



WRMarketplace

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Portability 101 – How it Works and When it Makes Sense.

MARKET TREND: With portability now a permanent fixture, more clients are interested in the perceived simplicity it offers.

SYNOPSIS: The ability to transfer an unused estate tax exclusion from one spouse to another provides additional planning options for many clients. Although intended to simplify the use of the estate tax exclusion for married couples by eliminating the need for a bypass trust and the division of assets between spouses, a complex set of rules must be followed, like filing a federal estate tax return even when one would not otherwise be required. Even determining whether a portability election should be used requires an analysis of both tax and non-tax factors and, if used, requires both lifetime and postmortem planning.

TAKE-AWAY: Although portability was intended to simplify estate planning for taxpayers, it really added a level of complexity and uncertainty. Portability also is not a complete substitute for traditional estate planning using bypass trusts and asset segregation. Barring state estate tax considerations, for many clients, the benefits offered by traditional bypass and marital deduction trusts (such as creditor protection, GST tax planning) can still outweigh any perceived benefits offered by portability.

PRIOR REPORTS: *12-30, 11-101, 11-44, 10-135.*

MAJOR REFERENCES: [*Internal Revenue Code \(“Code”\) §§ 2010\(c\) and 2505\(a\); TD 9593, 06/15/2012; Regs. § 20.2001-2T; § 20.2010-1T, -2T, and -3T; and § 25.2505-1T and -2T.*](#)

Before 2011, traditional estate planning for married couples involved creating a so-called “bypass trust” (or “credit shelter trust”) to hold a deceased spouse’s remaining estate tax exclusion, which prevented those assets from being taxed again in the surviving spouse’s estate. If the deceased spouse’s estate did not fully use the exclusion, the unused amount was lost. For decedents dying on or after January 1, 2011, however, the introduction of exclusion “portability” between spouses has changed the playing field for married couples and provided more options for preserving the deceased spouse’s unused estate tax exclusion.

WHAT IS PORTABILITY?

“**Portability**” refers to the ability to transfer the deceased spouse’s unused exclusion (“**DSUE**”) to the surviving spouse. Subject to the rules discussed below, with portability, the surviving spouse can add the DSUE to his or her own basic estate tax exclusion and can use the additional exclusion to make lifetime gifts or apply it against his or her estate at death.¹

HOW IS THE DSUE CALCULATED?

Basic Calculation. The DSUE is the lesser of (1) the deceased spouse’s basic estate tax exclusion in his or her year of death (e.g., \$5.43 million in 2015), or (2) the deceased spouse’s applicable exclusion amount, reduced by the deceased spouse’s taxable estate and prior adjusted taxable gifts.²

Example: H and W are married.³ H’s only lifetime gift is a \$1 million taxable gift to his son in 2012. H dies in 2015, when the basic exclusion amount is \$5.43 million. H leaves another \$2 million to his son and his remaining estate to W. H’s DSUE is \$2.43 million (H’s \$5.43 million applicable exclusion amount - \$1 million gift - \$2 million estate left to son).

Lifetime Gifts Incurring Gift Tax. A special rule applies to the calculation of the DSUE when the deceased spouse has made lifetime gifts for which gift tax was paid. In such cases, for purposes of calculating the DSUE, adjusted taxable gifts are reduced by the amount of lifetime gifts on which gift taxes were actually paid.⁴

Example: H and W are married. H’s only lifetime gift is a \$1.5 million taxable gift to his son in 2002, when the gift tax exemption was \$1 million. H paid gift taxes on the \$500,000 that exceeded the exemption. H dies in 2015, when the basic exclusion amount is \$5.43 million, and leaves his remaining estate to W. H’s DSUE is \$4.43 million (H’s \$5.43 million applicable exclusion amount - \$1 million (calculated as H’s \$1.5 million lifetime gift - \$500,000 on which H paid gift taxes)).

Surviving Spouse is U.S. Resident but Not U.S. Citizen. The calculation of the DSUE also is adjusted when property passes from a deceased spouse to a qualified domestic trust (“**QDOT**”) benefiting a non-U.S. citizen spouse. In such cases, the initial DSUE is calculated as discussed above, but is then recalculated upon distribution of the QDOT property (generally at the surviving spouse’s death) to include the value of the QDOT at that time.⁵

Example: Assume H, a U.S. citizen, makes no lifetime gifts and dies in 2014 with a \$4 million estate and when the basic exclusion amount is \$5.34 million. H’s wife, W, is a U.S. resident but not a U.S. citizen. H bequeaths \$2 million to a QDOT for W’s benefit and the balance of his estate to W outright. Since W is not a U.S. citizen, H’s estate is allowed a marital deduction for only the \$2 million held in the QDOT, leaving a taxable estate of \$2 million. H’s initial DSUE is \$3.34 million (H’s \$5.34 million applicable exclusion amount – H’s \$2 million taxable estate).

No taxable distributions are made from the QDOT during W’s lifetime. W dies in 2015. At W’s death, the QDOT’s value is \$2.5 million. H’s DSUE is recalculated to account for the QDOT property, which reduces H’s DSUE to \$840,000 (H’s

\$5.34 million applicable exclusion amount - \$4.5 million (calculated as H's \$2 million taxable estate plus the \$2.5 million QDOT)).

Deceased Spouse or Surviving Spouse Not U.S. Resident or Citizen. Special rules also apply if the deceased spouse or the surviving spouse is neither a resident nor citizen of the U.S. (a "NCNR"). A portability election cannot be made for a deceased spouse who is a NCNR at death.⁶ Further, if a surviving spouse is a NCNR at death, his or her estate may not take into account the DSUE of any deceased spouse except to the extent allowed under a U.S. treaty.⁷

- **Note:** In cases where either spouse is a NCNR or a non-citizen U.S. resident, life insurance can play a vital role in replacing assets that are used to pay estate taxes or to supplement assets that otherwise pass to the surviving spouse, either outright or in trust.

THE PORTABILITY ELECTION

Portability is only available to married couples and only if the deceased spouse dies on or after January 1, 2011. To transfer the DSUE to a surviving spouse, the executor of the deceased spouse's estate must make a portability election.⁸ The requirements for making the election (or opting out of the election) must be carefully observed.

Timely Filed Estate Tax Return. The portability election is made by timely filing an estate tax return for the deceased spouse's estate (including extensions).⁹ Thus, every estate electing portability must file an estate tax return, even if the estate would not otherwise be required to file because its value is less than the filing threshold.

- *Election Irrevocable.* The election becomes irrevocable after the return's due date (plus extensions) but can be revoked by the executor before that date.
- *Opting Out.* If an estate must otherwise file an estate tax return (e.g., because the value of the estate meets the filing threshold) but does not wish to make the portability election, the executor must make an affirmative statement that the estate is not electing portability. Smaller estates may opt out by not filing a timely estate tax return.

Election Made by the Executor. The election must be made by the executor of the deceased spouse's estate, or if no executor is appointed, qualified, and acting within the U.S., then by any person in actual or constructive possession of any property of the decedent.¹⁰

Properly Prepared and Complete Return. The estate tax return must be complete and properly prepared,¹¹ which typically requires valuation of all property held by the decedent as of the date of death. For smaller estates, this requirement may impose a significant burden and expense. To help alleviate this burden, a special rule allows executors of smaller estates to avoid reporting specific values for certain marital or charitable deduction property.¹² Instead, the executor may make a good faith estimate of the total value of such property on the estate tax return.

Limitations on this special rule, however, impact its utility for smaller estates in many common planning situations. The rule does not apply to property passing to beneficiaries other than the surviving spouse or charity. It also does not apply if: (1) the value of the property relates to, affects, or is needed to determine, the value passing from the decedent to another recipient (e.g., property bequeathed 50% to spouse and 50% to child); (2) only part of the property qualifies for the marital or charitable deduction, or (3) a partial disclaimer or partial QTIP election is made. In such cases, all regular estate tax return requirements, including valuations, will apply.

Return Must Compute DSUE Amount. The estate tax return must include a computation of the amount of the DSUE.¹³

SURVIVING SPOUSE'S USE OF DSUE

If the deceased spouse's estate makes the portability election, the DSUE is added to the surviving spouse's basic exclusion amount, creating a new applicable exclusion amount for the survivor effective as of the deceased spouse's death.¹⁴

Example: H and W are married and have made no lifetime gifts. H dies in 2015, leaving his entire estate to W. H's executor elects portability, calculating H's DSUE as \$5.43 million. W's applicable exclusion amount for 2015 is \$10.86 million (H's DSUE amount of \$5.43 million plus W's basic exclusion amount of \$5.43 million).

Subject to the rules set out below, the surviving spouse may use the new applicable exclusion amount for lifetime gifts or apply the amount to his or her estate at death.

Last Deceased Spouse Rule. Portability is allowed only with respect to the survivor's last deceased spouse.¹⁵ If the surviving spouse remarries, he or she will lose the unused DSUE of the first deceased spouse if the new spouse dies first, regardless of whether the new spouse's estate makes a portability election.

Example: H1 and W are in their first marriage and have not made any gifts. H1 dies in 2014 and leaves his entire estate to W. H1's executor elects portability, calculating H1's DSUE as \$5.34 million. W's applicable exclusion amount in 2015 is \$10.77 million (H1's DSUE of \$5.34 million plus W's basic exclusion amount of \$5.43 million). In January 2015, W marries H2. Neither H2 nor W makes any gifts. H2 dies in November 2015, leaving a taxable estate of \$10 million. H2's estate does not elect portability. Because H2 is now W's last deceased spouse, W has lost H1's DSUE, and her applicable exclusion amount is again \$5.43 million.

Variation if H2 Survives W: Same facts as above, but assume W dies in 2015 before H2. Now, H1 is still W's last deceased spouse, so W's applicable exclusion amount at her death remains \$10.77 million (calculated as above). Further, if W does not use all her applicable exclusion amount, the balance (up to W's basic exclusion amount of \$5.43 million) is portable to H2.

Rules Regarding Multiple Marriages. A surviving spouse may only use the DSUE of his or her last deceased spouse, which is determined on the date of a taxable gift or the surviving spouse's death.¹⁶ A spouse who has survived multiple spouses may use the DSUE of the "first" last deceased spouse before the death of the next spouse, but not after. Further, when a surviving spouse makes a taxable gift, the DSUE of the last deceased spouse will apply before the surviving spouse's own basic exclusion amount. Thus, a surviving spouse with multiple predeceased spouses could take advantage of multiple DSUEs by making lifetime gifts that use up the last deceased spouse's DSUE before the death of the "new" spouse.¹⁷

Rule Regarding Marriages Ending in Divorce or Annulment. If the surviving spouse remarries and the marriage ends in divorce or an annulment, the subsequent death of the divorced spouse

does not end the status of the prior deceased spouse as the last deceased spouse - the divorced spouse is not married to the surviving spouse at death and so is not the last deceased spouse.¹⁸

Authority to Examine Returns of Deceased Spouses. The IRS may examine the estate tax return of each deceased spouse whose DSUE has been or is being claimed (whether for lifetime gifts or at the survivor's death). While the IRS cannot impose additional tax assessments on the predeceased spouse's estate if the period of limitations has expired for the return, it can adjust or even eliminate the reported DSUE.¹⁹ This ability to look back creates a level of uncertainty that must be considered when using portability.

WHEN SHOULD PORTABILITY BE USED?

The portability election is available only when the client's taxable estate is less than the basic exclusion amount. This could potentially occur in two situations:

1. The value of the client's estate is less than the basic exclusion amount (i.e., \$5.43 million in 2015); or
2. The value of the client's estate exceeds the basic exclusion amount but part or all of the assets pass to the surviving spouse or to charity and qualify for the marital or charitable deductions, reducing the taxable estate to less than the basic exclusion amount.

For many clients the creation of a bypass or other type of trust on the death of the first spouse will make more sense than relying on portability. Both tax and non-tax factors, such as those listed below, should be carefully considered.

- *The value and type of assets owned and the potential for growth.* A bypass trust can protect such growth from imposition of estate tax on the survivor's death.
- *Importance of creditor protection for the surviving spouse.* Assets that pass outright to the surviving spouse will not be protected from his or her creditors, while assets held in a properly structured bypass or marital deduction trust can provide a level of asset protection for the surviving spouse.
- *Whether the client wishes to create a dynasty trust for the benefit of descendants.* Portability does not apply to the generation-skipping transfer ("GST") tax exemption and, if elected, could result in the loss of the deceased spouse's unused GST tax exemption. If the client intends to create a dynasty trust, using a bypass trust (or perhaps a GST exempt marital trust) can preserve the GST tax exemption.
- *Importance of receiving another step-up in basis on surviving spouse's death.* If the client elects to use portability and gives his or her assets to the surviving spouse at death, the assets will receive a second stepped-up basis, while assets in a bypass trust will not.
- *Likelihood surviving spouse will remarry.* If the surviving spouse remarries, the DSUE can be lost.
- *Desire to control distribution of assets at surviving spouse's death.* A bypass trust ensures disposition of exempt assets in the manner desired by the deceased spouse.

- *Whether the client's spouse is a U.S. citizen.* As discussed above, special portability rules apply if the surviving spouse is not a U.S. citizen or is a NCNR.
- *Difference in the value of the client's and spouse's estates.* Portability may work well if there is a significant difference in the value of the spouses' estates.
- *Application of separate state estate tax.* For states imposing a separate estate tax, portability generally is not available for state estate tax exemptions. If the client lives in such a state, the state estate tax exemption can be lost if assets pass outright to the surviving spouse or state estate taxes may be assessed if the bypass trust is fully funded.
- *Ability of surviving spouse to manage assets after client's death.* If the client's spouse is elderly or ill, a trust can provide ongoing asset management.
- *Estate primarily comprised of retirement plan benefits that should pass outright to the surviving spouse.* If the client's estate consists primarily of an IRA or other retirement plans, the client can designate the spouse as the beneficiary and elect portability for his or her DSUE. The portability election allows the client to benefit from income tax rules associated with stretching out distributions over the surviving spouse's lifetime. It also preserves his or her estate tax basic exclusion amount without the complexities and income tax disadvantages associated with naming a bypass or marital deduction trust as the beneficiary.

Please find attached as an Appendix a table that compares the portability election against the use of a bypass trust.

TAKE-AWAYS

- *Although portability was intended to simplify estate planning for taxpayers, it really added a level of complexity and uncertainty.*
- *Portability also is not a complete substitute for traditional estate planning using bypass trusts and asset segregation.*
- *Barring state estate tax considerations, for many clients, the benefits offered by traditional bypass and marital deductions trusts (such as creditor protection, GST tax planning) can still outweigh any perceived benefits offered by portability.*

APPENDIX A

Portability Election vs. Use of Bypass Trust

Consideration	Portability	Bypass Trust
Use of GST Tax Exemption	No (GST tax exemption not portable)	Yes
Basis Step-Up On Death of Each Spouse	Yes	No (Only on deceased spouse's death)
Asset Protection	No	Yes
Estate Tax on Growth After Deceased Spouse's Death	Yes	No
Surviving Spouse Can Control/Redirect Assets to Others	Yes	No
Expense of Ongoing Trust Maintenance	No	Yes
Tax on Income Accumulations	No (Income taxed to surviving spouse)	Yes
Estate Tax Return Filed	Yes	Maybe (Only if deceased spouse's estate exceeds his/her remaining exclusion)
Use of State Estate Tax Exemption	No (Portability generally not available for state estate tax exemptions)	Yes

NOTES

¹ See Code § 2010(c).

² Code § 2010(c)(4); Treas. Regs. § 20.2010-1T(d)(4).

³ For purposes of the examples in this report, assume each spouse is a U.S. citizen and amounts left to the surviving spouse qualify for the federal estate tax marital deduction, unless otherwise specified.

⁴ Treas. Regs. § 20.2010-2T(c)(2). See also Treas. Regs. § 20.2010-2T(c)(5), Example 2.

⁵ Treas. Regs. § 20.2010-2T(c)(4). See also Treas. Regs. § 20.2010-2T(c)(5), Example 3.

⁶ Treas. Regs. § 20.2010-2T(a)(5).

⁷ Treas. Regs. §§ 20.2010-3T(e) and 25.2505-2T(f).

⁸ Code § 2010(c)(5)(A).

⁹ Treas. Regs. § 20.2010-2T(a)(1).

¹⁰ Treas. Regs. § 20.2010-2T(a)(6)(i)-(ii).

¹¹ Treas. Regs. § 20.2010-2T(a)(7).

¹² Treas. Regs. § 20.2010-2T(a)(7)(ii).

¹³ Treas. Regs. § 20.2010-2T(b).

¹⁴ Treas. Regs. §§ 20.2010-3T(c) and 25.2505-2T(d).

¹⁵ Treas. Regs. §§ 20.2010-3T(a) and 25.2505-2T(a).

¹⁶ Treas. Regs. §§ 20.2010-3T(b) and 25.2505-2T(c).

¹⁷ As an example of this rule, assume H1 and W are in their first marriage and have not made any gifts. H dies in 2014 and leaves his entire estate to W. H1's executor elects portability, calculating H1's DSUE as \$5.34 million. W's applicable exclusion amount as of 2014 is \$10.68 million (H1's DSUE of \$5.34 million plus W's basic exclusion amount of \$5.34 million). In June 2014, W marries H2 and they make no gifts. In November 2014, W transfers \$5.34 million to a dynasty trust for the benefit of her descendants. Under the portability rules, H1's DSUE

is applied to the gift first, leaving W with her basic exclusion amount intact. H2 dies in October 2015, leaving his entire estate to W. H2's executor elects portability, calculating H2's DSUE as \$5.43 million. Following H2's death, W will effectively have an applicable exclusion amount in 2015 of \$16.2 million (H1's DSUE amount of \$5.34 million that was applied to the 2014 gift, plus H2's DSUE (W's last deceased spouse) of \$5.43 million plus W's basic exclusion amount of \$5.43 million).

¹⁸ Treas. Regs. § 20.2010-3T(a)(3).

¹⁹ Treas. Regs. §§ 20.2010-3T(d) and 25.2505-2T(e).

DISCLAIMER

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