Portability of the Deceased Spousal Unused Exclusion Amount under the Tax Relief Act of 2010

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February 7, 2011

I. Introduction

After much speculation and anticipation, portability has finally arrived. The new portability rules are intricate, uncertain, and replete with traps for the unwary.

The purpose of portability, of course, is to permit a decedent's estate or a donor to take advantage of the unused applicable exclusion amount of a decedent's or donor's previously deceased spouse. The stated policy behind portability is to prevent families from incurring estate tax that could have been avoided through sophisticated planning prior to the death of the first spouse to die.[1]

While portability of a deceased spouse's unused exemption amount may negate the need for more sophisticated trust planning for some clients, especially if the provisions are made permanent, there remain ample tax and non-tax reasons to use credit-shelter and similar trusts.

II. Background

A. Portability is a new concept in the Internal Revenue Code (IRC).

B. The portability provisions are included in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, enacted on December 17, 2010, in Title III, Section 301 et seq.

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[1] Although it is somewhat unclear whether portability applies to gifts by a surviving spouse, it appears that it is intended to apply to lifetime gifts. See section V. B. below.

C. Shorter title is the Taxpayer Relief Act of 2010 (TRA 2010).

III. Basic Transfer Tax Rules Under TRA 2010

A. Beginning on January 1, 2011, the federal Estate, Gift and Generation-Skipping Transfer tax exemption amounts are each $5,000,000.

B. The Gift and Estate taxes are reunified and are also now unified with the Generation-Skipping Transfer tax.

C. Maximum transfer tax rate is 35%.

IV. New Terms of TRA 2010

Portability requires the use of new terms and a formal definition of a previously understood but undefined term.

A. *Applicable Exclusion Amount*

The Applicable Exclusion Amount *(for Purposes of Portability)* is the sum of:

(1) The Basic Exclusion Amount, *and*

(2) the Deceased Spousal Unused Exclusion Amount.

TRA 2010 Title III, Section 303(a)(2).

B. *Basic Exclusion Amount*

The Basic Exclusion Amount is $5,000,000. Section 303(a)(3)(A).

The Basic Exclusion Amount is increased for inflation (in increments of $10,000) from 2010 beginning in 2012. Section 303(a)(3)(B).

C. *Deceased Spousal Unused Exclusion Amount (DSUEA)*

The DSUEA is the *lesser of*:

(1) the Basic Exclusion Amount, and

(2) the excess of (a) the Basic Exclusion Amount of the last deceased spouse of the surviving spouse, over (b) the amount with respect to which the tentative tax is determined under Section 2001(b)(1) on the estate of the deceased spouse.

Section 303(a)(4).

In other words, the DSUEA is the amount of the taxpayer's most recently deceased spouse's Basic Exclusion Amount not used by that spouse.

Note that notwithstanding the statute of limitations on assessing estate or gift taxes for the predeceased spouse, the IRS may examine the estate tax return of the predeceased spouse at any time to determine the DSUEA available for use by the surviving spouse. Section 303(a)(5)(B).

V. <u>How Portability Works</u>

A. Estate Tax

When a spouse dies his or her unused Applicable Exclusion Amount may be used by a surviving spouse when the executor of the deceased spouse's estate so elects on a timely filed estate tax return.[2] Thereafter, when the surviving spouse dies her Applicable Exclusion Amount is determined by adding her Basic Exclusion Amount to her inherited DSUEA.

- <u>Example 1</u>: Husband 1 dies in 2011, having made taxable transfers of $3 million and having no taxable estate. An election is made on Husband 1's estate tax return to permit Wife to use Husband 1's deceased spousal unused exclusion amount. As of Husband 1's death, Wife has made no taxable gifts. Thereafter, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1).

Remarriage by a Surviving Spouse.

If a surviving spouse, who has inherited the applicable exclusion amount of the predeceased spouse (the DSUEA), remarries and that spouse dies, what is her applicable exclusion amount?

- <u>Example 2</u>: Assume the same facts as in Example 1, except that Wife subsequently marries Husband 2. Husband 2 also predeceases Wife, having made $4 million in taxable transfers and having no taxable estate. An election is made on Husband 2's estate tax return to permit Wife to use Husband 2's deceased spousal unused

[2] This means that taxpayers whose estates would normally not file estate tax returns, because the gross estate was within the applicable exclusion amount will now have to file a return.

exclusion amount. Although the combined amount of unused exclusion of Husband 1 and Husband 2 is $3 million, only Husband 2's $1 million unused exclusion is available for use by Wife, because the deceased spousal unused exclusion amount is limited to the lesser of the basic exclusion amount ($5 million) or the unused exclusion of the last deceased spouse of the surviving spouse (Husband 2's $1 million unused exclusion). Thereafter, Wife's applicable exclusion amount is $6 million (her own $5 million basic exclusion amount plus $1 million deceased spousal unused exclusion amount from Husband 2), which she may use for lifetime gifts or for transfers at death.

Thus, *only the most recent deceased spouse's unused exemption may be used* by the surviving spouse. It appears from an explanation in the Joint Committee Report that this requirement applies even if the last deceased spouse had no unused exclusion and even if no election was made upon the last deceased spouse's death.

If a surviving spouse, who has inherited the DSUEA of a predeceased spouse, remarries and then predeceases the second spouse, what is the applicable exclusion amount of the second spouse?

- Example 3: Assume the same facts as in Examples 1 & 2, except that Wife predeceases Husband 2. Following Husband 1's death, Wife's applicable exclusion amount is $7 million. Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million. Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife.

  The statute does not seem to support the conclusion reached in Example 3.

- Consider adding language to wills or trusts directing that the fiduciaries are required to file an estate tax return for the first to die spouse if so requested by the surviving spouse.

- The election, once made, is irrevocable.

B. Gift Tax

Some commentators have posited that the new Act's provisions for portability do not expressly provide for the use of the DSUEA by the surviving spouse for lifetime gifts. Given the reunification of the estate and gift tax exclusion amounts and the overall statutory scheme, it appears likely that the intention is to permit such use. In addition, the Joint Committee on Taxation Report specifically states that the surviving spouse may use her DSUEA "for lifetime gifts or for transfers at death." See Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (JCX-55-10), at page 52.

Finally, most commentators seem to have concluded that portability does, in fact, apply to lifetime gifts.

C. Generation-Skipping Transfer Tax

The Generation-Skipping Transfer Tax exemption is <u>not</u> portable.

D. DSUEA is available only from and to decedents who are U.S. Citizen or U.S. Resident spouses.

E. There are no minimum term of marriage or anti-manipulation provisions in the statute restricting use of portability.

VI. <u>Interaction with Connecticut Estate Tax</u>

The Connecticut estate tax exemption, currently $3.5 million, is not portable.

VII. <u>Open Issues</u>

A. Is DSUEA applicable to gifts made by a surviving spouse? This seems to be the case.

B. Joint Committee Report Example 3 seems to imply that a spouse may use his or her spouse's DSUEA from a prior marriage, which is inconsistent with the statute. Is this correct?

C. Will Treasury create a new "short-form" 706 to elect portability?

D. Will portability be made permanent?

Treasury has indicated that guidance has been made a priority and should be issued soon.

VIII. <u>Effective Dates</u>

The new rules providing for portability described above are generally effective for decedents dying (and gifts made) after December 31, 2010 and they sunset for decedents dying (and gifts made) after December 31, 2012. Section 303(c)(1).

Thus, under TRA 2010 portability applies in 2011 and 2012 <u>only</u>.

IX. When Not to Rely on Portability Upon the First Spouse's Death

If married clients who are reasonably expected to die with combined estates of less than $10 million can avoid estate tax with only simple wills, what's left for us, sophisticated estate planners, to do?

Not to worry, there remain many tax, economic and other reasons to avoid portability and to use credit-shelter trusts, including the following:

1. Although the Basic Exclusion Amount will increase with inflation beginning in 2012, in increments of $10,000, the DSUEA will not be indexed for inflation.

2. Appreciation after death of the first to die spouse does not escape estate tax without the use of a credit-shelter trust.

- This is a significant limitation of portability, and alone a compelling reason to continue utilizing credit-shelter trusts, as they will shield all future asset appreciation.

3. The Generation-Skipping Transfer Tax exemption is not portable.

4. State estate taxes are not portable.

5. Creditor protection is not available without use of trusts.

6. Avoids the filing of an estate tax return for gross estates with values under the exclusion amount.

7. Uncertainty as to whether portability will be made permanent.

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