Federal Estate Tax Portability

Making Sense of Changes in Estate Tax Law

By Dan Holbrook

> "The future isn't what it used to be."
>
> — Paul Valery

Late in 2010, Congress amended the federal estate tax. A chart on page 19 lists the new federal estate and gift tax exemptions and the Tennessee inheritance tax exemptions by year, as well as the combined federal and Tennessee death taxes and effective death tax rates for different sizes of estates.[1] The immediate good news for taxpayers is an increase in the unified federal gift and estate tax exemption[2] to $5 million in 2011, indexed for inflation beginning in 2012, along with a maximum tax rate of 35 percent.

The second bit of good news in the tax act is a long overdue estate tax reform known as "portability," effective for estates of decedents dying after 2010.

Historically, although the law grants each spouse a federal estate tax exemption, it was "use it or lose it." The only way a married couple could use both spouses' federal estate tax exemptions was to create and fund a trust when the first spouse died, with the amount of

the then-available exemption. These are commonly known as a "credit shelter trust," "bypass trust" or "AB trust." Although such trusts can be desirable for a myriad of non-tax reasons, many couples with potentially taxable estates would prefer simply to leave everything to each other. Such couples have too often reluctantly engaged in planning that seemed unnatural and of only limited benefit to themselves during their lives, profiting only their beneficiaries after their deaths.[3] Indeed, some couples have simply refused to do death tax planning, no matter the ultimate potential tax cost to their children, because they could not brook the inconveniences. Other couples have executed tax planning wills but later forgot about the necessity of keeping their assets separately titled, inadvertently undoing the planning, at significant tax cost to their descendants.

The solution was simple: give the surviving spouse both exemptions, by making exemptions portable between spouses. Congress has finally done so, but the devil is in the details. Should your clients now rely on portability, or should they still use the old system of creating and funding a trust at the death of the first spouse to die? Here's a checklist.

Advantages[4]

1. Simplicity. For couples with projected taxable estates no greater than twice the federal exemption, portability provides simplicity.[5] Any exemption unused by the estate of the first spouse to die passes to the surviving spouse. Couples can attend to their non-tax estate planning issues with little or no concern over federal estate tax implications. Although the future federal exemptions of $5 million or more are guaranteed only for 2011 and 2012, and uncertain after 2012 (reverting to $1 million after 2012 unless Congress acts), many taxpayers may reasonably conclude that the likelihood of Congress's extending portability of these large (and increasing) exemptions well into the future adequately limits exposure to federal estate tax.[6]

2. Basis Step-up. When a surviving spouse dies, all assets in his or her estate, including assets received from the predeceased spouse, will receive a step-up in income tax basis under Code §1014, effectively forgiving all capital gains on both spouses' assets as of the date of the survivor's death.[7]

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Disadvantages

1. Portability Expires after 2012. Various aspects of the new estate tax law, including portability, the $5 million exemption, and the 35 percent top estate tax rate, have been referred to as the "Mayan" provisions, since like the Mayan calendar, they expire after 2012. Under current law, to be eligible for portability, both spouses must die in either 2011 or 2012. Unless Congress acts, the estate tax in 2013 reverts to the law as of 2001, with no portability, no recognition of prior portability for deaths during 2011 or 2012, an exemption of only $1 million, and a top estate tax rate of 55 percent. Congress will no doubt be wrestling with tax extender legislation late in 2012, an election year, when their ability to reach agreement may be compromised. In other words, relying on federal estate tax portability requires an assumption of Congressional ability to extend the current law to years in which your clients' deaths actually occur. Congress itself is unlikely to be able to predict the probabilities of that assumption.

2. Tennessee Inheritance Tax Planning. The Tennessee inheritance tax exemption is not portable. It has been, and probably will continue to be, $1 million per spouse. Like the federal exemption before 2011, it is still "use it or lose it." Since the top Tennessee inheritance tax rate is 9.5 percent, the tax burden to the beneficiaries of a surviving spouse's estate when a predeceased spouse fails to create a "credit shelter trust" for at least $1 million will be about $95,000.[8] Whether this potential tax burden is sufficient incentive for couples to put up with the hassles and complexities of tax planning (as discussed in footnote 3) is a decision each couple must make in conjunction with their advisors.

3. Requirement of Filing a Timely Federal Estate Tax Return. Portability is lost unless there is a timely filed federal estate tax return after the death of the predeceasing spouse, on which the executor affirmatively elects portability. It would seem desirable to file a return for every predeceasing spouse, since one can never know when the surviving spouse might win a lottery or otherwise come into wealth. Nevertheless, executors may be loath to take the time or spend the money to prepare a return, or may be ignorant of the potential benefit. Perhaps there will be many surviving spouses who lose portability by failing to meet this requirement.[9]

4. Unused Exemption from Predeceased Spouse Potentially Lost If Survivor Remarries and Next Spouse Also Predeceases. Only the most recent deceased spouse's unused exemption can be used by a surviving spouse. According to an explanation of the tax act by the Joint Committee on Taxation, this is true even if the last deceased spouse has no unused exemption and even if the last deceased spouse's estate made no timely election. Thus, for example, a widow with $5 million carried over from her first husband could lose all the carryover if her second

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husband were wealthy and predeceased her leaving his estate to his own children. This potential "remarriage penalty" may need to be addressed in premarital agreements. In our example, the widow might require that her new husband, if he predeceased her, leave her an amount at least equal to the projected estate tax loss to her estate by the loss of her first husband's unused exemption (e.g., 35 percent of $5 million). Perhaps prior gift tax returns will need to be examined to verify remaining exemptions.

5. GST Exemption Not Portable. Only the federal gift and estate tax exemptions are portable, not the federal generation-skipping transfer tax (GST) exemption. Clients desiring to maximize generation-skipping have no alternative but to utilize "credit shelter" planning, by allocating some or all of the estate of the predeceasing spouse to trusts ultimately reaching grandchildren.

6. Appreciation after Predeceased Spouse's Death Included in Survivor's Estate. If a Credit Shelter Trust is established by the predeceased spouse's estate, all appreciation in the value of assets in the Credit Shelter Trust escapes estate taxation at the surviving spouse's death. However, if the predeceasing spouse dies and leaves everything to the survivor, the survivor's later taxable estate will include all the couple's assets as of the survivor's death, including all appreciation in value.

7. Predeceased Spouse's Exemption Not Indexed for Inflation. The predeceasing spouse's unused exemption may be carried over to the surviving spouse, but it is not adjusted for inflation like the surviving spouse's exemption. The longer the surviving spouse lives, the lower the economic value of the predeceasing spouse's portable exemption. This is closely related to the preceding disadvantage, since a Credit Shelter Trust established on the death of the predeceasing spouse effectively allows the sheltered amount to grow free of further estate tax exposure.

8. Credit Shelter Trusts Provide Gift Tax Benefits. Tax-free gifts by a surviving spouse to descendants are limited to the annual gift tax exclusion amount, as adjusted for inflation (currently $13,000 per donee per calendar year).[10] By contrast, Credit Shelter Trusts are often drafted to allow the Trustee to make discretionary distributions to descendants, which are free of gift or estate tax because they are forever "sheltered" by the estate tax exemption of the predeceased spouse. Better yet, Credit Shelter Trusts are often drafted to give the surviving spouse a lifetime (as well as testamentary) limited power of appointment to appoint assets of the trust to descendants. This gives the surviving spouse flexibility to make generous gifts without federal gift tax concern. Without a Credit Shelter Trust, the good news is that the unused exemption of the predeceased spouse is portable to the surviving spouse and increases the amount that the surviving spouse can gift without incurring federal gift tax. The bad news without a Credit Shelter Trust is that (1) the surviving spouse would have to file gift tax returns for gifts in excess of the annual gift tax exclusions, and (2) if the unified gift and estate tax exemption drops back to $1 million in 2013, some commentators believe that gifts made in 2011 or 2012 in excess of $1 million will be subject to recapture or "clawback" of the gift tax.

9. Credit Shelter Trusts Provide Non-tax Benefits. Non-tax benefits of a Credit Shelter Trust can be legion, limited only by the imaginations of our clients. Most commonly, assets set aside in a Credit Shelter Trust when the first spouse dies can provide (1) asset protection from creditors of the surviving spouse, (2) professional investment management, (3) assurance that trust assets will ultimately pass to descendants and not be lost to others on account of a surviving spouse's remarriage, (4) protection against a surviving spouse's spendthrift inclinations or other wasting of assets resulting from dementia or other loss of judgment, and (5) benefit during the surviving spouse's life to descendants or other beneficiaries besides the surviving spouse.

Conclusion

The 2010 tax act clarified many federal estate tax uncertainties, at least through 2012, and by introducing portability, it has potentially relieved many taxpayers of the burden of expensive and complex estate planning. But it also postponed many uncertainties until 2013. Will Congress enact further changes before then, and if so, will such changes again be temporary or will they finally return some sense of stability to the estate tax regime? In particular, having introduced portability as a governing principle only if both spouses die in 2011 or 2012, will Congress make portability permanent? Who knows?

One partial solution is to use a "disclaimer trust," i.e., keep spouses' assets separate just in case, and provide that assets disclaimed by the surviving spouse pass to a Credit Shelter Trust. The surviving spouse will then have nine months from the predeceasing spouse's death to weigh all factors, determine the advisability of a Credit Shelter Trust, and disclaim if desirable.

Meanwhile, the best we can do in most situations may be to educate and advise our clients on the pros and cons of available alternatives, knowing that neither we nor they have the benefit of hindsight, and that Congress can do anything, or nothing.

Notes

1. Because the federal estate tax law through 2012 allows a deduction for state death taxes paid, the actual amount that can pass free of federal estate tax is greater than the federal exemption. For example, the federal estate tax exemption in 2011 is $5 million, but there is no actual federal estate tax on a Tennessee decedent who dies in 2011 until the estate exceeds $5,407,072. At that point the Tennessee inheritance tax is exactly $407,072, which when deducted from the estate leaves a $5 million federal taxable estate. Once the federal tax

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applies, the federal tax rate is 35 percent in 2011 and 2012, and the Tennessee inheritance tax rate is 9.5 percent. However, the net effective rate is not the sum of those two rates, but only 41.175 percent, being the sum of 9.5 percent and (35 percent minus (35 percent times 9.5 percent)).

2. The federal estate tax exemption is not technically termed an "exemption" but rather is defined in Code 2010(c) as the Applicable Exclusion Amount (AEA). Effective in 2011 and 2012 only, the AEA equals the sum of two newly defined amounts: (1) the Basic Exclusion Amount (BEA), which is $5 million, indexed for inflation beginning in 2012, and (2) the Deceased Spousal Unused Exclusion Amount (DSUEA), the portion of the predeceased spouse's BEA that was not used by the predeceased spouse during life or at death, and which is transferred to the surviving spouse by the filing of a timely federal estate tax return.

3. In order for couples to accomplish "credit shelter" planning to use both of their death tax exemptions, they must typically during their joint lives divide assets into separate names and limit joint ownership. Then, after one spouse dies, the surviving spouse must endure the existence of a trust, causing additional complexity, at least some loss of control, expenses such as trust income tax return preparation, and possibly trustee fees if the spouse is not the sole trustee.

4. Three other advantages of portability could be noted, although of questionable value:

(1) *Marriage for Estate Tax Portability.* A surviving spouse or single person facing federal estate tax with only one exemption could marry a poor dying person and, after the death of such short-term spouse, add the deceased spouse's unused exemption to their own (this might be called "marriage in contemplation of death"). This could effectively double a $5 million estate tax exemption to $10 million. One could imagine consideration exchanged for this privilege, even a black market arising for such exemptions on Craigslist or eBay: "Dying man with no assets and no debts will marry to provide portable estate tax exemption. Physician affidavits and bank references available. $50,000 or best offer."

(2) *Divorce for Estate Tax Portability.* If a wealthy couple divorces, each remarries a poor dying person as provided in the prior paragraph, and they do not later remarry each other, then they can effectively use portability to increase their federal estate tax exemptions from a combined $10 million to a combined $20 million.

(3) *Marriage for Gift Tax Portability.* As discussed below among the disadvantages, only the most recent predeceased spouse applies for estate tax portability. In other words, one cannot simultaneously carry over exemptions from two predeceased spouses (often referred to as the "privity" requirement). But there is no limit on serial carryovers for federal gift tax purposes. Thus, a wealthy widow who marries a poor dying man can add up to $5 million to her unified gift and estate tax exemption, which (after first using up her own $5 million lifetime gift exemption) she could use to make another $5 million gift to her children free of federal gift tax. The tax act appears to allow this to be repeated indefinitely, unless the IRS or the courts could successfully apply a "sham marriage" theory.

5. As explained in footnote 1, the federal estate tax deduction for state death taxes paid increases the amount that can actually pass free of federal estate tax beyond the exemption, and the same is true with regard to the doubled portable exemption. For example, if both spouses die in 2011, when both have a federal estate tax exemption of $5 million, or a combined total of $10 million, the actual amount that can pass free of federal estate tax in the estate of the survivor is $10,931,934. That is because at that point the Tennessee inheritance tax (using $1 million as the Tennessee exemption for only one spouse) is exactly $931,934, which when deducted from the gross amount leaves a net federal taxable estate equal to the couple's combined federal exemptions of $10 million. Accordingly, in round numbers, it is more accurate to say that in Tennessee, couples can use portability to pass $11 million free of federal estate tax rather than just $10 million.

6. The tax act provides that the $5 million unified gift and estate tax exemption is indexed for inflation, beginning in 2012. Assuming Congress extends this provision, the compounding effect can be substantial. Although interest rates have recently been lower than normal, the average annual cost-of-living increase on various tax exclusions and exemptions over the last 20 years has been about 4 percent. Assuming a conservative 3 percent annual adjustment, the 2011 exemption of $5 million will be about $6,720,000 in 2021 and about $9,030,000 in 2031. Assuming a 4-percent annual adjustment, the 2011 exemption of $5 million will be about $7,400,000 in 2021 and about $10,960,000 in 2031.

7. Use of a Credit Shelter Trust normally sacrifices the basis step-up for trust assets at the surviving spouse's death. At least some basis step-up might still be available if the Credit Shelter Trust gives the surviving spouse a testamentary general power of appointment by formula over whatever portion of the trust can be sheltered by the surviving spouse's unused exemption, if any, possibly protected by requiring that it be exercisable only with the consent of an independent trustee. Perhaps a "Trust Protector" could be authorized to grant the surviving spouse a testamentary general

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Combined Federal and Tennessee Death Tax Chart

Prepared by Holbrook, Peterson & Smith PLLC

TN Death Tax Exemption:		1,000,000		1,000,000		1,000,000		1,000,000		1,000,000
Federal Credit/Exemption:	1,455,800	3,500,000	N/A	Infinity	1,730,800	5,000,000	1,765,800	(est) 5,100,000	345,800	1,000,000
Federal Gift Tax Exemption:		1,000,000		1,000,000	1,000,000 (2010)	5,000,000 (2011)		(est) 5,100,000		1,000,000
GST Exemption:		3,500,000		5,000,000		5,000,000		(est) 5,100,000		(est) 1,480,000
Year:	**2009**		**2010 Election****		**2010** & 2011**		**2012**		**2013 & After**	
Taxable Estate	**Tax**	**Marg. Rate**	**Tax**	**Marg. Rate**	**Tax**	**Marg. Rate**	**Tax**	**Marg. Rate**	**Tax**	**Marg. Rate**
1,000,000	0	5.5%	0	5.5%	0	5.5%	0	5.5%	0	41.0%
1,040,000	2,200	6.5%	2,200	6.5%	2,200	6.5%	2,200	6.5%	16,400	41.0%
1,100,000	6,100	6.5%	6,100	6.5%	6,100	6.5%	6,100	6.5%	41,000	41.0%
1,200,000	12,600	6.5%	12,600	6.5%	12,600	6.5%	12,600	6.5%	82,000	41.0%
1,250,000	15,950	7.5%	15,950	7.5%	15,950	7.5%	15,950	7.5%	102,500	43.0%
1,300,000	19,700	7.5%	19,700	7.5%	19,700	7.5%	19,700	7.5%	124,000	43.0%
1,400,000	27,200	7.5%	27,200	7.5%	27,200	7.5%	27,200	7.5%	167,000	43.0%
1,440,000	30,200	9.5%	30,200	9.5%	30,200	9.5%	30,200	9.5%	184,200	43.0%
1,500,000	35,900	9.5%	35,900	9.5%	35,900	9.5%	35,900	9.5%	210,000	45.0%
1,600,000	45,400	9.5%	45,400	9.5%	45,400	9.5%	45,400	9.5%	255,000	45.0%
1,700,000	54,900	9.5%	54,900	9.5%	54,900	9.5%	54,900	9.5%	300,000	45.0%
1,800,000	64,400	9.5%	64,400	9.5%	64,400	9.5%	64,400	9.5%	345,000	45.0%
1,900,000	73,900	9.5%	73,900	9.5%	73,900	9.5%	73,900	9.5%	390,000	45.0%
2,000,000	83,400	9.5%	83,400	9.5%	83,400	9.5%	83,400	9.5%	435,000	49.0%
2,500,000	130,900	9.5%	130,900	9.5%	130,900	9.5%	130,900	9.5%	680,000	53.0%
3,000,000	178,400	9.5%	178,400	9.5%	178,400	9.5%	178,400	9.5%	945,000	55.0%
3,500,000	225,900	9.5%	225,900	9.5%	225,900	9.5%	225,900	9.5%	1,220,000	55.0%
3,749,614	249,614	50.225%	249,614	9.5%	249,614	9.5%	249,614	9.5%	1,357,288	55.0%
4,000,000	375,370	50.225%	273,400	9.5%	273,400	9.5%	273,400	9.5%	1,495,000	55.0%
5,000,000	877,620	50.225%	368,400	9.5%	368,400	9.5%	368,400	9.5%	2,045,000	55.0%
5,407,072	1,082,072	50.225%	407,072	9.5%	407,072	41.175%	407,072	9.5%	2,268,890	55.0%
5,517,569	1,137,569	50.225%	417,569	9.5%	452,569	41.175%	417,569	41.175%	2,329,663	55.0%
6,000,000	1,379,870	50.225%	463,400	9.5%	651,210	41.175%	616,210	41.175%	2,595,000	55.0%
7,000,000	1,882,120	50.225%	558,400	9.5%	1,062,960	41.175%	1,027,960	41.175%	3,145,000	55.0%
8,000,000	2,384,370	50.225%	653,400	9.5%	1,474,710	41.175%	1,439,710	41.175%	3,695,000	55.0%
9,000,000	2,886,620	50.225%	748,400	9.5%	1,886,460	41.175%	1,851,460	41.175%	4,245,000	55.0%
10,000,000	3,388,870	50.225%	843,400	9.5%	2,298,210	41.175%	2,263,210	41.175%	4,795,000	55.0%
20,000,000	8,411,370	50.225%	1,793,400	9.5%	6,415,710	41.175%	6,380,710	41.175%	10,295,000	55.0%
30,000,000	13,433,870	50.225%	2,743,400	9.5%	10,533,210	41.175%	10,498,210	41.175%	15,795,000	55.0%
40,000,000	18,456,370	50.225%	3,693,400	9.5%	14,650,710	41.175%	14,615,710	41.175%	21,295,000	55.0%
50,000,000	23,478,870	50.225%	4,643,400	9.5%	18,768,210	41.175%	18,733,210	41.175%	26,795,000	55.0%
100,000,000	48,591,370	50.225%	9,393,400	9.5%	39,355,710	41.175%	39,320,710	41.175%	54,295,000	55.0%

** Estates of Decedents who die in 2010 are generally subject to estate tax with a $5 million exemption, with a complete step-up in income tax basis, in which case the tax chart for 2010 is the same as for the year 2011. However, the Executor may instead elect an unlimited estate tax exemption, in which case the estate is subject to "carryover" basis, with an automatic basis increase of $1.3 million allocated by the Executor, plus another $3 million of marital stepup in basis for assets passing to a surviving spouse.

power of appointment to the extent deemed desirable. On the downside, inclusion of such a general power of appointment to the extent applicable would waste any of the GST exemption allocated by the estate of the predeceased spouse. Also, this technique would not work with a "disclaimer" trust.

8. The estimated $95,000 of Tennessee inheritance taxes "lost" by failing to use the predeceased spouse's $1 million inheritance tax exemption will be (1) less than $95,000 if the taxable estate of the surviving spouse is less than $2,440,000, below which the tax calculation uses marginal tax rates less than 9.5 percent, or (2) increased to the extent that assets that would have been put in trust at the death of the first spouse have appreciated in value between the spouses' deaths.

9. The requirement of filing a timely estate tax return raises several practical issues.

(1) *What is "timely"?* The tax act states that "no election may be made … if such return is filed after the time prescribed by law (including extensions) for filing such return." If an estate is valued at less than the federal exemption, then no federal estate tax return is due at all, and thus there is technically no "time prescribed … for filing." In such case, the normal due date for filing a required return (nine months after death, plus extensions) would seem not to apply. Filing within nine months of death may be the best practice, but until the law is clarified, late filings may actually be acceptable, giving the surviving spouse (or other executor of the predeceasing spouse's estate) time to "wait and see" whether it would be advisable or necessary to file to elect portability or not.

(2) *What is a federal estate tax return?* Must the entire lengthy Form 706 be filed, with all exhibits, attachments, appraisals, etc., or will the IRS create a special form (706-EZ?) for the sole purpose of disclosing the unused exemption amount and electing portability?

(3) *Who files the return and makes the portability election?* Normally it is the executor, but the Code defines "executor" so broadly as to include almost anyone in possession of estate assets or receiving assets from the estate. Portability can be valuable, and therefore the election is valuable. What if the executor refuses to file any return because it is of no benefit to him, or because the cost is borne by him without benefit to him, or even because he intentionally desires to hurt the surviving spouse? For example, the surviving spouse might be a step-parent whom the executor dislikes. What if the executor demands that the surviving spouse compensate him for filing a return to elect portability? Can the surviving spouse file his own return and make his own election anyway? What is the effect if more than one return is filed?

(4) *Who gets a copy of the return?* If the executor is not the surviving spouse, how will the surviving spouse's tax preparers know how to prepare gift tax returns for the surviving spouse's gifts or an estate tax return at the surviving spouse's death unless they have access to the return?

(5) *When might it be better NOT to elect portability?* The tax act provides that the statute of limitations on determining the amount of the predeceased spouse's unused exemption keeps running until the statute of limitations expires on the surviving spouse's estate tax return. If there are family business interests, or other hard-to-value assets, the executor of the predeceasing spouse's estate may choose to file the estate tax return but not elect portability, in order to run the statute of limitations earlier, possibly a more important concern.

(6) *What special provisions should be added to wills?* Examples might include (1) to require election of portability, (2) to require notification to the surviving spouse, (3) to give the surviving spouse all the power to require an election or not, (4) to indemnify the executor if the election is not made, or (5) to specify who bears the costs of preparing the estate return, especially if the estate is small enough that no return is legally required.

10. Tax-free gifts may also be made for education or medical care, if paid directly. The Tennessee annual gift tax exclusion is only $3,000 instead of $13,000 for "class B" beneficiaries.

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