

## IMPLEMENTING "PORTABILITY" OF A DECEASED SPOUSE'S UNUSED EXCLUSION AMOUNT

### Overview

One of the most important changes under the Tax Relief Act of 2010 is the addition of "portability" of the first Deceased Spouse's Unused Exclusion Amount, or what we may mercifully call *DESUEA*. The portability of *DESUEA* basically means that married couples can now take advantage of **both** of their estate tax exclusion amounts (now \$5 million per person) even if they have not engaged in specific planning to do so. In other words, the unused portion of their \$5 million exclusion amount is transferrable to a surviving spouse by law.

Portability is a major shift in estate tax law because it never previously existed, and married couples who wanted to take advantage of each others exclusion amounts were forced to implement relatively complex tax planning to do so. Portability may simplify estate tax planning, but it does not remove the need for careful consideration of how the concept may apply to each unique situation. The application of this rule will be illustrated in several examples below.

The 2010 Tax Relief Act provides that an executor can elect to allow the decedent's surviving spouse (but no other beneficiary) to take advantage of the *DESUEA*, for the spouse's estate and gift tax purposes. This rule applies with respect to estates of decedents dying after 2010. This election must be made on a timely estate tax return that computes the amount of the unused basic exclusion amount and that affirmatively elects for the surviving spouse to receive this *DESUEA*. The election, once made, is irrevocable.

The *DESUEA* can be used by the surviving spouse to offset gift or estate taxes, but it does not increase the surviving spouse's Generation Skipping Transfer Tax (GST) exemption. This means that anyone wanting to take full advantage of both spouses' GST exemptions must have the first spouse to die create a nonmarital trust or a re-

verse QTIP marital trust to take advantage of his or her GST exemption.

The increased basic exclusion amount also does not change the base amount on which the obligation to file an estate tax return is set. The estate of a surviving spouse who has a combined applicable exclusion amount of \$10 million, including a *DESUEA* of \$5 million and a basic exclusion amount of \$5 million, still would be required to file an estate tax return if the gross estate were over \$5 million.

The *DESUEA* received by the surviving spouse is not indexed for inflation. Only the surviving spouse's basic exclusion amount benefits from future adjustments to the amount of the exemption to reflect inflation.

### Remarriage Problems

The surviving spouse cannot take advantage of a *DESUEA* from more than one predeceasing spouse. Only the *DESUEA* of "*the last such deceased spouse of such surviving spouse*" can be used.

**Example:** Harold and Wanda are married, and both are U.S. citizens. On 1/1/11, Wanda makes \$5 million of gifts to trusts for their children, using up all of her basic exclusion amount. Harold dies in 2012, leaving his entire estate outright to Wanda, who now has a \$5 million *DESUEA*. Wanda then marries Hugo, and dies leaving her entire estate outright to Hugo. Hugo cannot receive any of Wanda's *DESUEA*, because Hugo is not Harold's surviving spouse. Therefore, Hugo has his own basic exclusion amount, but Wanda's \$5 million *DESUEA* is wasted.

This rule creates several interesting tax and social issues. The Staff of the Joint Committee on Taxation has included in its Technical Explanation an example that strongly suggests that, when a surviving spouse dies, he or she first uses up any *DESUEA*, before using his or her

own basic exclusion amount. This often will mean that there is more basic exclusion amount remaining to pass to a subsequent surviving spouse.

**Example:** Harold dies in 2011, having made lifetime taxable transfers of \$3 million and leaving his entire estate to his wife, Wanda. Harold has no taxable estate, because the bequests to Wanda qualify for the estate tax marital deduction. Harold's executor files a timely estate tax return and elects to permit Wanda to use Harold's DESUEA. As of Harold's death, Wanda has made no taxable gifts. Thereafter, Wanda's combined exclusion amount is \$7 million (her \$5 million basic exclusion amount plus \$2 million DESUEA from Harold). Wanda may use this combined exclusion amount for lifetime gifts or for transfers at death.

**Example:** The facts are the same as in the preceding example, except that Wanda later marries William. William also predeceases Wanda, leaving \$4 million of his estate to his children, and the rest to Wanda. William owes no estate tax, because his \$5 million basic exclusion amount exceeds the bequests he is making to his children, and the bequest to Wanda qualifies for the estate tax marital deduction. William's executor files a timely estate tax return electing to permit Wanda to use William's \$1 million DESUEA.

Although the combined amount of unused exclusion of Harold and William is \$3 million (\$2 million for Harold and \$1 million for William), only William's \$1 million unused exclusion is available for use by Wanda, because the DESUEA 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 (here, William's \$1 million unused exclusion). Thereafter, Wanda's basic exclusion amount is \$6 million (her \$5 million basic exclusion amount plus \$1 million DESUEA from William), which she may use for lifetime gifts or for transfers at death.

**Example:** The facts are the same as in the preceding example, except that Wanda predeceases William. Following Harold's death, Wanda's basic exclusion amount was \$7 million (her \$5 million basic exclusion amount plus \$2 million DESUEA from Harold). Wanda made no taxable transfers and had a taxable estate of \$3 million. Wanda's executor files a timely estate tax return and elects to permit William to use

her DESUEA, which is \$4 million (Wanda's \$7 million combined exclusion amount less her \$3 million taxable estate). William's applicable exclusion amount is increased by \$4 million—the amount of Wanda's DESUEA.

The Code contains no ordering rule, and the example in the Joint Committee's Technical Explanation does not expressly state that there is an ordering rule, though the last example above is difficult to explain without such a rule. Furthermore, the example involves only testamentary dispositions, and any ordering rule might not necessarily have to apply uniformly to testamentary and lifetime uses of a DESUEA. One hopes that this will be clarified by either technical corrections legislation or Regulations.

A surviving spouse's remarriage to someone who uses all of his or her own basic exclusion amount to leave property to others and who also predeceases the surviving spouse will deprive the surviving spouse of the basic exclusion amount received from the first deceased spouse. This might become a bargaining point in premarital agreement negotiations.

The determination of the last predeceased spouse of a surviving spouse can be made only when the second (or later) spouse has died. Therefore, it seems likely that the surviving spouse can make gifts using the basic exclusion amount received from the first deceased spouse, if they are made while the second spouse is still alive. The language is not absolutely clear, but it does not appear to require that the surviving spouse surrender the first deceased's spouse's unused basic exclusion amount until it is determined whether or not the surviving spouse survives his or her next spouse, so the use of this exclusion for lifetime gifts should be permissible.

### **Order of Death Issues**

The statute does not address the issue of death of spouses in a common disaster. Regulations will have to clarify how portability will work in this context.

**Example:** Harold and Wanda, a married couple, die in a common disaster under circumstances in which it is not possible to determine who died first. Wanda has \$10 million in assets and Harold has no assets. Under the Uniform Simultaneous Death Act, each spouse is presumed to have survived as to his or her separate assets, and those assets pass to the next persons named in the deceased spouse's governing instruments or under the laws of intestacy. Therefore, Wanda's \$10

million estate passes to her alternative beneficiaries.

If Wanda can inherit Harold's unused exemption, there will be no tax liability for either estate, but if she cannot, then her estate will owe \$1,750,000 in estate taxes. Until clarification is provided, it is possible that the inability to establish that Wanda survived Harold will preclude Wanda's estate from using Harold's exemption.

Thus, pending clarification, in this situation Wanda should include a common disaster clause in her estate planning documents that conclusively presumes that Harold survives her, in any situation in which it cannot be established which of them actually survived. Under current law, such a presumption would be respected. If, as a result, \$5 million passes to Harold, each spouse would be able to fully use the exemption and thereby fully eliminate the tax liability.

A situation also might arise where death occurs in a clear order, but very close together. In such cases, the positive effects of portability could be forfeited in the absence of sound drafting.

**Example:** The facts are the same as in the immediately preceding example, except that Harold actually survives Wanda by a few hours. Wanda's will states that no beneficiary is deemed to have survived her unless he or she is alive 120 hours after the date of Wanda's death. Harold would be deemed to have predeceased Wanda for state law purposes and her estate would pass entirely to her next designated beneficiaries. As a result, none of Wanda's assets pass to Harold or his estate, and Harold's unused estate tax exemption is wasted. Wanda's estate cannot use Harold's exemption because Harold actually survived Wanda.

To prevent this outcome, Wanda's document should rebut the presumption to allow half of Wanda's estate to pass to Harold. Harold's estate would then be able to use his exclusion amount fully, which would result in the elimination of the couple's estate tax liability.

Therefore, while at first blush it might appear that portability eliminates the need to take the common disaster into account in drafting, there is in fact a continuing need to draft for this contingency.

## Portability vs. Nonmarital Trust

Relying on portability could result in a reduction of the aggregate available shelter from tax, if the exclusion amounts are subsequently reduced. This is specifically contemplated in the statute, which creates a ceiling on portability equal to the basic exclusion amount available at the second death.

Portability will convince a large number of people that they do not need significant estate tax planning and, for some clients, this will be true. Persons whose total estates are between \$5 million and \$10 million can avoid all estate taxes on both estates, but using simple wills and trusts will have several important deficiencies in comparison with an arrangement that creates a nonmarital trust at the first spouse's death.

The DESUEA is not adjusted to reflect the appreciation of, or income generated by, specific assets. Coupled with the lack of indexing for the DESUEA, the ability of a nonmarital trust to shelter future growth strongly favors its use.

A couple whose total estate is only slightly over \$5 million may find this point immaterial, but a couple whose total estate is close enough to \$10 million (two basic exemption amounts) that it may exceed that figure before the surviving spouse dies, should very seriously consider using a nonmarital trust at the first spouse's death to protect a greater sum from ultimate estate taxes.

**Example:** Harold dies in 2012, having made no lifetime or testamentary taxable transfers. He leaves his entire estate to his wife, Wanda. Harold's adjusted gross estate is \$10 million, but he has no taxable estate, because the bequests to Wanda qualify for the estate tax marital deduction. Harold's executor files a timely estate tax return and elects to permit Wanda to use Harold's DESUEA. Thereafter, Wanda's combined exclusion amount is \$10 million (her \$5 million basic exclusion amount plus \$5 million DESUEA from Harold).

Wanda dies in 2020, not having remarried. Assume that the 2010 Tax Relief Act portability rules were continued after 2012 and the EG-TRRA sunset rules were not permitted to apply to the portability rule or the basic exclusion amounts. Wanda has lived off of the income of her assets, but the corpus of her investments has appreciated by 4% per annum over eight years. Wanda dies with a total estate of

\$13,686,000 (\$10 million increased by 4% for eight years).

Wanda's basic exclusion amount, but not her DESUEA, will have been indexed for inflation. Assuming that the entire 4% growth in the value of Wanda's assets was the same percentage as the rate of inflation, Wanda will have a total of \$11,843,000 of combined exclusion amount (\$5 million DESUEA plus \$6,843,000 of inflation-adjusted basic exclusion amount). Therefore, Wanda will owe \$645,050 of estate taxes (\$13,686,000 adjusted gross estate – \$11,843,000 of combined exclusion amount = \$1,843,000;  $35\% \times \$1,843,000 = \$645,050$ ).

Second, any married couple wanting to take advantage of both \$5 million GST exemptions will need to create a nonmarital GST-exempt trust at the first spouse's death. Portability does not apply with respect to the GST exemption. Couples with estates of \$8 to \$10 million often appreciate the value of avoiding estate taxes for several successive generations, and portability will not really do much to simplify the estate planning for these clients.

Unlike a nonmarital trust, merely leaving one's estate outright to the surviving spouse or to the surviving spouse's revocable trust will not provide many of the other nontax benefits associated with good estate planning, including protection from the claims of creditors of the surviving spouse, protection from the claims of a new spouse, diversion of the assets from the first spouse's family to a new family created on remarriage of the surviving spouse, and professional asset management. Some of these benefits can be achieved with an estate plan that leaves the entire estate in trust for the surviving spouse, but they cannot all be achieved through an outright marital gift or a gift to a surviving spouse's revocable trust.

Unlike a nonmarital trust, the portable annual exclusion would give the surviving spouse a full step-up in basis at death.

This is a distinct advantage of the portable basic exclusion amount over a nonmarital trust, because the nonmarital trust does not receive such a second step-up in basis. On the other hand, the nonmarital trust takes a full basis increase on the first \$5 million of assets passing at the first spouse's death, and avoids estate taxes on the balance. For taxable estates, this should almost always be a superior tax result to that produced by an outright gift to the surviv-

ing spouse coupled with use of the DESUEA. For estates that are under the \$10 million tax-free level, the basis adjustment strongly favors use of the deceased spousal unused exemption amount.

**Example:** Harold has an estate of \$5 million and his wife, Wanda, has a separate estate of \$1 million. Harold dies in 2012 and leaves his entire estate outright to Wanda. Harold has no estate tax because the gift to Wanda qualifies for the estate tax marital deduction. Harold's assets largely consisted of highly appreciated securities, with an aggregate basis on the date of his death of only \$2 million. Wanda inherits these assets with a full basis step-up to \$5 million.

Wanda dies in 2020, not having remarried. Assume that the 2010 Tax Relief Act portability rules were continued after 2012 and the EG-TRRA sunset rules were not permitted to apply to the portability rule or the basic exclusion amounts. Wanda's \$6 million estate has grown by 5% per annum during the eight years between Harold's death and Wanda's death. The \$5 million of securities she inherited from Harold is now worth \$7,387,000. The \$1 million that Wanda already had is now worth \$1,477,000. Wanda's total estate is now worth \$8,864,000 ( $\$7,387,000 + \$1,477,000$ ). Wanda's estate owes no estate tax, because she had both her own \$5 million basic exclusion amount and Harold's \$5 million DESUEA. Also, Wanda takes a new basis in all of the assets equal to their estate tax values, which eliminates the income tax on both her own appreciated assets, and also the \$2,387,000 ( $\$7,387,000 - \$5 \text{ million}$ ) in appreciation in the assets she inherited from Harold.<sup>27</sup>

**Example:** The facts are the same as in the preceding example, except that Harold had an estate of \$7 million and Wanda had a separate estate of \$3 million. Wanda dies in 2020, with an estate of \$14,775,000 ( $\$7 \text{ million} + \$3 \text{ million} = \$10 \text{ million}$ ;  $\$10 \text{ million plus } 5\% \text{ per annum for eight years} = \$14,775,000$ ). Assume that Wanda's basic exemption amount has been indexed for inflation at a rate of 4% per annum, producing a \$6,843,000 basic exemption amount on the date of her death. Therefore, Wanda owes \$1,026,200 in estate taxes ( $\$14,775,000 - \$6,843,000 \text{ basic exemption amount} - \$5 \text{ million deceased spousal unused exemption amount} = \$2,932,000$ ;  $35\% \times \$2,932,000 = \$1,026,200$ ).

On the other hand, Wanda avoids capital gains taxes on her own estate (which would get a basis step-up under any estate plan) and also on the \$3,342,000 growth in the value of the property she inherited from Harold (\$7 million plus 5% for eight years = \$10,342,000; \$10,342,000 - \$7 million = \$3,342,000 growth). It seems unlikely, however, that the capital gains tax on \$3,342,000 would exceed the \$1,026,200 estate tax on Wanda's estate.

**Example:** The facts are the same as in the preceding example, except that Harold left \$5 million of his \$7 million estate to a nonmarital trust for Wanda's benefit. When Wanda dies in 2020, her gross estate includes her own \$3 million, the appreciation in her own assets at a presumed 5% per annum for eight years (\$1,432,000), the \$2 million she inherited free of trust from Harold, and the \$955,000 appreciation in the value of the assets she inherited from Harold. Her total estate is \$7,387,000. The \$2,387,000 growth in the value of the nonmarital trust, however, is not included in Wanda's gross estate. Therefore, Wanda's estate tax will be only \$190,000 (\$7,387,000 estate - \$6,843,000 indexed basic exemption amount = \$544,000; 35% × \$544,000 = \$190,000). The nonmarital trust, however, still will owe capital gains taxes on the \$2,387,000 in appreciation in the value of its assets. Of course, these taxes will not be due until the assets themselves are sold, whereas estate taxes are due nine months after the date of death.

### **Optimal Planning for Portability**

The optimal planning for clients with estates of under \$7 million may be to leave the entire estate in a QTIP marital trust for the surviving spouse. This provides several distinct advantages:

- It is a very simple estate plan that the family can understand.
- It defers all estate taxes until the surviving spouse's death.
- It eliminates all estate tax on both estates, to the extent sheltered by an indexed \$5 million applicable exclusion amount of the surviving spouse and an unindexed \$5 million applicable exclusion amount of the first spouse.
- Because the entire trust fund is included in the surviving spouse's estate under Section 2044, the entire trust fund should take an es-

tate-tax-value basis at the surviving spouse's death.

- It offers asset protection planning, the traditional disability asset management, and professional investment benefits of a trust.

The \$7 million figure was selected in this situation because it leaves sufficient room for the estate to grow between the deaths of the first and second spouse without exceeding the combined basic exclusion amounts. Older clients who can expect a shorter time between the deaths of the two spouses may adopt this approach for an estate of \$8 million or \$9 million. Clients who have large families and anticipate making substantial annual exclusion gifts (including gifts of tuition and medical expenses) also may select a relatively high threshold for adopting this estate plan.

### **Impermanence of Portability**

Under the law as it is written, portability disappears after 2012. Hence, either both spouses must die before 2013, or at least one must die and the other make a significant taxable gift by the end of 2012, in order for portability to be effective. Therefore, it is not wise to base an estate plan entirely on portability unless and until Congress makes it permanent.



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