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Tax Topics

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Final “portability” regs issued

On June 12, 2015, the IRS issued final regulations dealing with “portability,” shorthand for the surviving spouse’s ability to effectively “inherit” the deceased spouse’s unused exclusion against gift and estate tax. These regulations are very similar to the temporary ones they replaced; they clarify a few matters, and punt on several others. Before getting into details, some background may be helpful.

“Portability” basics. At the end of 2010, Congress retroactively reinstated the estate tax, which had expired at the beginning of that year. Congress also temporarily provided for a \$5 million “applicable exclusion amount” against gift and estate tax; as of 2011, that exclusion could be carried over from a deceased spouse to the surviving spouse (what’s known as “portability”). In late 2012, Congress made both the \$5 million applicable exclusion amount and portability permanent.

As of 2011, the applicable exclusion amount has two parts: the \$5 million “basic exclusion amount,” and for surviving spouses, if applicable, the “deceased spousal unused exclusion amount,” or DSUE. (If there is no DSUE, the applicable exclusion and basic exclusion amounts are the same.) Inflation-indexing has increased the basic exclusion amount as follows: \$5.12 million (2012), \$5.25 million (2013), \$5.34 million (2014) and \$5.43 million (2015). This means that in 2015, married couples can protect a total of \$10.86 million from gift and estate tax *without* having to create a “credit shelter trust” for the survivor to ensure that they have protected as much as they can from estate tax.

Portability was thus designed to simplify planning for married couples (some would argue that it has done just the opposite). These historical examples illustrate why the classic credit shelter trust was used:

Example 1. It is 1997, and the exclusion amount is \$600,000. Mom and Dad are U.S. citizens, and have made no lifetime taxable gifts. They live in Florida, which has no separate estate tax, but merely charges whatever Uncle Sam allows as a credit for state death taxes paid. Mom and Dad have identical wills, and leave everything to each other (their kids will get what’s left when they’re both gone). They each have \$1.5 million in their own name (collectively \$3 million). Dad dies in January 1997, and Mom receives Dad’s \$1.5



million estate outright; because of the marital deduction, no estate tax is currently payable. Mom dies in December 1997. The total federal and state estate tax on Mom's \$3 million estate is nearly \$1.1 million; the kids net \$1.9 million.

Example 2. Same facts as above, except that Dad's will carves out a "credit shelter trust" for Mom and the kids equal to his \$600,000 exclusion amount; the rest of his estate (\$900,000) passes to Mom. Dad dies in January 1997, and no estate tax is currently payable because his taxable estate (the credit shelter trust) equals his exclusion amount and the marital deduction applies to what passes to Mom. Mom dies in December 1997. The trust, which was not taxable in Dad's estate, is also not taxable in Mom's estate since she didn't "own" it for estate tax purposes; it pays out to the kids, tax-free. The total federal and state estate tax on Mom's \$2.4 million estate is about \$785,000, or about \$315,000 less than in Example 1, where Dad "wasted" his exclusion by leaving everything to Mom. The kids now net over \$2.2 million.

Pre-portability, then, the message to married couples about the exclusion amount was: use it or lose it. Post-portability, that is no longer the case.

Regs. On June 15, 2012, the IRS issued temporary regulations fleshing out the details of portability. Those regs were about to expire when the IRS issued the final regs on June 12th. This could explain why the IRS left several matters open: they may need to resolve internal disagreements regarding a) whether to provide permanent relief for executors who miss the filing deadline for portability, and b) how Rev. Proc. 2001-38 might apply to an "unnecessary" election for qualified terminable interest property (QTIP) (more on this below). Despite these open issues, the IRS left much unchanged from the temporary regs, and explains why in the preamble to these final regs.

Here are some **key points about portability** that the regulations address:

Portability election required. To claim portability, the executor of the deceased spouse must file a "timely" estate tax return, even if the deceased spouse's estate is under the "filing threshold."

- **"Timely"** means that the return is filed within nine months of the decedent's death, or within 15 months of death if the executor requests an extension within those first nine months.
- The **"filing threshold,"** in 2015, is \$5.43 million. In other words, if the decedent's "gross estate" plus "adjusted taxable gifts" is under this amount, an estate tax return is only required if the decedent's executor wants to elect portability.
 - The **"gross estate"** means everything in which the decedent has an "interest" at death (such as bank and brokerage accounts, retirement accounts, life insurance, etc.).
 - **"Adjusted taxable gifts"** means lifetime gifts that used up some of the decedent's applicable exclusion; these are typically gifts other than: a) annual exclusion gifts (\$14,000 per donee, or \$28,000 if the donor's spouse agrees to split the gift), and b) direct payments of tuition, medical expenses and health insurance premiums.

Note: Merely filing an estate tax return is deemed to elect portability – if that is not the desired result, the executor must opt out of the election or simply not file a return if the decedent's estate is under the filing threshold.

Who can make the election? The deceased spouse's executor can make the election (or may opt out of making the election). If there is no appointed executor, then "any person in actual or constructive possession" of the decedent's property may timely file an estate tax return (if the decedent's will is not probated, and the decedent's estate is being administered by the trustee of the decedent's revocable trust, for example, the trustee could file an estate tax return and elect portability).

Is there a “706EZ”? No. If the decedent’s estate is under the filing threshold, and the executor is only filing an estate tax return (Form 706) to claim portability, there is no “706EZ.” Under certain circumstances, the executor may be eligible for simplified reporting of assets passing to the surviving spouse and charity – yet if the value of those assets is needed to determine the value of other gifts, a “full-blown” return will be necessary.

When does the statute of limitations run on the DSUE? Not until the statute of limitations runs on the surviving spouse’s estate. This ensures that the IRS won’t lose out if, for example, Dad’s estate is under the filing threshold and his executor only files an estate tax return to elect portability; the IRS doesn’t need to audit Dad’s estate, but can wait to question his DSUE until Mom’s death. Executors (and heirs) should therefore hold onto whatever materials support the claimed DSUE until after the surviving spouse’s death.

Note: because so many (non-taxable) returns are now being filed solely for portability purposes, this could explain why the IRS recently announced that it will only issue a closing letter for an estate IF the executor requests one; that request should be made four months after the return is filed.

What is the order for using the DSUE? If Dad dies and Mom gets his DSUE, it is stacked on top of her exclusion. In other words, if widowed Mom makes a taxable gift to children, it is treated as first coming from Dad’s DSUE, and not from her own exclusion amount. (But see “last deceased spouse” below.)

Who is the “last” deceased spouse? The surviving spouse can receive DSUE from the “last” deceased spouse. What does that mean if the surviving spouse remarries? In other words, suppose that Dad dies, and Mom gets Dad’s DSUE; she later remarries. As long as H2, Mom’s new husband, is alive, Dad is still Mom’s “last” deceased spouse, and she can use Dad’s DSUE both for lifetime gifts and at death, assuming she predeceases H2 (if she does, H2 can receive what’s left of Mom’s basic exclusion amount). If, instead, H2 predeceases Mom, he becomes her “last” deceased spouse; Mom can receive his DSUE, if any, but loses Dad’s remaining DSUE (if Mom used any of Dad’s DSUE for lifetime gifts, it will be included in her applicable exclusion amount, at death, for purposes of her estate tax computation).

How does the DSUE work with a QDOT? Suppose that Mom is a U.S. resident but not a U.S. citizen. Dad dies and leaves property to Mom in a qualified domestic trust (QDOT), which qualifies for the marital deduction and postpones estate tax. Dad’s DSUE passes to Mom. Yet because most principal distributions from a QDOT are taxable in Dad’s estate, they will use up more of his exclusion after his death. The temporary regs therefore provided that the earliest Mom could use Dad’s DSUE was after the final QDOT distribution or other final event (generally, Mom’s death or the termination of the QDOT). The final regs acknowledge that the QDOT regime ceases to apply if Mom becomes a citizen after Dad’s death. If that happens, and Mom satisfies other requirements, Dad’s DSUE will be available to her for lifetime gifts as well as at her death.

Is the DSUE available to the estate of a non-resident and non-citizen surviving spouse? Only to the extent allowed under “any applicable treaty obligation of the United States.” In other words, widowed Mom (a non-resident alien) could not use Dad’s DSUE to protect a lifetime gift of U.S.-situs property, and could only use the DSUE at her death to the extent that an estate tax treaty might allow it. In addition, a non-resident alien spouse has no DSUE that can pass to the surviving spouse, regardless of whether the surviving spouse is a U.S. resident or citizen.

What if there is an “unnecessary” QTIP election? This is the key issue on which the IRS punted in these final regulations – namely, the potential interplay between Revenue Procedure 2001-38 and portability. To explain, a “qualified terminable interest property” (QTIP) election is typically made so that a trust that is exclusively for the surviving spouse – let’s say it’s Mom – can qualify for the marital deduction, and postpone

estate tax until Mom's death, when the trust is includible (and therefore taxable) in her estate. But what if, at Dad's death, his estate would not have been taxable anyway, even without the QTIP election?

That is the situation that Rev. Proc. 2001-38 addressed: unnecessary QTIP elections. The revenue procedure said that if the taxpayer could show that the unnecessary QTIP election was within the scope of the revenue procedure, the IRS would treat the election as "null and void" for transfer tax purposes – meaning, for example, that the trust would not be includible (and therefore taxable) in the surviving spouse's estate. The revenue procedure said it did not apply, however, to situations where the executor only elected QTIP for part of the trust and elected too much, or where the election was stated as a formula designed to reduce the estate tax to zero. In other words, the revenue procedure seemed to be directed at helping unsophisticated taxpayers, and not those who knew what they were doing, but had simply miscalculated. So what does Rev. Proc. 2001-38 mean in light of portability? That is what the IRS intends to address at a future date; it is presumably concerned that taxpayers may try to garner some unintended benefit – made possible through portability – by asking the IRS to "undo" an unnecessary QTIP election.

Putting this issue to one side, here is an example of why an executor might make an "unnecessary" QTIP election:

Mom and Dad each have \$5 million in their own name (\$10 million collectively), and haven't made any taxable gifts. They live in New York, which has its own estate tax and a current exclusion of \$3.125 million (the exclusion disappears entirely if a decedent's taxable estate exceeds the exclusion by more than 5%). Unlike the federal exclusion, the New York exclusion is not portable: if Dad dies first, for example, and doesn't use it, he wastes it; and if widowed Mom's taxable estate exceeds the exclusion by more than 5%, she won't have any to protect her taxable estate, the first dollar of which will be subject to New York estate tax. Result: their kids will receive a smaller inheritance. Mom and Dad agree that a New York credit shelter trust for the survivor of them makes sense, and that they would like to leave the balance of their property to a trust for the survivor that will qualify for QTIP treatment. (They would like this second trust for both creditor protection and asset management purposes, and to ensure that whatever is left at the survivor's death passes to children – although neither one wants to admit it, they are concerned about the survivor remarrying or being subject to importuning relatives).

Dad dies in April 2015. His will creates a credit shelter trust for Mom and the kids equal to his \$3.125 million New York exclusion, and the balance of his property (\$1.875 million) passes into a QTIP trust for Mom. Mom, Dad's executor, files a timely return for Dad's estate on which she elects QTIP treatment for her trust; she gets Dad's DSUE of just over \$2.3 million (what's left of his \$5.43 million basic exclusion amount). No federal or New York estate tax is currently payable: Dad's taxable estate (the credit shelter trust) equals his New York exclusion, and the QTIP trust for Mom qualifies for the marital deduction. Mom dies in December 2015 with a taxable estate of \$6.875 million. Thanks to Dad's DSUE, no federal estate tax is payable; the New York tax is \$622,000. Without the credit shelter trust, Mom would have had a \$10 million taxable estate on which the New York estate tax would have been nearly \$1.1 million – a difference of nearly \$500,000.

Is there an issue with claiming portability with respect to this unnecessary QTIP? Presumably not – although there may be an issue if a taxpayer wants to undo the election à la Rev. Proc. 2001-38. It will be interesting to see what the IRS says in future guidance.

To sum up. Portability can be tricky, especially for married couples who are subject to state estate tax: of the 18 or so states with such a tax, only Delaware and Hawaii have exclusions that match the basic exclusion amount AND are portable. Thus, it can be challenging to make sure that the state exclusion

amount isn't wasted in light of the temptation to rely on federal portability. So *does* portability really make planning easier for married couples? As with most things, the answer is a rousing "it depends."

p.s. regarding GST exemption. The generation-skipping transfer tax is an additional transfer tax that applies to transfers to people such as grandchildren, both outright and in trust. The exemption from this tax equals the basic exclusion amount – meaning that in 2015, the GST exemption (along with the basic exclusion amount) is \$5.43 million. This exemption is NOT portable, however – so that if married couples, in 2015, wish to protect \$10.86 million from GST, they must plan appropriately. In other words, the GST exemption is still a "use it or lose it" proposition.

July 7520 rate

The IRS has issued the July 2015 applicable federal rates: the July 7520 rate is 2.2%, a 0.20% (20 basis points) increase from June's 2.0% 7520 rate. The July mid-term rates are: 1.77% (annual), 1.76% (semiannual and quarterly) and 1.75% (monthly). The June mid-term rates were: 1.60% (annual), 1.59% (semiannual and quarterly) and 1.58% (monthly).

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