

## Wealth Strategy Report

# Portability of a Deceased Spouse's Unused Exclusion Amount

### OVERVIEW

The concept informally known as “portability” is now permanent as a result of the enactment of the American Taxpayer Relief Act of 2012 (the “2012 Act”). Portability allows a surviving spouse to use a deceased spouse's unused estate tax exclusion (up to \$5.25 million in 2013). This summary will (1) summarize the portability law; (2) highlight requirements and restrictions of the portability law; and (3) examine planning opportunities.

### BRIEF HISTORY

Portability was first introduced as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010 (“TRA 2010”), and became effective for married persons dying on or after January 1, 2011. Portability, like other provisions of the estate and gift tax laws, was scheduled to “sunset” on December 31, 2012. However, as a result of the passage of the 2012 Act, portability is now a permanent mainstay in the transfer tax system.

### THE PLANNING ISSUE

The 2012 Act provides that in 2013 the gift and estate tax exclusion amount is \$5.25 million. Historically, the exclusion amount was \$5.12 million in 2012 and \$5 million in 2011. By law, the exclusion is inflation adjusted each year.

The gift and estate tax exclusions are “unified”, which means if some of the \$5.25 million gift tax exclusion is used to shield lifetime gifts, the exclusion available to shield testamentary bequests is reduced accordingly.

**Example 1:** W makes her first lifetime taxable gift of \$3 million in 2011. In 2013 she dies, survived by H. She is said to have used \$3 million of her gift tax exclusion amount, and at the time of her death, she would have \$2.25 million of estate tax exclusion amount available to be used as provided for in her estate planning documents.

A common estate planning goal of a married couple is to take full advantage of both spouses' estate tax exclusions. Typically this is done by funding a Family Trust (also sometimes called a Credit Shelter Trust) at the death of the first-to-die with the exclusion amount and

leaving the rest to one's spouse (outright or in trust). Nevertheless, sometimes a spouse's exclusion is wasted for one of two common reasons – unbalanced asset ownership or an inefficient estate plan.

Unbalanced asset ownership. Unbalanced ownership occurs when a spouse owns less than his or her lifetime exclusion amount.

**Example 2:** Assume H and W (U.S. citizens) are married, and H dies first. Assume further that H owns \$3 million and W owns \$17 million. H has the potential of leaving up to \$5.25 million to a Family Trust, which would avoid estate tax in both spouses' estates. However, because H only has \$3 million, he does not take full advantage of the \$5.25 exclusion. Prior to portability, \$2.25 million would have been wasted. With portability, such \$2.25 million can be saved and passed to W for her use.

Inefficient estate documents. Waste due to inefficient estate documents occurs in cases where even though there is proper balancing of assets, the documents that effect the transfers at death do not do so in a tax-efficient manner.

**Example 3:** Assume H and W (U.S. citizens) are married, and H dies first. Assume further that each of H and W owns \$10 million of assets in their individual names. H has the potential of leaving up to \$5.25 million to a Family Trust; thus, avoiding estate tax in both of their estates. H and W have the balanced asset ownership needed to each take full advantage of the \$5.25 million exclusion. However, further assume H's estate plan simply leaves everything to the surviving spouse (rather than to a Family Trust).

In that case, since assets passing to a surviving spouse do not utilize the \$5.25 million exclusion (because it passes to W and thus qualifies for the unlimited marital deduction), H would have used none of the available \$5.25 million exclusion; it all will have been wasted. Portability could potentially eliminate the waste.

There are ways to address this issue ahead of time. In **Example 2**, W could have transferred at least \$2.25 million to H, and the result would be that H owned at least \$5.25 million and would be able to take full advantage of the exclusion. Special rules apply if the donee spouse is not a U.S. citizen. In **Example 3**, a change in documentation would allow the first-to-die's \$5.25 million to fund a Family Trust rather than going to the surviving spouse.

## SUMMARY OF PORTABILITY

For those dying in 2011 and later, if a first-to-die spouse has not fully used the estate tax exclusion, the unused portion technically called the "Deceased Spousal Unused Exclusion Amount," or "DSUE amount," can be transferred or "ported" to the surviving spouse. Thereafter, for both gift and estate tax purposes, the surviving spouse's exclusion is the sum of (i) his/her own exclusion (as such amount is inflation adjusted), plus (ii) the first-to-die's ported DSUE amount.

**Example 4:** H and W (U.S. citizens) have only been married to each other. W owns \$3 million and H owns \$7.5 million. W dies in 2013 and funds a Family Trust with her \$3 million, using \$3 million of her exclusion to shield it from estate taxes. W's DSUE amount is \$2.25 million (her exclusion of \$5.25 million less the \$3 million used to shield the Family Trust). H's exclusion in 2013, for gift and/or estate tax purposes, is \$7.5 million (his own \$5.25 million plus the \$2.25 million ported DSUE amount). H could make gifts of \$7.5 million in 2013 and fully shield those gifts. If H did not make gifts but died later in 2013, he could fully shield his \$7.5 million estate from estate taxes.

**Example 5:** H and W (U.S. citizens) have only been married to each other. W owns \$5.25 million and H owns \$5.25 million. W dies in 2013 leaving her entire \$5.25 million to H, using none of her estate tax exclusion. W's DSUE amount is \$5.25 million (her exclusion of \$5.25 million less the \$0 used, because

all of her assets were transferred to H, her spouse). H's exclusion in 2013, for gift and/or estate tax purposes, is \$10.5 million (his own \$5.25 million plus the \$5.25 million ported DSUE amount). H could make gifts of \$10.5 million in 2013 and fully shield those gifts. If H did not make gifts but died in 2013 with a \$10.5 million estate, he could fully shield his estate from estate taxes.

Portability allows both of the planning problems mentioned at the beginning (i.e., unbalanced asset ownership and inefficient estate documents) to be retroactively addressed. And, it does much more than that. We discuss this in the planning section of this report.

## REQUIREMENTS AND RESTRICTIONS

Portability has many requirements and restrictions. We highlight the more common, important ones in this section.

Election required. In order for the surviving spouse to be able to use the DSUE amount, the executor of the first-to-die's estate must make an election on a timely-filed estate tax return. This could necessitate the preparation and filing of a return just to make this election when a return might not otherwise be needed.

Extended Statute of Limitations. Normally the statute of limitations for a properly filed estate tax return is three years. That is, the IRS has three years from the initial filing deadline to challenge the estate tax return. However, if the estate tax return includes an election to allow portability of the DSUE amount to the surviving spouse, then the time limit on when the IRS can review the first-to-die's return is extended until the statute of limitations runs on the survivor's estate (i.e., generally three years after the estate tax return is filed for the survivor's estate).

Only last deceased spouse's DSUE amount is portable; however, there is a special rule when there were multiple spouses. The general rule is that surviving spouse can use the DSUE amount of his/her last deceased spouse. This will be an issue only if the survivor marries again.

**Example 6:** H1 and W (U.S. citizens) have only been married to each other. W owns \$18.25 million and H1 owns \$2.25 million at the time of H1's death. H1 dies in 2013 leaving his \$2.25 million to his children. H1's DSUE amount is \$3 million (his exclusion of \$5.25

million less the \$2.25 million used). W's exclusion in 2013, for gift and/or estate tax purposes, is \$8.25 million (her own \$5.25 plus the \$3 million DSUE amount from H1). Assume that after H1's death, in 2013, W marries H2, who owns \$10 million. Assume, in 2013, soon after that marriage, H2 dies leaving his entire estate to his children (and thus consuming all of his \$5.25 estate tax exclusion). At the instant of H2's death, H2 becomes W's "last deceased spouse" (H1 is no longer the "last deceased spouse" – as discussed in the next section we call H1 a "prior deceased spouse").

When W later dies in 2013, unfortunately, she has lost the \$3 million of DSUE from H1, as a result of H2's death. And, because H2 had no DSUE amount to port to W, W is left only with her estate exclusion of \$5.25 million to shield her estate taxes. With an \$18.25 million estate, W's estate will be liable for estate taxes on \$13 million. At a 40% rate, that equates to \$5.2 million tax liability.

As a result of H2's death, the loss of H1's \$3 million DSUE amount equated to the children suffering an economic loss of \$1.2 million (i.e., 40% of \$3 million).

**Multiple Spouses - Special Rule.** As part of the portability regulations, there is a new taxpayer-friendly rule that now allows the possibility of using the DSUE amount of a deceased spouse, who is no longer the "last deceased spouse", (because of marriage of the survivor and death of the new spouse) which we call a "prior deceased spouse." The survivor can only take advantage of the prior deceased spouse's DSUE amount, if such survivor made lifetime gifts while the "prior deceased spouse" was the survivor's "last deceased spouse." Yes, it is complicated, but the following example explains the rule.

**Example 7:** Assume the same facts as in **Example 6**; however, assume that before H2 died, W made a gift of \$3 million, using up H1's DSUE amount that was ported to W.

Recall that at the instant of H2's death, H2 became W's "last deceased spouse" and H1 became a "prior deceased spouse" as to W.

When W later dies in 2013, the special multiple spouses rule works in her favor since W utilized H1's DSUE amount while H1 was still W's "last deceased spouse" (i.e., at the time of the gift H1 was W's last

deceased spouse, even though W was later married to H2). After H2's death, even though W is only left with her \$5.25 million estate tax exclusion to shield her estate taxes, the use of the \$3 million DSUE from H1 is credited to W (because she used it timely, i.e., before H2 died). The use of that \$3 million of DSUE, at a 40% estate tax rate, equates to \$1.2 million tax savings. In this example, W's estate tax liability will be \$4 million.

In **Example 7**, because W used H1's DSUE amount before H2 died, W had full use of the \$3 million DSUE amount, whereas, in **Example 6**, W lost H1's DSUE amount as a result of not timely using H1's DSUE amount before H2 passed. When it comes to "prior deceased spouses" and unused DSUE amounts from such spouses, the planning strategy is "use it or lose it."

Does not apply to GST. In addition to increasing the gift and estate tax exclusions, the 2012 Act also increased the Generation-Skipping Transfer (GST) tax exemption to \$5.25 million in 2013, which is indexed for inflation in future years. By its terms, portability does not apply to GST tax, and thus to the GST exemption. If the first-to-die spouse does not fully use his/her GST exemption, it is wasted. However, with proper planning, it is possible to use portability for estate and gift tax planning and not waste one's GST exemption. We discuss this below.

## PLANNING OPPORTUNITIES AND ISSUES

Take advantage of a DSUE amount sooner rather than later. We believed when portability had the possibility of "sunsetting" that one should have "used it sooner rather than later." Even though portability is permanent (with no current possibility of a sunset), depending upon the circumstances, that line of thinking may be appropriate. This may be true if the surviving spouse marries again, because the potential loss that can occur if the new spouse predeceases the survivor. We explored this in **Examples 6** and **7**.

This "use it sooner rather than later" is akin to our advice about making lifetime gifts (regardless of if one is single or married). If we assume growth in assets, the sooner one makes gifts to the next generation (whether outright or in trust), not only is the gift out of the estate, but so is the growth. Thus, if you can afford to make the gifts, make them sooner rather than later.

Community Property States. In community property states, each spouse owns half of the community property regardless of how titled.

**Example 8:** Assume the first-to-die spouse owns \$3.25 million and the surviving spouse owns \$7.25 million. If all assets are community property, they each own \$5.25 million and can take full advantage of his/her separate \$5.25 million exclusion.

This feature of community property reduces or eliminates some of the planning problems summarized earlier (i.e., imbalance of assets), and portability's fix is not as consequential. However, if the first-to-die's community property is also owned as joint tenants with rights of survivorship or is otherwise left to the surviving spouse, then the first-to-die's \$5.25 million exclusion might not be fully used to shield \$5.25 million of wealth. In that case, portability offers a solution.

Should you rely on portability? The answer to that is not clear and depends on a number of factors unique to each person. What is clear is that portability should be considered as part of your overall plan, and not simply relied upon in case a mistake is made in planning (e.g., imbalance of assets), or as a back-up plan.

Before portability, the planning challenges mentioned at the beginning would be better addressed by (i) making sure both spouses have \$5.25 million in their own names, and (ii) making sure that for each, the \$5.25 million passed in a way that could be shielded by the first-to-die's \$5.25 million exclusion (e.g., leaving that \$5.25 million to a Family Trust rather than to the surviving spouse).

Now, with the advent of portability, the traditional planning (i.e., planning before portability) should be re-evaluated. We note that, for some, a plan relying on portability (a "portability plan") could yield a better result than a "traditional plan." In other cases, the result may be the same. Yet, in other cases, the traditional plan may yield a better result.

What is the take-away? – Consider portability up front when planning; don't rely on it as a backstop or an after-thought. And, analyze whether a portability plan (i.e., a plan where portability will be relied upon after the death of the first spouse) would be a better plan than a traditional plan.

Today, when incorporating portability, it appears that the important factors are not only the total federal estate

taxes, but also: income taxes, distributions of the estate after the death of both spouses, investment returns, length of time between both spouses' deaths, and client desires for assets after each person's death (i.e., whether in trust, or not). There is no "one-size-fits-all" approach. There is a new paradigm to planning, and one's individual circumstances would have to dictate the type of plan to use.

It might make sense to have both spouses use a traditional plan (i.e., fully funding a Family Trust at the first death); it might make sense to use a "portability-type" plan. It really depends on the circumstances. Often, when one hears the term "portability plan," it generally conjures up notions of a "simple" plan, such as creating "I love you Wills" (i.e., Wills that leave everything to the survivor) or holding all assets in joint names with the surviving spouse's right to completely own the asset. We advocate that a portability plan could be that simple, but in many, many cases, it will be much more. It could be, and in many cases, it should be, as sophisticated as a traditional plan (i.e., where multiple trusts are created upon the death of the first-to-die). Suffice it to say, portability-based plans do not eliminate the use of trusts, rather they take better advantage of trusts (in all aspects) and further enhances the tax benefits.

There are some who advocate the traditional Family trust approach should be maintained in planning, notwithstanding portability, because of a number of reasons. We advocate that one should take a balanced approach and examine the pros and the cons of the plans and see which may be better for you. We address this as follows:

1. Appreciation Factor:
  - a. On the One Hand: If a Family Trust is funded at the first death and shielded from estate tax, all subsequent appreciation is also shielded from estate tax upon the survivor's death. By comparison, if the surviving spouse relies on portability and there is any time gap between (i) the death of the first spouse and (ii) the time the surviving spouse subsequently uses the DSUE amount, any appreciation occurring in the time gap may not be shielded.
  - b. On the Other Hand: If the time gap is short (i.e., the surviving spouse makes a gift of the DSUE amount soon after the death of the first spouse-

to-die), then there will likely be little or no appreciation; thus, there is no real difference between plans. Or, if there is no or modest appreciation, there will also be no real difference.

## 2. Income Tax Basis Step Up

- a. On the one hand: With a traditional plan (where the Family Trust is funded upon the death of the first spouse), upon the death of the surviving spouse, the assets in the Family trust do not get a step up in basis. Thus, if there has been appreciation between the deaths of the spouses, then there is a “built-in” income tax liability associated with the assets which will be due on the appreciation when they are sold.
- b. On the other hand. With a portability plan, the assets that pass in trust or otherwise to the surviving spouse will get a step up in basis upon the death of the surviving spouse. Thus, if there has been appreciation, since the assets are stepped-up at the second spouse’s death, there will be no income tax liability.

## 3. Wasting of GST Exemption:

- a. On the One Hand: A Family Trust funded at the first death and shielded from estate tax can also be shielded with the first-to-die’s GST exemption, shielding that trust from estate tax for multiple generations. By contrast, if you leave assets to the surviving spouse outright, relying on portability, the GST exemption would be wasted.
- b. On the Other Hand: While a simple portability plan may cause the loss of the GST exemption, a portability plan that incorporates the use of trusts can be structured to take advantage of portability and to avoid the loss of the GST exemption. For instance, the portability plan could incorporate a GST Exempt QTIP trusts, where the first spouse-to-die’s GST exemption can be allocated to a GST Exempt QTIP trust, and thus avoid most, if not all of the wasting, while taking advantage of portability.

## 4. Asset Protection:

- a. On the One Hand: A Family Trust funded at the first death and shielded from estate tax can include the surviving spouse as a discretionary

beneficiary and protect the trust’s assets from creditors of the surviving spouse. By contrast the assets protection may not be available if one uses a simple portability plan, such as using I love you Wills or holding assets in joint names with rights of survivorship. The reason is that the assets will not be in a trust to protect them from creditors.

- b. On the Other Hand: Portability planning does not necessarily mean simple planning, rather one could structure the portability plan to use trusts, where one creates a marital trust that allow for the DSUE amount to be ported to the survivor, and still hold assts in a trust. The assets held in the marital trust could provide the same protection as assets held in a traditional plan’s Family Trust.

## 5. State death Taxes

- a. On the One Hand: Portability addresses only the federal gift and estate tax. Many states have state estate taxes, and there is no portability provision at the state level. Therefore, relying on portability to avoid wasting the federal exclusion might cause you to waste the state-level exclusion, in which case relying on portability might not be the most prudent approach.
- b. On the Other Hand: Yes, to date no state with a state death tax has adopted a state portability provision, but that does not necessarily mean that portability yields inferior results from a state death tax perspective. In fact, portability could do quite the opposite; portability can save you more in state death taxes. For instance, one could structure the plan so that assets are left in a marital trust for the surviving spouse, and the surviving spouse could make a gift into another trust for descendants (which would use the ported federal exemption) and which would avoid state gift and death taxes. With the exception of one state, Connecticut, which has a gift tax, this plan could literally save most of the state death taxes that would have been associated with the first spouse’s passing. In some cases, that could be hundreds of thousands of dollars. Thus, with proper portability planning, better state death tax results could be accomplished.

## 6. Grantor Trusts in Planning

- a. On the One Hand. With traditional plans, the trusts that are created after death (i.e., the Family Trust) is what is called a “non-grantor” trust for income tax purposes. What this means is that either the beneficiary or the trust pays the income tax on the income generated by the trust. Thus, assets grow subject to the income tax.
- b. On the Other Hand. With a portability plan, it is possible to structure an estate plan so that you take advantage of portability at the death of the first spouse, and the survivor uses a portion of (or all of) the ported exclusion amount to create a “grantor trust” for the benefit of the descendants. The benefit of a grantor trust is that the survivor (and not the trust or the beneficiaries) would be liable for the income taxes of the trust. The result of this is that the assets grow income tax free to the beneficiaries during the grantors lifetime. Thus, when comparing assets that pass to the descendants, it is generally preferably to have assets grow on an income tax free basis. Understand, that when the trust is created, the surviving spouse would likely have to give up the control of the assets and taking advantage of the benefits (i.e., receiving income or principal) of the

assets that are in the trust. Thus, this must be considered when utilizing this type of plan.

To summarize, portability may be beneficial for some, and not for others. What is important is to have your estate planner evaluate whether portability yields a better result. This can only be done by examining your personal circumstances and needs to see what type of estate plan would yield the better result.

### CONCLUSION

Portability's intricacies have changed the way estate planning should be approached today. With each person's estate plan being unique (estate size, composition and ownership of assets, client desires and the like), there is no one plan for all (there never has been). Rather, the estate plan should be tailored, more so than ever, to each individual situation, and in tailoring that plan, portability should no longer be viewed as a secondary estate planning tool. Portability should be considered a primary tool to be fully utilized in the planning stage.

If you would like to discuss how portability could possibly enhance your plan, please speak with your Wealth Strategist.

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Any examples are hypothetical and are for illustrative purposes only.

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Feb 2013 AR78EDF6