and assists in analyzing the issues raised.

> **Example 7**—In 2008, the wife makes a $500,000 gift to a trust during her lifetime, which does not qualify for the annual exclusion, and no election is made to split the gift with the husband. The wife dies in 2009 and leaves her entire estate to the husband. Because of the wife's prior gift, she has only $3 million of applicable exemption amount available to be transferred to the husband assuming that portability is applicable. As such, the husband only has $3 million worth of the applicable exemption amount available to add to his applicable exemption amount. If the husband dies later in 2009 after portability is permitted, the husband would have $3.5 million of his own exemption in addition to the wife's $3 million, resulting in a total applicable exemption amount in the husband's estate of $6.5 million.

If the lifetime gift tax exemption amount is portable, then the husband should receive two separate tax benefits. Specifically, the husband's lifetime gift tax exemption in Example 7 would be increased from $1 million to $1.5 million (that is, the unused portion of the wife's lifetime gift exemption), while his applicable exemption amount remains at $6.5 million. As with the wife, should the husband make any gifts during his lifetime that do not qualify for the annual exclusion, such gifts would reduce dollar for dollar the applicable exemption amount available on the husband's death.

> Portability of the lifetime gift tax exemption will provide wealthy taxpayers with the opportunity to make significant lifetime gifts without incurring gift tax liability.

Portability of the lifetime gift tax exemption will provide wealthy taxpayers with the opportunity to make significant lifetime gifts without incurring gift tax liability. Combining portability of the gift tax exemption with the already existing significant income and transfer tax advantages afforded lifetime gifts creates a scenario that the author believes Congress will react to unfavorably for budgetary, administrative, and equitable reasons. The author notes that, if the estate and gift tax systems were reunified, there would be no need to separately consider whether the gift tax exemption should be portable because the distinction between the gift tax exemption and the applicable exemption amount would cease to exist.

Interaction with State Estate Taxes

A potentially complicating item is the interaction between portability and state estate taxes. If a state that assesses its own estate tax does not automatically conform with the Internal Revenue Code, estates in such a jurisdiction might face the dilemma of whether to use portability that would not be recognized on the state level.

Effect on Income Taxes

Portability may result in fewer trusts from two different perspectives. First, some estate planning might not take place until the death of the first spouse, resulting in fewer trusts created by the first spouse to die, either during his or her lifetime or on his or her death. Second, even if a client engages in estate planning, he or she may choose not to use credit shelter trusts, opting instead to pass property outright to the surviving spouse. Under either perspective, fewer fiduciary income tax returns would be required to be filed.

As a result, some of the issues relating to subchapter J (such as the *Knight* case) will have even less importance. In addition, there might be an income tax savings to families as a result of fewer trusts because trusts reach the highest marginal income tax rate with a relatively low amount of taxable income when the surviving spouse might not be in the highest marginal income tax bracket for his or her personal income taxes.

Conclusion

Although many people view portability as a tremendous change in how estates will be planned for estate tax purposes, this article has demonstrated the author's belief that the overall effect may not be as significant as currently believed. If portability is to be enacted, Congress will need to seriously consider some of the issues in this article, and professionals will need to review how portability can best be used to accomplish their clients' objectives. ■