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Portability – A Simple Concept That's Not So Simple

At the end of 2010, Congress passed, and President Obama signed, the Tax Relief, Unemployment Insurance Restoration, and Job Creation Act of 2010, otherwise known as the 2010 tax act. The most notable provision of the 2010 tax act affecting estate planning was an increase in the tax-free amount for gift, estate, and generation-skipping transfer tax purposes to $5 million, indexed for inflation following 2011. In addition, the 2017 year-end tax act doubled that amount to $10 million, again indexed for inflation following 2011 –but only through the end of 2025. Absent further legislation, in 2026, the tax-free amount will revert to $5 million, indexed for inflation following 2011. Another notable 2010 tax-act provision in the estate planning arena introduced the concept of "portability," intended to simplify estate planning decisions for married couples. Two years later, the American Taxpayer Relief Act of 2012 made both the $5 million (indexed) tax-free amount and the portability concept permanent. But in order to explain portability, let's go over some basic estate planning techniques.

The tax-free amount and the unlimited marital deduction. There are two basic estate tax concepts you need to understand. First, for purposes of this discussion, the "tax-free amount" is the amount that a person may give away, either during their lifetime, or upon their death, without paying any gift or estate taxes – regardless of the identity of the recipient or the manner of the gift. The "tax-free amount" is also sometime referred by other terms, such as the "unified credit amount," the "exemption equivalent amount," the "estate tax exemption," the "basic exclusion amount," or some other term. In addition, since 1981, our tax laws have allowed one spouse to give an unlimited amount to the other spouse (as long as that other spouse is a U. S. citizen). This is called the unlimited marital deduction. To qualify for the marital deduction, a gift must be made in a qualifying manner (usually either outright or in a special trust commonly called a QTIP trust) designed to assure that the property remaining at the survivor's death will be subject to estate taxation at that time.

Simple estate planning. If a married couple's entire combined estate is unlikely to exceed **one** tax-free amount at the death of the survivor, then tax planning to avoid estate taxes isn't really needed -- there won't be any estate taxes due no matter what they do. When the first spouse dies and gives all of his or her property to the survivor, it all qualifies for the marital deduction. The first spouse has no "taxable" estate. When the survivor dies owning all of the entire combined estate, no estate taxes are due because that combined estate is covered by the survivor's tax-free amount. In this case, the tax-free amount of the first spouse was never used because the unlimited marital deduction and the size of the combined estate made it unnecessary. We can recommend all sorts of fancy estate planning designed to reduce estate taxes, but we still haven't figured out how to reduce estate taxes below zero.

The need for tax-planning. Unfortunately, many couples are under the **mis**impression that their estates are safe from estate taxes as long as their combined estates are less than **two** tax-free amounts – one tax-free amount for each spouse. That can be the case, but only with proper planning. Here's an illustration.

Assume the same will as in the scenario above, but in this case, the couple's combined estate is equal to two tax-free amounts. The first spouse dies and gives all of his or her property to the survivor. Everything still qualifies for the marital deduction – regardless of the size of the first spouse's estate, so the first spouse still has no "taxable" estate. However, when the survivor dies owning all of the entire combined estate, the value equals two tax-free amounts. Yet the survivor has only his or her own single tax-free amount to shield the assets from estate taxes. Property equal in value to an entire tax-free amount is going to be subject to estate tax at the survivor's death.

Basic tax-planned wills. So why do many couples have the impression that two tax-free amounts can be shielded from estate taxes? Because they can – with proper planning. Let's say the same couple, with a "two tax-free amount" combined estate, revises their wills. Each of their wills now say that when the first spouse dies, an amount of that spouse's property up to the tax-free amount passes to a special trust for the survivor. This trust is not a QTIP trust designed to qualify for the marital deduction. Rather, this trust is specifically designed to provide the survivor access to the funds for the survivor's lifetime, **without being taxed at the survivor's death**. Because the value of the assets in this type of trust is designed to bypass the survivor's estate for estate tax purposes, we typically refer to this as a "bypass trust." (Other terms for the same trust include "credit shelter trust" or "unified credit trust.") The first spouse's will also includes a provision giving the value of his or her estate that exceeds the tax-free amount to the survivor in a manner that qualifies for the marital deduction. The result is that when the first spouse dies, that spouse won't have a zero taxable estate. Rather, that spouse will have a taxable estate equal to the value of the property passing to the bypass trust – possibly as much as the tax-free amount. But as long as that property doesn't **exceed** the tax-free amount, there are still no estate taxes due at the first spouse's death. When the survivor dies, his or her taxable estate will include all of the combined estate **excluding the property that passed to the bypass trust**. So if an entire tax-free amount originally passed to the bypass trust at the first spouse's death, that property will pass tax-free at the survivor's death, and the survivor can protect the remaining portion of the combined estate with his or her own tax-free amount. That's how the couple protects up to two tax-free amounts.

Why is this so complicated? Why should it be so complicated to protect two tax-free amounts. Why should a couple have to pay for more complicated estate planning, and then deal with a trust during the survivor's lifetime? Why not just let the first spouse "transfer" his or her tax-free amount to the survivor? That way, the first spouse can still have a simple will giving everything outright to the survivor, and the survivor can still shield two tax-free amounts from estate taxes at the survivor's death. These discussions have been going on for years, and a number of proposals incorporating this concept, known as "portability," have been introduced. But until the end of 2010, none of those proposals had made any headway.

Portability arrives. The 2010 tax act included the new portability concept. When one spouse dies, there is now a way to "transfer" any portion of that spouse's tax-free amount that went unused to the survivor. If the first spouse's will gives everything outright to the survivor, the first spouse's entire estate will qualify for the unlimited marital deduction, and none of the first spouse's tax-free amount will be used. This means that all of the first spouse's tax-free amount will be eligible to be "transferred" to the survivor.

How do you transfer the first spouse's tax-free amount? Good question. The executor of the first spouse's estate must file an estate tax return that shows how much of the first spouse's tax-free amount remains unused. And the estate tax return must be filed on time (including any extensions). If the first spouse's estate is under the tax-free amount, no estate tax return is normally required. But now, even if no return is **required**, the executor of the first spouse's estate will need to make a determination as to whether it makes sense to go to the expense of preparing a return anyway in order to, effectively, double the survivor's tax-free amount. And there is no "short form" estate tax return just for electing portability (although the IRS has provided some not-so-simple shortcuts for completing the return).

Should everyone plan on using portability in order to keep their estate planning documents simpler? Not necessarily. Here are some of the disadvantages of portability vs. the traditional bypass trust technique for preserving two tax-free amounts:

- **Estate and gift tax – but not GST tax – portability.** First, portability only applies to the tax-free amount for estate and gift tax purposes. If the couple wishes to maximize the property that will eventually pass to lifetime "tax-free" trusts for their descendants, the tax-free amount of the first spouse for generation-skipping transfer tax purposes is **not** "portable."

- **No inflation adjustment.** The amount of the first spouse's unused tax-free amount transferred to the survivor is not indexed for inflation during the survivor's lifetime. Contrast this with assets placed in a bypass trust that are shielded from future estate tax, regardless of how much they appreciate during the survivor's lifetime.

- **No creditor protection.** Assets placed in a bypass trust can be structured so that they are protected from the surviving spouse's creditors – even if the surviving spouse is a beneficiary and trustee of the trust. That won't be the case for outright gifts to the survivor, except to the extent those assets are invested in otherwise exempt assets, such as a homestead.

- **Only the tax-free amount of the last deceased spouse matters.** A survivor only gets to utilize the unused tax-free amount of his or her **last** deceased spouse. Let's say the executor of your first spouse's estate transfers that spouse's unused tax-free amount to you by filing an estate tax return. Then you remarry. Your first spouse is still your "last deceased spouse," and you still retain that transferred unused tax-free amount. However, your new spouse also dies before you, this time leaving all of the new spouse's sizable estate to his or her children, using up all of the new spouse's tax-free amount. Now, your first spouse is no longer your **last** deceased spouse, and the last deceased spouse had no unused tax-free amount to transfer to you. You're left with only your own tax-free amount to shield the combined assets accumulated by you and your first spouse. Had your first spouse given the tax-free amount to a bypass trust, the value of those assets would still have been excluded from your estate at your death.

- **What if the survivor is not a beneficiary of the deceased spouse's estate?** Let's say the deceased spouse leaves all of his or her estate to children by a prior marriage. If that deceased spouse's estate is relatively small, and the survivor has a large estate, it would be in the survivor's interests for the executor to file an estate tax return transferring the unused portion of the deceased spouse's tax-free amount to the survivor. But why would the executor spend any of the children's inheritance on the cost of preparing an estate tax return that would only benefit the survivor (who is not a beneficiary of the estate)?

- **Blended families and future marriages.** If the couple has a blended family with children from prior marriages, each spouse may want to assure some future inheritance by that spouse's children that an outright gift to the survivor may not provide. Even if there aren't children by prior marriages, some spouses are concerned about the possibility that the survivor may remarry and give some of the first spouse's property to that new spouse, instead of the couple's children. A bypass trust can provide some protection in each case.

- **Will the executor of the first spouse's estate be able to accurately estimate how large the survivor's estate is likely to be?** That would affect the decision of whether it is worth it to go to the expense of filing an estate tax return. How long will the survivor live? How much will the survivor's assets appreciate (or depreciate)? What if the survivor buys a winning lottery ticket?

- **Will the executor of the first spouse's estate be able to accurately predict what the survivor's tax-free amount will be?** The 2012 tax act made the increased tax-free amount introduced by the 2010 tax act permanent. However, since it is indexed for inflation, the executor would have to accurately predict both the year in which the survivor will die **and** the rate of inflation between the two deaths. On top of that, the 2017 tax act doubled the base tax-free amount (still indexed for inflation), but only through the end of 2025. And who knows what legislative changes might be made between the first and second spouse's deaths?

Two clear benefits of portability. Because of the concerns listed above, we are unlikely to recommend reliance on portability as a primary estate planning strategy where estate tax planning is advisable. However, there are two situations where portability provides a clear benefit.

- **Retirement plans.** If a large part of a couple's assets consist of interests in retirement plans, it can be extremely complicated to have the first spouse's retirement benefits pass into a bypass trust for the survivor (for estate tax reasons) and also preserve the income tax benefits of deferred minimum required distributions. Making these benefits payable outright to the surviving spouse is often the best strategy from an income tax standpoint. But that strategy may leave the first spouse's estate vulnerable to an underfunded bypass trust, and therefore increased exposure of assets to estate taxation at the survivor's death. Portability solves this problem by allowing the first spouse to just transfer the portion of his or her tax-free amount that would have covered the portion of the plan benefits otherwise passing to the bypass trust to the surviving spouse, reducing the problem of an underfunded bypass trust. Not a perfect solution, but very possibly better than the solutions previously available to us.

- **Basis step-up.** When someone dies, with a few exceptions, each asset included in that person's estate for estate tax purposes receives a new basis (for calculating capital gain when the asset is sold) equal to the value of the assets when the person dies, whether or not estate taxes are actually due. This means that the capital gains tax on the appreciation of the asset between the date it was purchased and the person's death vanishes. Further, if the person is married and owns an interest in any community property, the survivor's half of those community assets receive a new basis also. If the first spouse's will contains the bypass trust planning described above, then when the survivor dies, the survivor's assets will receive another new basis equal to their value on the date of the survivor's death, but the assets in the bypass trust will **not** receive a new basis because they weren't included in the survivor's estate for estate tax purposes. If instead the first spouse's will relied on portability and gave all assets to the survivor outright, those assets would be included in the survivor's estate at the survivor's subsequent death and would receive a new basis at that time.

Considerations following the death of the first spouse – where portability wasn't an intentional part of the estate plan. There will obviously be some situations where the spouses plan their estate plan in a relatively simple manner (*e.g.*, everything passes outright to the survivor), intending for the executor of the first spouse's estate to take advantage of the benefits of portability. In those cases, the decision to file an estate tax return for the first spouse's estate electing the benefits of portability is relatively easy. But what about those situations where portability wasn't considered in advance?

- **Portability as "insurance."** Probably the most common situation when a first spouse dies involves an estate plan that gives all of the first spouse's estate outright to the surviving spouse, the first spouse's estate is under the tax-free amount (so no estate tax return is "required"), and the combined estate of both spouses seems unlikely to ever exceed a single tax-free amount. We assume that in most cases, the executor of the first spouse's estate will probably decline to incur the expense of preparation of an estate tax return. However, this decision should not be made without weighing the benefits of portability against that cost. If the combined estate is large enough that there is a possibility of exceeding a single tax-free amount (either because of appreciation of the assets or a legislative change reducing the survivor's tax-free amount), it may be worth paying the cost of preparing an estate tax return to maximize the tax-free amount of the survivor and provide an additional cushion against possible estate taxes at the survivor's death.

- **"Protection" against winning the lottery.** Let's say a couple fits within the situation described above where there is no apparent need for paying the cost of preparing an estate tax return to preserve the benefits of portability. There is always the possibility that the surviving spouse could "hit it big," through the purchase of a winning lottery ticket, through an ownership interest in long-held family land that just happens to sit atop a soon-to-be-discovered oil and gas formation, or some other fortuitous event. Portability will increase the tax-free amount of the survivor available to shield those assets from estate tax. But again, it will be up to the executor of the first spouse's estate (often the surviving spouse) to weigh these potential future benefits against the current cost.

- **Portability added to estate tax planning.** A couple may have already included traditional bypass trust planning in their estate plan. However, at the first spouse's death, that spouse's estate passing to the bypass trust may still be significantly less than that spouse's tax-free amount. The executor may choose to file an estate tax return to preserve that excess tax-free amount for the survivor's use for the same reasons set forth above.

- **"Buying" portability?** What if we're looking at a blended family, and the first spouse's will gives all of his or her relatively small estate to his or her children. The first spouse may have a relatively large portion of their tax-free amount that will go unused. The executor of the first spouse's estate (one of those children?) has no particular reason to file an estate tax return claiming the benefits of portability, because the cost of preparing the return will come out of the assets otherwise passing to the children, but only provide a benefit to the surviving spouse. But that survivor may want the benefit of portability to shield more of his or her large separate estate from estate taxes when those assets pass to the survivor's children at his or her subsequent death. Can the survivor offer to pay not only the cost of preparing the return, but also an extra "bonus" to the first spouse's children in exchange for their agreement to have the executor file the estate tax return that preserves portability? Probably.

It's not always an easy decision – but it's <u>your</u> decision. As you can probably tell by now, portability is a "simple" concept that leads to some not-so-simple choices. One of the purposes of this memo is to provide you with some of the factors you should consider – either during the estate planning process, when deciding whether to rely on portability as a key element of your estate planning, or during an estate administration, when deciding whether to incur the cost of preparing an estate tax return in order to preserve a future tax-free amount that may never be needed. We will be happy to discuss these issues with you further, but we hope that in many cases, this memo will assist you in making an informed decision on your own.

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