

Understanding Portability*

Portability- The Basics

The Tax Relief and Job Creation Act of 2010 amended section 2010(c) of the Internal Revenue Code to allow the estate of a decedent who is survived by a spouse to make a "portability election." A "portability election" allows the surviving spouse to apply the Deceased Spouse's Unused Exclusion (DSUE) amount to the surviving spouse's own transfers during life and at death. Portability was set to expire December 31, 2012. However, in January, 2013, the American Taxpayer Relief Act of 2012 ("ATRA") made the portability provisions permanent. On June 16, 2015 the IRS released final regulations.

The original portability requirements remain unchanged by the final regulations, which are as follows: 1) the decedent must be a U.S. citizen; 2) the DSUE amount portability election must be made on a timely filed 706 return within 9 months of the decedent's date of death, or when allowed, within 15 months using an automatic extension; 3) the estate tax return must be complete and property prepared; and 4) the unused exclusion amount may only be used from the "last deceased spouse."

The Amount of the Exemptions

For 2016, the lifetime gift, estate and Generation skipping transfer tax credit is \$5,450,000. The exemptions index up with inflation each year. The tax rate on transfer in excess of the applicable credit is 40%.

Portability Election

Portability is an ELECTION. It isn't an automatic "allocation." In order to elect portability, an executor must file a timely estate tax return, which is defined as 9 months after the date of decedent's death. The final regulations clarify that if an estate is required to file an estate tax return because the estate is over the federal estate tax threshold (\$5.45 million in 2016), an extension to elect portability under Regs. Sec. 301.9100-3 may not be granted because the due date for the return is governed by statute. However, if an estate is under the threshold, the IRS may grant an extension of time to elect portability.

Who is responsible for making the decision to file for portability?

The decedent's executor is responsible for deciding whether to make the portability election or not. If there is no appointed executor, "any person in actual or constructive possession" of any the decedent's property may file the estate tax return. If the elector chooses not to make an election, he or she can do so by either making an affirmative statement on the estate tax return or by not filing a timely estate tax return.

How do you make an election with assets qualifying for marital or charitable deduction?

A valid portability election is made on a complete and properly prepared estate tax return. For those wanting to take advantage of portability, but do not need to file an estate tax, a special rule applies for valuing assets that qualify for the marital or charitable deduction. If this rule is used, the executor is only required to report the description, ownership, and/or beneficiary of the property, along with information necessary to establish the right of the estate to the marital or charitable deduction of the property. By electing this option, the executor is responsible for estimating the total value of the gross estate based on the executor's good faith and due diligence in valuing the assets.

Importantly, this rule is not available if the value of the property is needed to determine the estate's eligibility for another estate or GST tax provision where the value of the property must be known.

How do we determine the DSUE Amount?

The value of the DSUE amount is critical for portability, as it determines what amount can be claimed by a surviving spouse. Calculating the DSUE amount starts by using the basic exemption in the year of the decedent's death. Next, if the decedent paid gift tax on taxable gifts because the taxable gifts exceeded the applicable exemption amount at the time of the gift, then these gifts are exempted from adjusted taxable gifts for the purposes of computing the decedent's DSUE amount. This adjustment is necessary so that the decedent's exemption amount is not used for amounts on which gift tax was paid.

The final regulations state that the eligibility for the estate tax credit does not factor into the calculation of the DSUE amount. Rather, estate tax liability is calculated by first subtracting the applicable credit amount and then applying the credits under Secs. 2012 through 2015. Any unused credit is lost, so there is no need to adjust the computation of the DSUE amount to account for any unused credits.

The impact of the "last deceased spouse" provision

The surviving spouse can claim any unused exclusion amount that is left over from the death of the first spouse to die, but the decedent must still be the survivor's "last predeceased spouse" when use

is made of transferred amount. The last predeceased spouse is the most recent deceased individual who was married to the surviving spouse at the individual's death.

The final regulations state that, if the surviving spouse has more than one deceased spouse, an ordering rule is applied. First, count any gifts made by a surviving spouse using the DSUEA of the last deceased spouse, is determined by the date of each gift, before using up the surviving spouse's exemption amount. Next, the surviving spouse's DSUE amount becomes the DSUE of the last deceased spouse, plus any DSUE actually applied to the surviving spouse's taxable gifts to the extent the gift was from a decedent who is no longer the deceased spouse.

Importantly, the final regulations indicate that the IRS may scrutinize returns of every deceased spouse of the surviving spouse in order to adjust, or even eliminate the DSUE amount, irrespective of any statute of limitations. Importantly, this expanded scrutiny only applies to adjusting the DSUE amount, and does not toll the limitation period for any prior estate tax returns.

How does portability work with noncitizen spouses and Qualified Domestic Trusts?

Qualified Domestic Trust ("QDOTs") are particularly interesting when it comes to portability. Specifically, where a non-citizen spousal beneficiary of a QDOT later becomes a United States citizen. Prior to the final regulations, a U.S. citizen decedent could pass his or her DSUE amount to a non-U.S. citizen surviving spouse, as long as it is left in a QDOT. However, there would be no portability of the DSUE amount to the surviving spouse until the assets of the QDOT are fully subject to estate tax (e.g. when the surviving spouse dies). At the surviving spouse's death, the predeceased spouse's DSUE amount would then be reported on the surviving spouse's estate tax return.

The final regulations allow a surviving spouse who becomes a U.S. citizen after the decedent spouse passes away to use the DSUE amount of the deceased spouse. The surviving spouse can use the DSUE amount as of the date of death he or she becomes a U.S. citizen as long as the estate of the deceased spouse elected portability. This is helpful as no additional steps are necessary other than the proper and timely filing of an estate tax return.

Is there a short form return if we're just filing for portability?

No. The IRS rejected the idea of a short form estate tax return to be used only to elect portability when an estate tax return is not otherwise required. The reasoning given by the IRS for this decision was that use of short and abbreviated forms creates accuracy and administrative problems.

The Continuing Case for a Bypass Trust

Portability has made the transfer tax side of estate planning much easier. Many times a client will ask if there is still any reason for a Bypass Trust. The answer is YES. The following are just a few situations where a Bypass Trust is absolutely advisable.

- 1) Creditor Protection- An outright gift of property to the surviving spouse provides virtually no protection
- 2) Blended Family. If there is no bypass trust, there is no "legacy protection" to ensure that the surviving spouse ultimately disposes of the property in a manner consistent with the decedent's objective.
- 3) Protection from subsequent unsuccessful relationship protection is needed to ensure they are not alienated from the trust assets.
- 4) A Bypass trust provides better protection for beneficiaries than general power of appointment marital deduction trust because the surviving spouse must have the right to receive all income and potentially distributions of principal.

In Summary

With clarity on these issues the IRS has created a clearer map for practitioners to navigate what has felt like a portability minefield. We now have direction on the timeline for filing for portability, who is responsible, how to determine the DSUE amount, and how remarriage may affect portability. All vital pieces of information when planning with clients to use portability.

There are still some unknowns that went unaddressed in these regulations. For example, the IRS provided no guidance on whether a QTIP election is valid when electing portability, particularly when an estate does not exceed the estate tax exemption. Some say that there is no need for clarification on this point because with portability, an executor may choose to make a QTIP election solely to preserve a decedent's exclusion amount to use it in the future. But absent clarity from the Service, the question may remain.

*Excerpts from Articles by Jeremiah H. Barlow, J.D and Matthew T. McClintock J.D.