



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 of Estate and Gift Tax Exclusion - Final Regulations Issued.

MARKET TREND: The Treasury Department and the IRS continue to clarify their portability regulations by issuing final regulations.

SYNOPSIS: Portability allows a deceased spouse's unused estate tax exclusion ("DSUE") amount to be transferred to his or her surviving spouse, enabling the survivor to apply the DSUE amount against lifetime gifts or the survivor's estate at death. The Treasury Department and the IRS have issued final regulations concerning spousal portability which lay out a complex set of rules and procedures that must be followed in order to elect portability and which govern the use of the DSUE amount by the surviving spouse. The final regulations adopt the temporary regulations issued in 2012 with relatively few changes, but leave a number of issues still open for future guidance. The final regulations are effective for decedents dying on or after June 12, 2015 – estates of decedents dying prior to that date must still comply with the temporary regulations.

TAKE-AWAY: Although intended to be uncomplicated, portability adds a new layer of complexity and clients should review their estate plans to comport with the new regulations. For most clients, portability will not be an adequate substitute for the benefits offered by traditional bypass and marital deduction trusts (such as creditor protection, GST tax planning and applicable estate tax treatment). Life insurance may be used to capture the decedent's unused estate tax exemption, rather than relying on portability.

PRIOR REPORTS: 15-18; 12-30; 11-101; 11-44; 10-135.

MAJOR REFERENCES: *Internal Revenue Code* ("Code") §§ 2010(c) and 2505(a); TD 9725, 06/29/2015; Regs. § 20.2001-2; § 20.2010-1, -2, and -3; and § 25.2505-1 and -2.

On June 12, 2015, the Treasury Department and IRS issued final regulations concerning portability of a spouse's unused estate and gift tax exclusion. While the final regulations provide some additional guidance, they largely adopt the temporary regulations issued in 2012¹ (the "temporary regulations") with few changes. The temporary regulations and use of the DSUE amount by the surviving spouse were recently discussed in AALU's *WRMarketplace* 15-18 ("WRM 15-18"). This report examines the principal changes made by the final regulations and the additional guidance they do and don't provide.

EXTENSION OF TIME TO ELECT PORTABILITY FOR SMALL ESTATES.

As noted in WRM 15-18, a portability election is effective only if made on an estate tax return filed by the executor of the decedent's estate within the time prescribed by law for filing such return.² Treas. Reg. § 301.9100-3 authorizes the IRS to grant an extension of time for making regulatory elections, such as a portability election for a small estate that is not otherwise required to file an estate tax return. The final regulations clarify that an extension of time to make the election may be allowed under Treas. Reg. § 301.9100-3 for small estates.³ The challenge, however, is that in order to obtain relief under Treas. Reg. § 301.9100-3, the estate must request a private letter ruling which can be an expensive proposition for a small estate (the filing fee alone is \$10,000). Relief under Treas. Reg. § 301.9100-3 is not available if the estate meets the value threshold and is otherwise required to file an estate tax return.

EFFECT OF PORTABILITY ELECTION WHERE DSUE AMOUNT IS UNCERTAIN.

The final regulations confirm that the portability election is made upon filing a complete and properly prepared estate tax return (unless the executor affirmatively elects out of portability). The final regulations reiterate that including a computation of the decedent's DSUE amount is an essential element of a complete and properly prepared return.

Comments received by the IRS regarding the temporary regulations point out that in some circumstances it may be difficult to calculate the DSUE amount (for example, where values are changed on audit or the return includes a protective claim for a refund with respect to a claim against the estate). In such circumstances, the final regulations provide that as long as the executor files a complete and properly prepared return (including a calculation of the DSUE amount, even if initially calculated to be zero) and does not elect out of portability, the computation requirement will be satisfied and any recalculated DSUE amount will be available to the surviving spouse.⁴

PERSONS PERMITTED TO MAKE THE ELECTION.

The final regulations continue the edict that the portability election is made by the appointed executor. The Treasury Department and the IRS declined to give the surviving spouse preferential status over an appointed executor. Accordingly, if a person other than the surviving spouse is appointed as the executor, the surviving spouse may not make the portability election even though he or she is directly impacted by that decision.

Like the temporary regulations, the final regulations provide that if there is no appointed executor, the election may be made by a "non-appointed executor" (that is, any person in actual or constructive possession of any property of the decedent, such as the surviving spouse). The final regulations also go a step further, however, by providing that if a portability election is made by a non-appointed executor, a subsequently appointed executor may make a later contrary election on an estate tax return filed on or before the due date of the return (including extensions).⁵

COMPLETE AND PROPERLY PREPARED ESTATE TAX RETURN.

As previously indicated, the portability election is made by timely filing a "complete and properly prepared" estate tax return for the decedent's estate. This typically requires listing and valuing all property held by the decedent as of the date of death. The final regulations do not elaborate on the circumstances under which a timely filed return may be considered deficient for

purposes of electing portability (for example, where the return includes errors or omits certain information). Rather, such determinations are to be made on a case-by-case basis.

The final regulations continue the special rule that allows executors of small estates to avoid reporting specific values for certain marital or charitable deduction property.⁶ Instead, the executor may make a good faith estimate of the value of such property on the estate tax return. The regulations also include specific circumstances under which the special rule does not apply, such as where only part of the property qualifies for the marital or charitable deduction, or where the value is needed to determine the value of assets passing to another recipient.

Example: H passes away in 2015. Upon his death, his estate is valued at approximately \$3 million. H made no lifetime taxable gifts. H's will provides that his entire estate is to be distributed to his wife, W. The property passing to W qualifies for the special exception to the general valuation rule and the executor of H's estate may make a good faith estimate of the value of the property passing to W.

Example: Same facts as above except that H's will provides that 50 percent of his estate is to be held in a marital trust for his wife, W, and the balance is to be held in a bypass trust for the benefit of W and their descendants. The amount passing to the bypass trust cannot be determined without determining the full value of the property in H's estate. The value of the property passing to the marital trust relates to the value of property passing to the bypass trust. Accordingly, the special rule for marital deduction property does not apply and all property included in H's estate must be valued.

The Treasury Department and the IRS declined requests to expand the special exceptions to the valuation requirement. Rather, the final regulations provide the IRS with flexibility to refine the exceptions to the special rule in future sub-regulatory guidance.

REJECTION OF SHORTER RETURN FOR SMALL ESTATES.

The Treasury Department and the IRS rejected suggestions by commentators to the temporary regulations that a shorter version of the estate tax return be made available for small estates that otherwise would not be required to file an estate tax return, citing problems encountered in the use of other abbreviated returns and administrative difficulties in administering such forms.

NON-CITIZEN SURVIVING SPOUSES.

Availability of DSUE Amount by Surviving Spouse Who Becomes a U.S. Citizen. The temporary regulations set out the general rule that a noncitizen, nonresident surviving spouse (or such spouse's estate) cannot use his or her last deceased spouse's DSUE amount. The final regulations modify this rule to provide that if the surviving spouse subsequently becomes a U.S. citizen, the surviving spouse may use the DSUE amount of his or her last deceased spouse beginning on the date he or she becomes a U.S. citizen provided the deceased spouse's executor made the portability election by timely filing a complete and properly prepared estate tax return for the decedent's estate and not opting out of portability.⁷

Special Rules for Qualified Domestic Trusts When the Surviving Spouse Becomes a U.S. Citizen. The final regulations continue the rule that if property passes to a qualified domestic trust ("QDOT") for the benefit of a non-citizen spouse, the DSUE amount cannot be finally

determined (and thus cannot be used) until final distribution (or other taxable event) of the QDOT. This generally occurs upon the death of the non-citizen spouse. The final regulations, however, create an exception to this rule if the surviving spouse becomes a U.S. citizen and either (i) the surviving spouse was a U.S. resident at all times after the death of the deceased spouse and before the surviving spouse becomes a U.S. citizen, or (ii) no estate tax was imposed with respect to any distribution from the QDOT to the surviving spouse prior to the surviving spouse becoming a U.S. citizen. In such circumstances, the deceased spouse's DSUE amount is no longer subject to adjustment and can be finally determined even though there are assets remaining in the QDOT. The DSUE amount becomes available to the surviving spouse on the date he or she becomes a U.S. citizen and may be used for lifetime taxable gifts or applied against his or her estate at death (subject to the last deceased spouse and other rules discussed in WRM 15-18).⁸ Any assets remaining in the QDOT on the surviving spouse's death will be included in his or her taxable estate much like a traditional marital deduction trust.

Example: H, a U.S. citizen, makes a \$500,000 taxable gift to his son in 2002. The applicable exclusion amount for that year is \$1,000,000 and no gift tax is due. H dies in 2015 with a gross estate of \$3,000,000. H's surviving spouse, W, is a resident of the U.S., but not a citizen. Under H's will, \$2,000,000 passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT. H's estate is allowed a marital deduction of \$2,000,000 for the value of that property. H's taxable estate is \$1,000,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be \$3,930,000. No taxable distributions are made from the QDOT to W during her lifetime.

W is a U.S. resident at all times after H's death and in 2016, W becomes a U.S. citizen. The trustee of the QDOT notifies the IRS that W has become a U.S. citizen by timely filing a final estate tax return for the QDOT. The estate tax ceases to apply to the QDOT property upon W becoming a U.S. citizen. Because H's DSUE amount is no longer subject to adjustment, H's DSUE amount is finally determined to be \$3,930,000 (as it was preliminarily determined as of H's death).

ORDER OF USE OF ESTATE TAX CREDITS.

The foreign death tax credit and other estate tax credits under Code §§ 2012 – 2015 generally can be used to reduce a decedent's taxable estate. The final regulations, however, clarify that a decedent's DSUE amount is calculated without factoring in such other credits.⁹

EFFECTIVE/APPLICABILITY DATE.

The final regulations apply only to estates of decedents dying on or after June 12, 2015. Advisors to estates of decedents dying on or after January 1, 2011 and before June 12, 2015 will still need to comply with the rules and procedures set out in the temporary regulations.

TAKE-AWAYS

- Although intended to be uncomplicated, portability adds a new layer of complexity.
- Clients should review their estate plans to comport with the new regulations. For most clients, portability will not be an adequate substitute for the benefits offered by traditional

bypass and marital deductions trusts (such as creditor protection, GST tax planning and applicable estate tax treatment).

- Life insurance may be used to capture the decedent's unused estate tax exemption, rather than relying on portability.

NOTES

¹ See, T.D. 9593, 77 FR 36150.

² Code § 2010(c)(5)(A).

³ Treas. Reg. § 20.2010-2(a)(1).

⁴ Treas. Reg. § 20.2010-2(b).

⁵ Treas. Reg. § 20.2010-2(a)(6).

⁶ Treas. Reg. § 20.2010-2(a)(7)(ii).

⁷ Treas. Regs. §§ 20.2010-3(c)(2), 25.2505-2(d)(2).

⁸ Treas. Regs. §§ 20.2010-3(c)(3), 25.2505-2(d)(3).

⁹ Treas. Reg. § 20.2010-2(c)(3).

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